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Newsletter

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■ ■ Insights & Ideas

1. Shanghai and Shenzhen Stock Exchanges Promulgate Pilot Measures for Issuance of Private Placement Bonds by SMEs

■ ■ Legal Updates

1. China Securities Regulatory Commission Issued the Notice on Issues concerning Further Implementing Cash Dividends Distribution of Listed Companies
2. SAT New Announcement on Enterprise Income Tax Treatment of Equity Incentive Schemes Implemented by Resident Enterprises

Insights & Ideas

Shanghai and Shenzhen Stock Exchanges Promulgate Pilot Measures for Issuance of Private Placement Bonds by SMEs (Authors: Yang CHEN, Loretta LI, Gina SHI)

On May 22, 2012, Shanghai Stock Exchange (“SSE”) and Shenzhen Stock Exchange (“SZSE”) promulgated their respective *Pilot Measures for the Issuance of Private Placement Bonds by Small and Medium-sized Enterprises* (collectively, the “Pilot Measures”), which stipulate that small, medium and micro enterprises not listed on SSE or SZSE (“SMEs”, excluding real estate enterprises and financial enterprises) and meeting the standards of small, medium and micro enterprises published by the Ministry of Industry and Information Technology (“MIIT”) are qualified to issue private placement bonds.

SMEs private placement bonds (“Private Bonds” or “Bonds”) are corporate bonds non-publicly issued and transferred by SMEs in China, with an agreement reached on repayment of principal amount and payment of interests within a given period of time. According to the *Notice on Publishing the Regulations on Criteria to Identify Small and Medium-sized Enterprises* issued by MIIT, MIIT divides the small, medium and micro enterprises based on the indicators such as the number of employees, the amount of revenues and total assets of such enterprises and in combination with the industry characteristics. For example, for software service and catering industries, enterprises with less than 300 employees or operating revenue of less than RMB 100 million shall be identified as small and medium-sized enterprises; for leasing and commercial business services, enterprises with less than 300 employees or total assets of less than RMB 1.2 billion shall be identified as small and medium-sized enterprises.

The Pilot Measures of SSE and SZSE are basically the same except for requirements on eligible investors. Concretely speaking, the Pilot Measures set forth the following matters.

Record-filing and Issuance of Private Bonds

Private Bonds shall be underwritten by security companies on a record-filing basis. Private Bonds shall meet the following conditions, (1) the issuer shall be a limited liability company or a company limited by shares incorporated in China; (2) the interest rate shall not exceed three times of the benchmark debt interest rate applicable to the same period; (3) the repayment period shall be not less than one year; and (4) other conditions prescribed by the relevant stock exchange.

Underwriters shall submit the issuance materials to the competent stock exchange for record-filing prior to the issuance. Except for regular materials, the materials for record-filing shall include the underwriting agreement and the prospectus for issuance of Private Bonds, the due diligence report issued by the underwriter, the trustee management agreement and the rules on meetings of the

bond holders, the audit report of the issuer's financial statements in latest two complete fiscal years, legal opinions and so on.

Upon the examination and confirmation of the completeness of the record-filing materials, the stock exchange shall issue a Notice on Acceptance of Filing Application within ten (10) working days after receipt of the materials. The issuer shall complete the issuance within six (6) months after the issue of the aforesaid Notice, otherwise it shall re-file the materials.

Besides, pursuant to the Pilot Measures, two or more issuers may issue the Private Bonds jointly. Issuers may also grant warrants or convertible rights with the Private Bonds to the extent of applicable laws and regulations.

Administration of Investor Eligibility

In accordance with the Pilot Measures, the total number of investors for each issuance of Private Bonds shall not exceed 200. Eligible investors for the subscription and transfer of Private Bonds shall meet the following requirements:

- 1) Financial institutions established with approvals of relevant financial supervision departments;
- 2) Financial products issued to investors by the abovementioned financial institutions;
- 3) Legal person enterprises with a registered capital of no less than RMB 10 million;
- 4) Partnership enterprises of which the total amount of capital subscribed by partners is not less than RMB 50 million, and the total amount of paid-up capital is not less than RMB 10 million; and
- 5) Other eligible investors recognized by the stock exchange.

Besides, SSE sets forth the requirements for an eligible individual investor, including: (1) the total amount of assets in the investor's personal securities accounts, fund accounts and assets management accounts is not less than RMB 5 million; (2) the investor has at least two years' experience in securities trading; and (3) the investor shall be fully aware of the risks of Private Bond. However, SZSE has not set forth the specific requirements for an eligible individual investor. This is the sole significant difference between the Pilot Measures of two stock exchanges.

In addition to the abovementioned eligible investors, the issuer's directors, supervisors, senior managers and shareholders holding more than 5% of the issuers' equity interests may also participate in the subscription and transfer of Private Bonds of such issuer. Underwriters may engage in the subscription and transfer of Private Bonds underwritten by them.

Besides the above, security companies shall establish complete investor eligibility systems in order to confirm that the investors participating in the subscription and transfer of Private Bonds are qualified, and the security companies shall require the investors to sign a Risk Acknowledgement before the initial subscription or transfer of the Private Bonds.

Transfer of Private Bonds

Private Bonds shall be transferred in spot transaction or such other ways as approved by the stock exchanges, which shall also be approved by the China Securities Regulatory Commission (“**CSRC**”). Where an issuer applies for a transfer of Private Bond, it shall submit a written application for transfer service, the registration documents of the Private Bonds and shall sign an Agreement for Private Placement Bond Transfer Service with the relevant stock exchange.

Eligible investors may transfer Private Bonds through the trading platforms of the stock exchanges (SSE’s Integrated Electronic Platform for Fixed-income Securities Trading or SZSE’s Comprehensive Agreement Transactions Platform) or securities companies. Private Bond transfer through security companies shall be declared to the related stock exchange by such security companies and shall become effective upon the confirmation by such stock exchange. Private Bond transfer shall be confirmed in the chronological order of declaration, and that involving more than 200 investors shall not be confirmed.

Private Bonds shall be registered and cleared according to relevant rules of the China Securities Depository and Clearing Corporation Limited.

Information Disclosure

The Pilot Measures regulate that issuers shall designate person(s) to take charge of information disclosure, and the underwriters shall designate persons to guide, supervise and inspect the issuers’ obligation of information disclosure. Information shall be disclosed to eligible investors on the special zone of the stock exchange’s website or by other means recognized by the applicable stock exchange.

As specifically prescribed in the Pilot Measures, the issuer shall:

- 1) Within three (3) working days after the completion of Private Bond registration, disclose actual issuance scale, interest rate, period, the prospectus and other relevant documents;
- 2) In a timely manner, disclose major matters that may affect its solvency, including but not limited to, i) the issuer is in default on debt payments due; ii) the issuer’s new borrowings or external guarantee amount exceed 20 percent (20%) of its net assets at the end of the previous year; iii) creditor's rights or properties waived by the issuer exceed ten percent (10%) of the net assets at the end of the previous year; iv) claims or assets given up by the issuer exceed 10 percent (10%) of its net assets at the end of the previous year; v) the issuer decides to reduce its capital, merger, split, dissolve or file bankruptcy; vi) the issuer is involved in major litigations or arbitrations or subject to major administrative punishments; vii) the issuer's senior executives are involved in major civil or criminal litigations, or have been under investigations by relevant departments with regard to certain major economic events.
- 3) Disclose matters concerning principal redemption and interest payment according to the rules of relevant stock exchange;

- 4) In the event that an issuer's directors, supervisors, senior executives and shareholders holding more than five percent of the shares transfer their Private Bonds, they shall duly inform the issuer, and the issuer shall disclose such transfer information within three (3) working days after the transfer is completed.

Protection of Investors' Interests

As Private Bonds have solvency risk, the Pilot Measures stipulate protection measures for investors' interests, stating that the issuer shall engage a trustee for the holders of Private Bond. The trustee may be an underwriter or other institution other than the guarantee for the issuance of the Private Bonds. The trustee and issuer shall formulate the rules on meetings of the Private Bond holders together, safeguard interests of the holders and perform duties as agreed during the existence of the Private Bonds.

The Pilot Measures also stipulate that the issuer shall establish a special account for repayment security to collect and manage redeemed interests and funds. The issuer shall promise in the prospectus to fully deposit the interests payable into the special account for repayment security ten (10) working days prior to the date of interest payment of the Private Bonds; the balance of repayment security thirty (30) days prior to the maturity date of principal amount shall not be lower than 20% of the balance of the Private Bonds. The issuer may take other internal and external measures for credit enhancement and control Private Bond risks, such as restraining the issuer from mortgaging assets to other creditors, third-party guarantee and assets mortgage, pledge and business insurance.

The SMEs Private Bonds provide not only an effective way to solve financing difficulties of SMEs but also new business chances for securities traders as well as more attractive investment opportunities for variable investors. However, securities traders and investors may be much more prudent due to the high risks arising from the low threshold for the Private Bond, thus a higher level of compensation for credit risk and liquidity is required to be formulated. Besides, issuance costs shall also be taken into consideration. Although large-scale issuance is not likely, the issuance costs may reach several millions adding the underwriting fees as of 1%-3% of the gross financing and fees paid to legal counsel and accountants all together.

Legal Updates

1. **China Securities Regulatory Commission Issued the Notice on Issues concerning Further Implementing Cash Dividends Distribution of Listed Companies (Authors: Loretta LI, Adrian LV, Lan LI)**

In order to further promote cash dividends of listed companies, improve the transparency and standardization thereof and increase shareholders' reasonable return from listed companies, China Securities Regulatory Commission (the "CSRC") officially published the *Notice on Issues concerning Further Implementing Cash Dividends Distribution of Listed Companies* ("the Notice") on May 9, 2012.

Since the *Administrative Measures on Issuance of New Shares of Listed Companies* was released and implemented in 2001, CSRC has successively issued the *Provisions on Strengthening the Protection of the Rights and Interests of Public Shareholders*, *Measures for the Administration of Securities Issuance of Listed Companies* and *Decision on Revising Certain Provisions Concerning Cash Dividends Distribution of Listed Companies* and other regulatory measures to standardize and improve cash dividends distribution mechanism of listed companies. Although the ratio of listed companies distributing cash dividends against all listed companies and average amount of cash dividend per share have both been increasing in the recent three years, the ratio of total amount of cash dividends of listed companies against total net profit yielded by all listed companies in the same year is descending. There are still several weaknesses on current cash dividends distribution mechanism of listed companies, such as that the awareness of repaying investors is weak and the policies of cash dividends payment are ambiguous, opaque, and not duly implemented, etc.

In light of the current situations of cash dividends distribution of listed companies and defects of related regulatory systems, the Notice stipulates more detailed provisions on procedural issues, information disclosure and other aspects of cash dividends distribution, and clarifies the requirements that sponsoring institutions and all branches of the CSRC shall implement the policies of the Notice. The main points of the Notice are as follows:

To require listed companies to establish procedures on cash dividend distributions

The institutionalization and standardization of cash dividend distributions of listed companies will effectively improve continuity and predictability of investment return and will be beneficial to cultivate long-term investment concept in capital market. The Notice provides that listed companies shall strictly implement the cash dividend policies and detailed distribution plans, which are formulated through due process on the basis of carrying out the principle of autonomous decision-making on profit distribution issues. Besides, any adjustment or amendment to cash dividend policies shall follow legitimate and valid procedures as well.

- 1) Necessary decision-making process shall be gone through when drawing up cash dividend policies

When drawing up cash dividend policies, Board of directors shall conduct specific research and demonstration of issues concerning shareholders' return and elaborate on reasons for the arrangement in the policies and other information. Listed companies shall fully solicit opinions from independent directors and small and medium-sized shareholders, and perform information disclosure. Meanwhile, the Notice explicitly requires listed companies to specify the decision-making process of cash dividend issues and detailed contents of cash dividend policies in their articles of association, such as measures with respect to soliciting opinions of independent directors and small and medium-sized shareholders, forms of profit distribution, conditions for make cash dividends distribution, minimum amounts or proportions of cash dividends in each quarter, etc.

- 2) To emphasize that board of directors, independent directors, general meeting of shareholders and small and medium-sized shareholders shall perform their respective duties and enhance interaction among them when formulating specific plans of cash dividends distribution.

In the first place, boards of directors shall research and demonstrate the timing, conditions and minimum proportion and other issues regarding cash dividend. After that, independent directors shall give clear opinions on the cash dividend distribution plan. At last, the general meeting of shareholders shall review the cash dividend plan in detail, during which the listed companies shall fully solicit opinions and appeals from small and medium-sized shareholders and make prompt response to small and medium-sized shareholders regarding the issues they concern.

- 3) To require listed companies to strictly implement cash dividend policies provided in articles of association and specific plans of cash dividend distributions approved by general meeting of shareholders

In order to ensure that listed companies could strictly implement established policies and plans as well as are able to make corresponding adjustments to such policies and plans through due process when situations change, the Notice explicitly stipulates that when it is necessary to adjust or amend cash dividend policies and specific distribution plans, a relevant shareholders' resolution shall be approved with at least 2/3 of votes of the shareholders attending the general meeting of shareholders, after the listed companies have satisfy the conditions set forth in article of association to make such adjustments and amendments, conduct elaborate demonstrations and perform decision-making procedures regarding this issue.

To enhance information disclosure to improve transparency of cash dividend issues

With a view to improving transparency of cash dividends of listed companies and avoiding situations that listed companies do not make cash dividends distributions when they could and should have done that, the Notice specifies disclosure duties of listed companies in different stages and situations:

1) Companies which make initial public offerings (the “IPO”)

The Notice requires that companies making IPO shall disclose the following information regarding profit distribution in prospectuses:

- a) Clauses of articles of association regarding profit distribution;
- b) Relevant information including specific research and demonstration results of shareholders’ return and reasons for corresponding plans and arrangements made by board of directors;
- c) Major considerations in drawing up profit distribution policies and decision-making procedures having been fulfilled by the companies, as well as the usages and arrangements of undistributed profits. Where the profit distribution policies specify that cash dividends will not be adopted or arrange a minimum proportion of cash dividends, issuers shall further disclose their major considerations in formulating relevant policies or proportions. Where issuers’ profits are mainly from their controlling subsidiaries, they shall disclose the financial management system, profit distribution clauses in articles of association of such holding subsidiaries and whether the issuers have the capability of paying cash dividends in the future;
- d) Profit distribution plans and long-term return arrangements of the issuers in the coming three years, as well as main considerations in formulating such plans and arrangements;
- e) To give “notice for major issues”, reminding investors to pay attention to profit distribution policies and long-term return arrangements of the issuers after IPO. The minimum proportion of cash dividends or specific profit distribution plans in the coming three years, if any, shall be listed in the “notice for major issues” as well.

2) Listed companies which propose to issue new securities

When listed companies propose to issue new securities, their prospectus or issuance plans shall disclose the profit distribution policies especially the information of establishment and implementation of cash dividend policies, the amount and proportion of cash dividends in recent three years, the arrangements of undistributed profit, and include aforesaid issues into the “notice for major issues”. For listed companies with relatively low level of cash dividends in recent three years, the issuers and their sponsors shall explain reasons for the low level of cash dividends and give clear opinions on whether the companies have given full consideration to shareholders’ demands and desires, whether the companies have given investors reasonable return and whether the companies’ cash dividend policies follow the principle of maximizing the benefits of shareholders of listed companies.

3) Listed companies involved in change of control

Where parties concerned are involved in backdoor listing, major asset restructuring, merger or split or changes of control of listed companies due to acquisition, they shall, in accordance with the requirements of the Notice, disclose information with respect to cash dividend policies of listed

companies and corresponding arrangements after the restructuring or changes of the control, formation of board of directors and other information in the major assets restructuring report, the equity change report or the acquisition report.

To continuously track the fulfillment and implementation of cash dividend policies

Besides clarifying cash dividend policies in prospectuses and articles of association during IPO, the listed companies shall also report the formulation and implementation of cash dividend policies in regular basis. As aforesaid, listed companies are under obligations to disclose relevant information when they go through financings or changes of the control, which arrangement could construct a long-term supervision mechanism and well encourage listed companies to pay cash dividends. Currently, CSRC has demanded its branches to learn detailed situations of listed companies in respective jurisdictions that have positive accumulative net profit as well as relatively good cash flow but fail to distribute dividends, and pay close attention to such companies, as well as verify their reasons disclosed to the public in light of no distribution of dividends, and whether the claim concerning usage of undistributed funds retained in companies accords with actual situations. With regard to those listed companies possessing positive accumulative net profit and good cash flow but having not distributed dividends for consecutive years, if any distribution policy does not conform with provisions of the companies' articles of association, or any distribution plan does not go through necessary decision-making procedures, or the information disclosed is inconsistent with facts, or other improper conducts occur, CSRC may publicize the name of such listed companies and take necessary supervision measures on them in accordance with laws and regulations. CSRC will also pay great attention to those new listed companies paying high proportion of cash dividends shortly after going public (there are more such cases on Growth Enterprises Board and Small and Medium-sized Enterprises Board), in order to prevent cash dividends from becoming the tool of cashing out for majority shareholders, which may affect the sustainable development of listed companies.

To require sponsoring institutions and supervision departments to reinforce external supervision

The Notice not only clarifies listed companies' obligations in respect of cash dividends, but also emphasizes on the external supervisions and restrictions on listed companies by sponsoring institutions and supervision departments.

1) The obligations of sponsoring institutions during companies' IPO

Sponsoring institutions shall urge issuers to fulfill the requirements of the Notice during their IPO sponsorship business. Sponsoring institutions shall reflect the improvement of issuers' profit distribution policies in sponsorship work statements and give clear opinions on whether issuers' profit distribution decision-making mechanism conforms to the Notice, and whether issuers' profit distribution policies and future dividend plans take investors' reasonable returns into account and

are conducive to protect investors' legitimate rights and interests.

2) The obligations of sponsoring institutions during refinancings of listed companies

Besides giving clear opinions on profit distribution policies and other aspects of listed companies in sponsorship work statements, as aforesaid, sponsoring institutions also assume the responsibility of making explicit explanations and comments on listed companies with low level of cash dividends in recent three years.

3) The responsibility of supervision departments

The Notice specifies that all branches of the CSRC, the Shanghai Stock Exchange and the Shenzhen Stock Exchange, as well as relevant departments of the CSRC shall strengthen supervision over listed companies in terms of decision-making procedures, implementation situations, information disclosure and other issues relating to cash dividend policies.

2. SAT New Announcement on Enterprise Income Tax Treatment of Equity Incentive Schemes Implemented by Resident Enterprises (Authors: Evan ZHANG, Kaiying WU, Chu LIU)

The State Administration of Taxation (“**SAT**”) issued on May 23, 2012 *the Announcement on Enterprise Income Tax Treatment of Equity Incentive Schemes Implemented by Resident Enterprises* (SAT Announcement No.18 [2012]) (“**Announcement**”), aiming to clarify certain issues relating to the enterprise income tax treatment of equity incentive schemes implemented by listed companies. Prior to the Announcement, China Securities Regulatory Commission (“**CSRC**”) has issued in 2005 the *Administrative Measures on Equity Incentive Schemes of Listed Companies (Trial)* (Zheng Jian Gong Si [2005] No. 151) (“**Administrative Measures**”), providing for basic rules on equity incentive schemes of resident companies listed within China (“**Listed Companies**”). Subsequently, in 2006, the Ministry of Finance promulgated the *Corporate Accounting Principles No. 11-Equity Payment* (Cai Kuai [2006] No. 3) and the *Application Guidelines of Corporate Accounting Principles No. 11-Equity Payment* (Cai Kuai [2006] No. 18) (collectively “**Chinese Accounting Standards**”), providing clarifications on the accounting principles for equity incentive schemes. Set forth below is a brief analysis on the enterprise income tax treatment relating to equity incentive schemes on the basis of the Announcement and other regulations as indicated above.

Equity incentive schemes

Equity incentive schemes mentioned in the Announcement refer to what is defined in the Administrative Measures, i.e., long-term incentives granted by Listed Companies, with its own stocks as the subject matter, to its directors, supervisors, senior management personnel and other employees (“**Incentive Recipient(s)**”). Equity Incentive may be implemented by granting

restricted stocks, stock options or in other means prescribed by laws or regulations. There are mainly two types of restricted stocks and stock options incentives. The rights for one of them are immediately exercisable after the implementation of the equity incentive scheme while the rights for the other are not exercisable until the Incentive Recipient has served a certain number of years or has met the prescribed performance requirements (“**Vesting Period**”).

Enterprise income tax treatment

The essence of the equity incentive plan employed by a Listed Company is transferring the capital reserve into payment in consideration of the services provided by the Incentive Recipient. According to the Article 8 of the Enterprise Income Tax Law of the People’s Republic of China (“**Enterprise Income Tax Law**”), an enterprise may deduct its reasonable expenses which are actually incurred in relation to its income earned; and the payment is one type of the expenses mentioned (salaries and wages in particular) and therefore deductible. Given that, the Announcement provides for the following Enterprise Income Tax treatment:

- 1) Where the rights of an Incentive Recipient are immediately exercisable after the implementation of the equity incentive scheme, the Listed Company may, according to the difference between the fair price of the stock at the time of exercise and the price per share paid by the Incentive Recipient for exercising his/her rights and the number of shares involved, calculate and determine the payment for its wages and salaries of the given year and conduct pre-tax deduction in accordance with the provisions of the Enterprise Income Tax Law;
- 2) Where, after the implementation of the equity incentive scheme, the rights of an Incentive Recipient are exercisable only after he/she has served a certain number of years or has met the prescribed performance requirements, and the relevant costs and expenses of the Listed Company that are calculated and recognized by accounting during the Vesting Period shall not be deductible for calculation of enterprise income tax of the corresponding year. Only after the rights under the equity incentive scheme can be exercised, the Listed Company may, according to the difference between the fair price of the stock at the time of exercise and the price per share paid by the Incentive Recipient for exercising his/her rights and the number of shares involved, calculate and determine the payment for its wages and salaries of the given year and conduct pre-tax deduction in accordance with the provisions of the Enterprise Income Tax Law;
- 3) For the purpose of the deduction, the fair price of a stock at the time of exercising rights shall be determined according to the closing price of the stock on the exercise date.

It is worth noting that the timing of determination of the salary expense in the given fiscal year will be the point of time of exercise. The underlying reason is that it is the principle of the Enterprise Income Tax Law that the salary expense will only become determinable when the salary is actually paid, and the market turbulence shall not be considered when determining the cost in order to avoid the uncertainty. In addition, this approach also matches with the personal income tax treatment

because the personal income is realized at the time of exercise and the personal income tax shall be determined at the same time. The Personal Income Tax Law also categorizes the payment as salary income. Yet, the Chinese Accounting Standards adopts a different approach than the Enterprise Income Tax Law on the timing of deduction. The Chinese Accounting Standards follow the principle of benefit vesting and cost matching. The accounting of the salary expense shall thus start from the very date the employees start providing service; and the cost thereof will be capitalized and spread over a period when there exists a Vesting Period for the exercise of rights. As a consequence, there won't be additional adjustments when the employees exercise their rights.

Other Companies can follow the same rules as the Listed Companies

The Announcement also points out that, with regard to issues concerning enterprise income tax relating to equity incentive schemes adopted by resident enterprises listed overseas and non-listed companies by referring to the Administrative Measures and of which the enterprise accounting comply with relevant provisions of Chinese Accounting Standards, provisions of the Announcement may also apply.

Important Announcement

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