



漢坤律師事務所  
HAN KUN LAW OFFICES

# Newsletter

China Practice  
Global Vision



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 Insights & Ideas

## China Introduces a Pilot Program of Preferred Shares (Authors: Yang CHEN, Kaiying Wu, Fanglu LIN)

On April 1, 2014, China Securities Regulatory Commission (the “CSRC”) released three guidelines on information disclosure related to the issuance of preferred shares by listed companies.<sup>1</sup> These guidelines are important supporting documents of *the Guiding Opinions of the State Council on Launch of Pilot Program for Preferred Shares* (the “**Guiding Opinions**”) and *the Administrative Measures for the Pilot Program for Preferred Shares* (the “**Administrative Measures**”). Successive announcement of relevant laws and regulations as well as supporting policies demonstrates China’s exploration of the pilot program of preferred shares. Based on the main contents of Administrative Measures and the latest guidelines on information disclosure, we set forth below a brief introduction to China’s existing pilot regulations on preferred shares and a comparison between China and the U.S.’s preferred shares system.

### Main Contents of the Administrative Measures

In accordance with the philosophy of the Guiding Opinions, on March 21, 2014, the CSRC announced the Administrative Measures, which stipulates the rules for the rights of preferred shareholder, issuance conditions and issuance procedure, etc. The Administrative Measures to some extent, filled the gaps in the specific area of laws and regulations for preferred shares in China, and served as instructions for detailed operation of preferred shares in China’s capital market activities.

#### i. Subjects and Methods of the Issuance of Preferred Shares

As stipulated by the Administrative Measures, listed companies may issue preferred shares publicly or privately, and unlisted public companies may make private placement of preferred shares.

#### ii. Rights of the Preferred Shareholders

According to the Administrative Measures, besides the priority in the company’s dividend distribution, preferred shareholders may also participate in the distribution of remaining profit (except for the preferred shareholders of a listed company); preferred shareholders shall be entitled to vote on the following matters: merger, division and dissolution of the company, change of corporation form, issuance of preferred shares and other matters relevant to the settings of preferred shareholders’

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<sup>1</sup> These guidelines include the Standards on the Contents and Formats of Information Disclosure by Companies Publicly Offering Securities No.32 - Application Documents for the Issuance of Preferred Shares, Standards on the Contents and Formats of Information Disclosure by Companies Publicly Offering Securities No.33 - Proposal and Report for Issuance of Preferred Shares, Standards on the Contents and Formats of Information Disclosure by Companies Publicly Offering Securities No.34 - Prospectus for Issuance of Preferred Shares.

rights. When a company fails to pay the dividend of preferred shares as agreed for three accumulative fiscal years or two consecutive fiscal years, preferred shareholders could restore their voting rights and be entitled to present the general meeting and vote together with ordinary shareholders. In addition, preferred shareholders have the rights to access the articles of association, register of members, minutes of general meeting, resolutions of the board of directors, financial and accounting reports and also have the rights to require for redemption of the preferred shares.

### iii. Conditions and Procedures of the Issuance of Preferred Shares

To publicly issue preferred shares, a listed company shall meet the following general provisions: 1) it shall be separated from its controlling shareholder or actual controller in respect of personnel, assets and finance, and be independent in organization and operation; 2) it shall have sound internal control systems; 3) it shall be profitable in the latest three consecutive fiscal years; 4) its cash dividend in the latest three years shall meet the relevant provisions of its articles of association and the requirements set by the CSRC; 5) its accounting treatment of major issues in the financial statements shall meet the enterprise accounting standards during the reporting period; 6) the use of proceeds for this issuance shall be legal and clearly stated; 7) preferred shares issued by it shall not exceed 50% of total ordinary shares of the company, and the funds raised shall not be more than 50% of the net assets before the issuance. In addition to the above general provisions, to publicly issue preferred shares, a listed company shall also meet at least one of the following conditions: 1) its ordinary shares are among the constituent stocks of SSE 50 Index; 2) it acquires or merges another listed company through public issuance of preferred shares as the means of payment; 3) where it repurchases ordinary shares to reduce the registered capital, public issuance of preferred shares be used as the means of payment, or, after the completion of its repurchase scheme, publicly issuance of preferred shares with an amount of no more than the total amount of capital reduction in the repurchase. The non-public issuance of preferred shares by listed companies shall be applicable only to certain qualified investors and the number of investors for any single issuance shall not exceed 200.

According to the Administrative Measures, for a listed company, the procedures of the issuance of preferred shares includes pre-disclosing of the issue plan, deliberating of the board of directors, making special opinion by the independent director, deliberating of the general meeting, filing an application to the CSRC under the recommendation of a sponsor, etc. For a unlisted public company, the number, price, terms and procedures of the non-public issuance of preferred shares shall follow the relevant provisions stipulated for the non-public issuance of preferred shares by listed companies.

### iv. Issuance of Preferred Shares and the Reorganization of Listed Companies

It is explicated in the Administrative Measures that listed companies may repurchase ordinary

shares from specific shareholders of the company with non-public issuance of preferred shares as the means of payment. The acquisition offer of listed companies shall apply to all shareholders of acquired company, however, different acquisition terms may be put forward for preferred shareholders and ordinary shareholders. What's more, listed companies may raise supporting funds while issuing preferred shares as the means of payment for asset purchase.

### **Main Contents of the Principles for Information Disclosure**

The Principles for Information Disclosure regulates the information disclosure system for issuance of preferred shares and strengthens the protection to investors by stipulating the contents and format of application documents, proposals and prospectus for the issuance of preferred shares by listed companies.

#### i. Application Documents for the Issuance of Preferred Shares

Application documents for issuance of preferred shares include prospectus, internal authorization documents of the company, sponsor's work report issued by the sponsor, legal opinion given by the lawyer, etc. Generally it manifests that the principles of deregulation and strengthened supervision insisted by the regulators, who relies more on daily information disclosure, stresses continuous supervision and simplifies application requirements.

#### ii. Proposal and Report for Issuance of Preferred Shares

The proposal for issuance shall disclose the information as follows which is benefit for minority shareholders to make a correct judgment during the financing process: the class and quantity of preferred shares to be issued, the way of issuance, the price and coupon dividend yield, the way by which preference shareholders participate in the distribution of profits, the repurchase and conversion terms, the purpose of issuance and the plan of using proceeds from the issuance. In addition, according to the Administrative Measures, where the proceeds are used for asset acquisition, the general information about the target assets, the price and the analysis for its fairness, and the asset ownership shall be disclosed in the proposal for issuance; in case of the acquisition of a company or equity, major debts newly formed in the acquisition and the ownership of income arising from the period from the end of asset self-assessment to the date of asset delivery, etc. shall also be disclosed.

The issuance report shall state the basic information about this non-public issuance, including but not limited to resolution procedures of the board of directors and the general meeting, the name of each investor of the issuance, the type and number of subscription, the type of preferred shares issued and the main clauses thereof, the opinion of the issuer's lawyer on the process of this non-public issuance and the compliance report of the investors of the issuance.

#### iii. Prospectus for Issuance of Preferred Shares

Prospectus for issuance of preferred shares shall emphasize on disclosure contents that are closely related to investors' value judgment such as issuance conditions, risk factors, basic information and major business of the issuer, as well as the use of proceeds. The full text of the prospectus is required to be disclosed on designated websites, and meanwhile, the core contents of the prospectus is required to be summarized into a table format and be published on designated newspapers and journals to instruct investors to pay attention to daily information disclosure documents.

### **Comparison of Preferred Share System in China and the U.S.**

The design of preferred shares, which is an interest mode design featuring preferred shareholders' priority in the distribution of profit and remaining property to the shareholders ordinary shares while restricting the preferred shareholder's right of corporate decision-making and management, provides company (especially to the commercial banks) with a significant financing mode, and is advantageous to solving the conflict between the investors' dividend demands and the circumstance that some listed companies make fewer or no dividend distribution, as well provides investors who concern about cash dividend and stable earnings with more optional investment channels and conducive to protecting minority shareholders' interests. The design of preferred shares has become a key approach for venture capital investment and private financing on developed financial markets such as the markets of the U.S. The preferred shares system in China is under the pilot stage and is quite different from the overseas preferred shares in terms of system design. Compared with the case of the U.S., the preferred shares system in China carries main differences as below:

#### i. Subjects of the Issuance of Preferred Shares

The subjects which may issue preferred shares in China are listed companies and non-listed public companies. While overseas, the configuration of preferred shares is generally stipulated in the articles of association of the company under the company's autonomy, without limitation on the nature of the company who may issue preferred shares; furthermore, preferred shares are generally issued by non-listed company in overseas practice.

#### ii. Classes of Preferred Shares

The Administrative Measures clearly specifies that, preferred shares with different priority in distribution of dividend and distribution of remaining property shall not be issued during the pilot stage (except for the company which issues both preferred shares with enforced dividend distribution and preferred share without enforced dividend distribution), however, preferred shares with different configurations in other terms and conditions are permitted to be issued; preferred shares issued by the same company in the same issuance shall bear the same terms and conditions; as for preferred shares issued in different issuances, the terms and conditions other than nominal dividend rate shall be the same. Nevertheless, in abroad, when preferred shares are issued, the

company normally issues several series of preferred shares with different priorities, shares of any priority type can be classified as a series, and preferred shares of different series may vary in many aspects, such as in terms of dividend rate, redemption price, redemption term and conditions, distribution in liquidation, terms and conditions for share conversion and voting rights.

### iii. Conversion of Preferred Shares and Ordinary Shares

Pilot program of preferred shares in China strictly limits convertible preferred shares. As specified in the Administrative Measures, listed company may not issue preferred shares which can be converted into ordinary shares (however, a commercial bank may, based on capital regulatory rules, issue in a non-public manner preferred shares which could be coercively converted into ordinary shares in case of a trigger event and abide by applicable provisions.). In abroad, preferred shareholders are entitled to convert preferred shares into ordinary shares even at any time in accordance with certain conversion rules (including the conversion price) as an option to protect the rights and interests of preferred shareholders.

### iv. Rights of Preferred Shareholders

As mentioned above, in China, preferred shareholders have priority in distribution of profit, and to certain extent, priority in distribution of remaining property, limited voting rights and information rights. The Administrative Measures specifies that, after obtaining the dividends distributed against their preferred shares in accordance with the specified dividend rate, preferred shareholders may not participate in the distribution of remaining profit together with ordinary shareholders. On the whole, the preferred shareholders' right scope is quite limited in China. In abroad, in the transactions related with preferred shares, broad and flexible right configurations are applied to preferred shareholders. For example, in a venture capital investment, arrangements in investment agreements can protect the investor from various aspects, of which the transaction documents such as articles of associations can specify dividend priority, liquidation preference, voting right in the election of directors, veto right for specific matters set forth in the protective provision for preferred shareholders, share conversion right, anti-dilution right and share redemption right granted to preferred shareholders; agreements related to the investors' rights empower them with the information right, the right to appoint directors who are on behalf of preferred shareholders and are entitled of veto power over specific matters in respect of company decision-making; furthermore, the pre-emption right, co-sale right and other special arrangement like drag-along right of investors may be specified in corresponding terms of transaction documents.

To sum up, the preferred shares system overseas emphasizes on variance of rights on different types and series shares, which flexibly adapts the company's system innovation and development demands, endows key functions of shares form design and selection in the articles of association or transaction agreements, extends the scope of power to preferred shareholders, configures flexible conversion terms and conditions, liquidation preference, anti-dilution terms and conditions, and

normally grants the voting rights to holders of preferred shares.

Our preferred shares system is still at the pilot stage and exercises many differences compared with the developed preferred shares system in the U.S. Successive promulgation of relevant regulations and rules will promote the perfection of the preferred shares system in China. It can be predicted that with expansion of pilot scope and perfection of rules and regulations, the system of preferred shares will provide more financing channels for enterprises, adds more investment varieties for investors and may also trigger the market adjustments in deeper levels with respects of the issuance system, corporate governance, market structure and functions of investment and financing, thus to establish a preferred shares system which is in line with the operation of Chinese capital market. We will follow up with the development of policies, rules and practice of preferred shares in China and share the developments with you.



## Legal Updates

### 1. NDRC Further Simplifies Outbound Investment Approval Procedures (Authors: Gloria XU, Diana CHEN)

On April 8, 2014, China's National Development and Reform Commission ("NDRC") published the Measures for the Administration of Approval and Record Filing of Outbound Investment Projects (the "Measures"). The Measures further revised and completed Interim Measures for the Administration of Approval of Outbound Investment Projects (the "No.21 Decree") published on October, 2004 and Circular of the National Development and Reform Commission on Delegating Powers on Approval of Outbound Investment Projects to Lower Authorities (the "No.235 Decree"). The Measures further narrows the scope of the projects which are subject to approvals, simplifies the approval procedures and shortens the approval timeframe.

Compared with No.21 Decree and No.235 Decree, the Measures have made changes in the following aspects.

#### **Narrow Approval Scope and Implement a Record Filing System for General Outbound Investment Projects**

The Measures no longer differentiates resource projects from non-resource projects. Except for the projects in sensitive countries or districts or in a sensitive industry, the total investment by Chinese investors of outbound projects subject to approval by NDRC has been increased to USD 1 billion from USD 300 million for resource projects and USD 10 million for non-resource projects (as provided by No.235 Decree). That is to say, outbound investment projects with a total investment of more than USD 1 billion by Chinese investors are subject to approval by NDRC (the "Approval Projects"). Those projects with a total investment lower than 1 billion will no longer be subject to approval and shall only be filed with the competent NDRC department in advance (the "Record Filing Projects").

#### **Simplify Approval and Record Filing Procedures**

##### **i. Approval Projects**

The Measures provides that outbound investment projects with a total investment of more than USD 1 billion by Chinese Investors are subject to approval by NDRC. Projects in sensitive countries or districts or involving sensitive industries are subject to NDRC's approval regardless of the amount of total investment. The projects in sensitive countries or districts or in a sensitive industry with a total investment of more than USD 2 billion need to be first reviewed by NDRC, which will then submit its review opinion to the State Council for a final approval.

Where a project is subject to approval by NDRC or the State Council as explicitly stated in the Measures, the local enterprise shall submit the project application report to the provincial-level NDRC department in its place of registration, which will then submit their opinion to NDRC for approval. Where the enterprise is under the administration of the central government, the application reports shall be submitted to NDRC by its group company.

## **ii. Record Filing Projects**

Where a project is subject to record filing, the following procedures shall be followed. Outbound investment projects invested by centrally administered enterprises and those invested by local enterprises with a total investment amount by Chinese Investor of more than USD 300 million shall be filed with NDRC; outbound investment projects invested by local enterprises with a total investment of less than USD 300 million shall be filed with the provincial-level NDRC department.

In order to save the time and costs for preparing application materials, for record filing purposes, the enterprise no longer needs to submit the application report, and only needs to complete and submit certain standard forms.

With regards to the projects subject to the record filing of NDRC, the local enterprise shall submit the record filing forms and related attachments to the provincial-level NDRC department, which will then submit the materials to NDRC. The group company of a centrally administered enterprise shall submit related materials to NDRC directly.

## **Specify the Time Limit of Approval and Record Filing**

The Measures specifically provides the time limit the approval and record filing process will take. The time limit of approval is twenty (20) working days (excluding the time for entrusting a consultancy agency to conduct evaluation). Where an approval decision cannot be made within 20 working days under specific circumstances, the period may be extended for another ten (10) working days subject to approval of the person-in-charge from NDRC. Where the application materials are not complete, NDRC shall notify the application enterprise within five (5) working days to provide supplemental materials. NDRC shall officially accept the application after receiving the supplemental materials. The time limit of projects which need to be evaluated by consultancy agency shall not exceed forty (40) working days.

## **No Approval and Record-filing Requirements for Reinvestments of Overseas Chinese Companies**

The Measures provides that the reinvestment projects conducted by Chinese enterprises established overseas are not subject to approval or record filing as prescribed in No.21 Decree, provided that the reinvestment projects do not require financing or security of the domestic investor.

## **Strengthen Supervision and Specify Legal Liabilities**

The Measures further specifies that the investor shall be responsible for the integrity and legitimacy of the application materials. Where an investor breaches the laws and regulations, conceals relevant facts and provides false materials, NDRC will not accept the application and refuse to approve. If the investor has already obtained approval documents or record-filing notice, NDRC shall retrieve the approval documents or record-filing notice and give such investor a warning.

With regards to projects that are carried out without approval documents or record-filing notice, and those conducted inconsistent with the approval documents or record-filing notice, NDRC shall stop the projects together with other related departments and shall submit the case to related authorities to investigate the administrative responsibilities and legal liabilities of the person in charge.

## **2. MIIT's New Measures on Foreign Investment in Value-added Telecommunications Business in the Shanghai Free Trade Zone (Author: Kelvin GAO, Winnie SHAO)**

On April 15, 2014, the Ministry of Industry and Information Technology ("MIIT") promulgated the Administrative Measures for the Pilot Operation of Foreign Investment in the Value-added Telecommunications Business in China (Shanghai) Pilot Free Trade Zone (the "Measures"). The Measures not only implements the Decision of the State Council on Temporarily Adjusting Relevant Administrative Regulations and Administrative Approval or Special Administrative Measures on Foreign Investment Access Provided in Documents the State Council in China (Shanghai) Pilot Free Trade Zone and the Opinions of the Ministry of Industry and Information Technology and the People's Government of Shanghai Municipality on Further Opening Up Value-added Telecommunications Business in China (Shanghai) Pilot Free Trade Zone, but also facilitate the opening up of value-added telecommunications business in Shanghai FTZ.

### **Key Points of the Measures**

The Measures set forth the conditions, approval procedures and time limit that a foreign-invested enterprise in the FTZ shall meet and follow to apply for operation of value-added telecommunications business.

#### **i. Application Conditions**

To apply for operation of value-added telecommunications business, a foreign-invested enterprise shall meet the following conditions: (i) being a company lawfully established in the FTZ; (ii) having capital and professional staff commensurate with its business operations; (iii) having the good will and competence for providing long-term services to users; (iv) having a minimum registered capital of RMB1,000,000; (v) having necessary sites, technical proposals, network and information

safeguard system and measures and service facilities, which shall be located in the FTZ; (vi) the applicant company, its principal investors and management having no record of violation of telecom supervision and administration system within recent three (3) years; (vii) other requirements stipulated by the State.

## **ii. Approval Procedures and Time Limit**

Shanghai Communications Administration (“SCA”) shall examine the application materials. Where the application materials are complete and in the legal form, SCA shall issue an acceptance notification to the applicant. Where the application materials are not complete or in the legal form, SCA shall notify the applicant of all contents to be supplemented at one time on the site or within five (5) working days.

SCA shall complete the examination and approval within sixty (60) days upon accepting the application. Where the application is approved, a written Approval on Foreign Investment in Shanghai FTZ Value-added Telecommunications Pilot Program shall be issued. The validity period of the approval is set for three (3) years. Where the application is not approved, it shall notify the applicant of the result and the reasons for the disapproval.

## **iii. Supervision and Inspection System**

SCA adopts an annual inspection system for foreign-invested telecommunications enterprises in the FTZ. Foreign-invested telecommunications enterprises shall submit materials of annual inspection in the first quarter of the year immediately following the year of annual inspection. During annual inspection, SCA will closely and thoroughly examine the materials submitted by the foreign-invested telecommunications enterprises and scrutinize their operation activities, fee structure, service quality, users' personal information protection, network and information security management status, etc.

## **iv. Evaluation**

MIIT shall be responsible for organizing evaluation on the operation of the FTZ's foreign investment in value-added telecommunications pilot program. SCA shall issue to MIIT a quarterly evaluation report on the basis of its annual inspection and daily supervision.

## **Simplify Approval Procedures**

The approval procedures for operation of value-added telecommunications business by foreign-invested enterprises in the FTZ have been simplified compared with those outside the FTZ in the following aspects:

### **i. Delegate Approval Authority**

In accordance with the Administrative Provisions on Foreign-Invested Telecommunications Enterprises (the “Provisions”), the establishment of a foreign-invested telecommunications

enterprise engaging in value-added telecommunications business within a province, autonomous region or municipality directly under the central government is subject to a preliminary approval by the provincial-level telecommunication department and a final approval by MIIT. The Measures has delegated the approval power to SCA, however, SCA shall report to MIIT for archival purpose within ten (10) days after it issues an approval to the applicant.

## **ii. Shorten Approval Time Limit**

The approval procedures under the Provisions involve two steps and take five (5) months. The Measures consolidate and simplify the two steps and the total approval time has been shortened to two (2) months.

In conclusion, the promulgation of the Measures facilitates the opening up of value-added telecommunications business to foreign investment in the FTZ, and is also a positive exploration on foreign investment approval system in the telecommunications sector.



## **Important Announcement**

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If you have any questions regarding this publication, please contact:



### **Contact Us**

#### **Beijing Office**

Tel.: +86-10-8525 5500  
Suite 906, Office Tower C1, Oriental Plaza  
No. 1 East Chang An Ave.  
Beijing 100738, P. R. China

#### **Shanghai Office**

Tel.: +86-21-6080 0909  
Suite 5709, Tower 1, Plaza 66, 1266 Nanjing  
West Road,  
Shanghai 200040, P. R. China

#### **Shenzhen Office**

Tel.: +86-755-3680 6500  
Suite 4709, Excellence Times Plaza, 4068  
Yitian Road, Futian District,  
Shenzhen 518048, P. R. China

#### **Estella CHEN Attorney-at-law**

Tel.: +86-10-8525 5541  
Email: estella.chen@hankunlaw.com

#### **Yinshi CAO Attorney-at-law**

Tel.: +86-21-6080 0980  
Email: yinshi.cao@hankunlaw.com

#### **Jason WANG Attorney at-law**

Tel.: +86-755-3680 6518  
Email: jason.wang@hankunlaw.com