

Conversion of Non-Listed Foreign Investment Shares into B Shares

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MOFTEC has issued a new circular that offers some clarification on prior legislation and give more details about how non-listed foreign investment shares can be converted into B shares.

Shares in listed companies in China are divided into two distinct types: listed shares and non-listed shares. As such, public offerings and listings, among the common exit mechanisms for investors in the international capital markets, probably do not mean that the promoting shareholders of Chinese listed companies can release their investment by listing their shares on stock exchanges. However, there has been an exemption given by regulators to B share foreign-invested companies since 2000. Since then, it has been seen that foreign parties to foreign-invested enterprises (FIEs) have released their equity after the IPO; this is especially true since the B share market was opened to domestic investors last year. Now the authorities are seeking stronger regulation over foreign participation exits through listing and circulation of non-listed foreign investment shares.

On August 16 2002, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) issued the Questions Relevant to the Conversion of Non-listed Foreign Investment Shares of Foreign-invested Companies Limited by Shares into B Shares for Circulation Supplementary Circular (the Supplementary Circular).

The Supplementary Circular is based on The Question of Listing and Circulating the Non-listed Foreign Investment Shares of Listed Foreign Investment Share (B Share) Companies Circular (the Circular), issued by MOFTEC on September 1 2000. In addition to the Circular, we may also find other rules dealing with or involving the same problem, such as the Questions Relevant to Foreign-invested Companies Limited by Shares Circular (the FICLS Circular) issued by MOFTEC on May 17 2001 and the Foreign Investment Issues Relating to Listed Companies Several Opinions (the Several Opinions) jointly issued by MOFTEC and the China Securities Regulatory Commission (CSRC) on November 8 2001. When comparing the Supplementary Circular with the legislation referred to above, we find the following issues worthy of discussion.

APPROVAL AUTHORITY

According to the Circular, if a B share company is a Sino-foreign equity joint venture before IPO, the listing for circulation of its non-listed foreign investment shares shall be based on the prior approval by the original approval authority. Depending on the case, such decisions of approval may be made by MOFTEC or its local delegates. However, the FICLS Circular requires such approval to be granted solely by MOFTEC at the first instance. Since the FICLS Circular was issued, MOFTEC has been reiterating such a requirement through the relevant rules and provisions, including the Several Opinions and the Supplementary Circular. Furthermore, the Supplementary Circular even definitely prohibits any approval made by a local provincial department beyond its scope of authority.

Capacity

According to the Supplementary Circular, two types of companies are entitled to apply for circulation of their non-listed foreign investment shares: i) the foreign-invested companies

limited by shares (the FICLS) established with the approval of MOFTEC in accordance with the Certain Questions on the Establishment of Foreign-invested Companies Limited by Share Tentative Provisions (the Tentative Provisions, issued by MOFTEC in 1995); and ii) those established before the issue of the Tentative Provisions with the approval of departments authorized by MOFTEC in accordance with the Relevant Issues Concerning the Establishment of Sino-foreign Companies Limited by Shares Circular (issued by MOFTEC in 1993). In practice, we may still find some FICLS that are established with the approval of provincial departments in charge of foreign direct investment. Although regulatory defects undoubtedly exist, there have been precedents that such defects have not been challenged by the CSRC when those FICLS apply for an IPO. Still, the Supplementary Circular clearly indicates that MOFTEC intends to strengthen its regulation over applicants regarding the circulation of non-listed foreign investment shares.

Special Obligations & Responsibilities

According to the Supplementary Circular, the shareholders of the non-listed foreign investment shares shall have performed the special obligations and responsibilities required of them by the articles of association, shareholders agreement and other legal documents (including, but not limited to, shareholder loans, security provided for loan facilities, technology transfers and trademark licences). In the older rules, such as the FICLS Circular and the Several Opinions, we can also see some relevant provision, but with different content. The FICLS Circular requires the transferee to undertake the obligations and responsibilities of the original shareholders. Such requirements definitely will not be satisfied if the relevant obligations, such as technology transfer or trademark licence, can only be performed by the original shareholder. The Several Opinions make an alteration, which requests the shareholders to continuously perform their obligations and responsibilities after their non-listed foreign investment shares have been listed for circulation. However, such provisions are to some extent unfair to the original shareholders since most of their obligations are strictly affiliated to their status as shareholders. There is still some confusion on this point although the Supplementary Circular now makes some clarification and specification as mentioned above. Actually, if the shareholders make amendments to or terminate the original shareholder's agreement or other legal documents, the obligations will be discharged, and thus also "performed". But the following two problems can still occur: i) such amendment or termination perhaps needs consent by the original approval authorities; and ii) it may constitute a breach of the agreement.

Two One-year Periods

The Several Opinions first raised the two one-year periods requirement, that the shareholders of the non-listed foreign investment shares will have held such shares for over one year for the purpose of converting those shares into B shares for circulation and will continue to hold such shares for one more year for the purpose of public trading after the conversion. A provision similar to the first one-year period requirement can be found in Section Three of the FICLS Circular, which requests that the non-listed foreign investment shares shall have existed for over one year before application for their conversion into B shares. Such a provision makes for different treatment between the promoting foreign shareholders and those foreign investors who purchase the non-listed foreign investment shares from the original shareholders. For instance, if the non-listed foreign investment shareholders for over one year, the transferees of such shares were exempt from conversion into B shares upon the completion of the relevant transfer. In the Several Opinions, such a difference was abolished.

In the Supplementary Circular, MOFTEC restates such a requirement and also specifies the application procedures for the conversion. According to Section Four of the Supplementary Circular, the application shall be made to local provincial department in charge of foreign direct investment and final approval shall come from MOFTEC. After obtaining MOFTEC's approval, the applicant shall also seek CSRC approval within MOFTEC and the administration for industry and commerce, respectively. Considering the complexity of these formalities, it can be reasonably expected that completion of such procedures will probably take more than two years.

Other Provisions relevant to Issue and Listing of Shares

In addition to the specific conditions, the Supplementary Circular requires that the conversion shall also be subject to those conditions normally required of listing and issuing of shares. A similar requirement is also provided in Item 4 of Section Three of the Several Opinions, and such a provision is usually called a "sweep-up clause" as commonly adopted in China's legislation practice. Although the sweep-up clause makes flexibility possible in judges' discretion and the work of legislators, sometimes it may also result in confusion and conflicts, which we can describe in the case as follows. The authorities have already issued various pieces of legislation governing the listing and issuing of shares from different perspectives, e.g., A share offerings, as opposed to B shares offerings, and IPOs versus offering of additional new shares. We have found that the provisions in the Supplementary Circular are in conflict with the previous legislation in some areas. For example, Item 4 of Section Three of the Supplementary Circular requires that the applicant company shall have been profitable for the previous two years, while three years of profitability is required according to other legislation governing listing and issuing of shares.

Conclusion

The Supplementary Circular shows MOFTEC's intention to strengthen its regulation over the conversion of non-listed foreign investment shares into B shares. However, it remains uncertain whether the relevant requirements provided in the Supplementary Circular will be honoured by the CSRC since the Supplementary Circular is issued by MOFTEC alone. However, the Several Opinions, jointly issued by MOFTEC and the CSRC, confirm the prior approval power of MOFTEC. As such, we can also expect that all the requirements provided in the Supplementary Circular will be effectively implemented in practice.

(China Law & Practice, October 2002)