The Initial Public Offerings Law Review

Editor
David J Goldschmidt

The Law Reviews

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URÍA MENÉNDEZ

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PREFACE

Welcome to the inaugural edition of *The Initial Public Offerings Law Review*. While it is largely agreed that the first 'modern' initial public offering (IPO) was by the Dutch East India Company (VOC) in 1602, IPOs now take place in nearly every corner of the world and involve a wide variety of companies in terms of size, industry and geography. Several of the earliest exchanges are still at the forefront of the global IPO market, such as the NYSE and LSE, however, the world's major stock exchanges now are scattered around the globe, and many of them are now public companies themselves. Aside from general globalisation, shifting investor sentiment and economic, political and regulatory factors have also influenced the development and evolution of the global IPO market. For example, markets in the Asia-Pacific region, including Hong Kong, Shanghai and Tokyo, have enjoyed a significantly stronger presence in the global IPO arena in recent years owing to economic growth in the Asian markets.

Every exchange operates with its own set of rules and requirements for conducting an IPO. Country-specific regulatory landscapes are often dramatically different between jurisdictions as well. Whether a company is looking to list in its home country or is exploring listing outside of its own jurisdiction, is it important that the company and its management are aware of the requirements from the outset as well as potential pitfalls that may derail the offering. Moreover, once a company is public, there are ongoing jurisdiction-specific disclosure and other requirements with which it must comply.

Virtually all markets around the globe have experienced significant volatility in recent years. In 2016, the uncertainty surrounding the US presidential election, the unexpected outcome of the Brexit vote and numerous other geopolitical issues facing regions throughout the world furthered the general decline in both overall deal count and proceeds raised. Moving forward, however, many regions have a healthy IPO pipeline for the coming 12 months, including many household names.

The Initial Public Offerings Law Review seeks to introduce the reader to the global IPO regulatory environment and main stock exchanges in 16 different jurisdictions. Each chapter provides a general overview of the IPO process in the region, addresses regulatory and exchange requirements and presents key offering considerations. We hope this inaugural edition of *The Initial Public Offerings Law Review* introduces the reader to the intricacies of taking a company public in these jurisdictions and serves as a helpful handbook for companies, directors and managers.

David J Goldschmidt
Skadden, Arps, Slate, Meagher & Flom LLP
New York
March 2017

Chapter 3

CHINA

Chen Yang and Zhi Bin[1]

I INTRODUCTION

There are two primary exchanges in China, the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE). The SHSE consists of the Main Board, while the SZSE consists of the Main Board, the Small and Medium Enterprises Board (SME Board) and ChiNext (a board consisting mainly of high-technology companies).

Shares traded on the SHSE and SZSE that are settled in Chinese yuan are referred to as 'A-shares', while shares settled in foreign currency are referred to as 'B-shares'. In practice, there are few (if any) B-share initial public offerings (IPOs) in China, as the regulatory framework for B-share IPOs is incomplete.

The content in this articles focuses on A-shares listings. For the purposes of this article, 'China' excludes Hong Kong, Macau and the Taiwan region.

According to the 2015 Annual Report of the China Securities Regulatory Commission (CSRC), at the end of 2015, 1,559 companies were listed on the Main Board of the SHSE and the SZSE, 776 companies were listed on the SME Board, and 492 companies were listed on ChiNext. The total market capitalisation of these listed companies was 53.15 trillion yuan, which was 78.54 per cent of China's total 2015 GDP.

The primary regulator of China's capital markets is the CSRC. The SHSE and SZSE are responsible for administering the CSRC's rules, and are empowered by the CSRC to enact rules under the CSRC's supervision.

IPO listings in China are subject to regulatory approval by the CSRC. Therefore, the approval system in China differs from the registration system in Hong Kong, the United States and other capital markets. The CSRC determines whether a prospective issuer provided accurate and adequate disclosure in accordance with listing requirements. In practice, applicants may face long waiting periods (sometimes two to three years or even more), due to administrative backlog and repeated requests for information.

There have been recent movements to transition from an approval-based system to a registration-based system. According to the Decisions of Several Significant Issues Relating to Overall and Comprehensive Reform promulgated at the Third Plenary Session of the 18th People's Congress in 2013, China will move towards adopting a registration-based IPO system. The Several Opinions of the State Council on Further Promoting the Sound Development of the Capital Markets promulgated by the State Council in 2014 states that China will actively and prudently adopt a registration system based on improved information disclosure. A revision to the Securities Law of the People's Republic of China is also ongoing.

1 Chen Yang and Zhi Bin are partners at Han Kun Law Offices.

Once adopted, the CSRC will focus on the post-listing supervision and administration, and its review of IPO applications will be non-substantive, instead of focusing on regulatory compliance.

II GOVERNING RULES

i Main stock exchanges

As discussed in Section I, *supra*, the SHSE consists of the Main Board, while the SZSE consists of the Main Board, the SME Board and ChiNext.

Main Board (SHSE and SZSE)

The Main Board primarily attracts established blue-chip companies. The Main Board of the SHSE has traditionally attracted state-owned enterprises, while the Main Board of the SZSE focuses on private companies.

SME Board

The SME Board targets small and medium-sized enterprises with shares in circulation of under 100 million. The listing requirements for the SME Board and the Main Board are nearly identical.

ChiNext

ChiNext was established on 30 October 2009 to support small and medium-sized enterprises, especially in the high-technology sector. Although the overall listing requirements for ChiNext are lower than the ones set forth for the Main Board and the SME Board, the CSRC generally exercises greater regulatory scrutiny, such as increasing the number of members on the issuance review committee, prolonging the sponsor's supervisory period, and imposing more rigorous delisting rules.

Presently, there are only a few Chinese companies (primarily state-owned enterprises) that are dual listed in China and a foreign exchange, most likely the Hong Kong Stock Exchange, although Chinese companies are not prevented from pursuing dual listings after listing on a domestic stock exchange.

Some Chinese companies choose to list on foreign exchanges in lieu of listing on a domestic exchange, such as the Hong Kong Stock Exchange, NASDAQ and the NYSE. Among foreign-listed Chinese companies, some choose to list overseas mainly for business reasons, such as avoiding profitability threshold requirements. Others choose to list overseas owing to China's restrictions on foreign investment in certain industries. Particularly in the technology, media and telecommunications industry, due to regulatory restrictions and practice that effectively prevents foreign ownership in a Chinese operating company, some issuers adopt foreign parent entities and list abroad using the variable interest entity structure. It should be noted, however, that joint ventures involving foreign ownership in a non-restricted sector are permitted to list on China's domestic exchanges.

ii Overview of listing requirements

Presently, all listing applications are submitted to and approved by the CSRC. If an applicant engages in a business subject to regulatory oversight by specific agencies, the CSRC will require such agencies to issue a no-objection letter in respect of the applicant.

The table below sets forth the main requirements for the Main Board, SME Board and ChiNext.

IPO requirements	Main Board and SME Board	ChiNext
Issuer qualifications	A company limited by shares that is duly incorporated and validly existing in China	A company limited by shares that is duly incorporated and validly existing in China
Business records	At least three years of continuous operations or as otherwise approved by the State Council (where a limited liability company is converted into a company limited by shares through the conversion of the entire original book value of its net assets, the term 'continuous operation' may start from the date the limited liability company was established)	At least three years of continuous operations (where a limited liability company is converted into a company limited by shares through the conversion of the entire original book value of its net assets, the term 'continuous operation' may start from the date the limited liability company was established)
Profitability	(i) Annual aggregate net profit exceeding 30 million yuan in each of the past three fiscal years (Note: Net profit shall be calculated based on the lower net profit before and after deduction of non-regular profits or losses.) (ii) Aggregate net cash flow over 50 million yuan, or aggregate revenue of over 300 million yuan, in each case for the past three fiscal years and (iii) No unrecovered losses at the end of the most recent accounting period	(i) Annual aggregate net profit of not less than 10 million yuan for the past two years; (Note: Net profit shall be calculated based on the lower net profit before and after deduction of non-regular profits or losses) or (ii) Annual aggregate net profit of not less than 50 million yuan in the past year (Note: While ChiNext does not require the issuer to be profitable in each of the past three years like the Main Board and SME Board, in practice, we see few issuers who do not satisfy such threshold receiving approval from the CSRC)
Assets	Proportion of intangible assets (after deduction of land use aquaculture, mining and similar rights) at the end of the most recent accounting period in net assets ≤20%	Net assets at the end of most recent accounting period ≥20 million yuan and no uncovered losses
Capital	Pre-listing capitalisation ≥ 30 million yuan or post-listing capitalisation ≥ 50 million yuan	Post-listing capitalisation ≥ 30 million yuan
Major business	No significant changes in the past three years	Only one major business; no significant changes in the past two years
Directors and senior management	No significant changes in the past three years	No significant changes in the past two years
Actual controller	No significant changes in the past three years (Note: The definition of 'actual controller' is based on a number of legally prescribed factors that are applied to each individual case based on the facts and circumstances of such case)	No significant changes in the past two years
Internal control	Effective internal control systems in all significant respects and An unreserved internal control report issued by a certified accountant	Effective internal control systems in all significant respects, proving the issuer's operational efficiency, legality and compliance, and the accuracy of its audit report and An unreserved internal control report issued by a certified accountant

IPO requirements	Main Board and SME Board	ChiNext
Competition	The issuer's business must not compete with the business of the issuer's controlling shareholder, actual controller, or other enterprises controlled by such controlling shareholder or actual controller. (Note: The definition of 'controlling shareholder' and 'actual controller' are based on a number of legally prescribed factors that are applied to each individual case based on the facts and circumstances of such case.) (Note: While this item was officially removed in a 2015 revision of the listing rules on the condition that there is full disclosure of this item in the prospectus, in practice, the CSRC still devotes special attention to this item. Therefore, it is effectively still a listing requirement)	
Related party transactions	No unreasonable related party transactions; related party transactions must be at arm's length and must not manipulate profits (Note: While this item was officially removed in a 2015 revision of the listing rules on the condition that there is full disclosure of this item in the prospectus, in practice, the CSRC still devotes special attention to this item. Therefore, it is effectively still a listing requirement)	Related party transactions must not significantly influence the issuer's independence or be unreasonable. (Note: While this item was officially removed in a 2015 revision of the listing rules of ChiNext on the condition that there is full disclosure of this item in the prospectus, in practice, the CSRC still devotes special attention to this item. Therefore, it is effectively still a listing requirement)
Capital management	Rigorous capital management procedures; the issuer's capital is not controlled by any controlling shareholder, actual controller or other enterprises controlled by any controlling shareholder or actual controller in respect of borrowing, the use of debt as compensation, advance payments or any other similar form	Not a listing requirement, but required to be disclosed in the prospectus
Tax	Taxes paid in accordance with law; no heavy reliance on tax preferences	Not a listing requirement, but required to be disclosed in the prospectus
Debt	No major credit risk; not a party to any major contingent liability such as a guarantee, litigation or arbitration that may adversely affect the issuer's continuous operation	Not a listing requirement, but required to be disclosed in the prospectus
Use of proceeds	Definitive plan for use of IPO proceeds; generally, IPO proceeds to be used for the principal business and investment projects (Note: While this item was officially removed in a 2015 revision of the listing rules on the condition that there is full disclosure of this item in the prospectus, in practice the CSRC still devotes special attention to this item. Therefore, it is effectively still a listing requirement)	Definitive plan for use of IPO proceeds; generally, IPO proceeds to be used for the principal business but not necessarily for investment projects (Note: While this item was officially removed in a 2015 revision of the listing rules of ChiNext on the condition that there is full disclosure of this item in the prospectus, in practice the CSRC still devotes special attention to this item. Therefore, it is effectively still a listing requirement)
Legal compliance	(i) In the past three years, no unauthorised direct or indirect public offering of shares or any unauthorised practice still in existence at present and (ii) No other material non-compliance in the past three years	(i) In the past three years, no unauthorised direct or indirect public offering of shares or any unauthorised practice still in existence and (ii) In the past three years, neither the issuer, its controlling shareholder nor its actual controller have committed a materially unlawful act that harms the legitimate rights and interests of investors and the public
Other authorities' opinion	Subject to the opinions of the provincial government and the National Development and Reform Commission	None

Compared with the NYSE, NASDAQ and the Hong Kong Stock Exchange, China's stock exchanges are unique in the following respects:

a Applicant eligibility: Unlike the NYSE, NASDAQ and the Hong Kong Stock Exchange, A-shares applicants have to be companies limited by shares that are incorporated in China. Therefore, foreign issuers (such as a Hong Kong, United States or Cayman

Islands parent company) cannot be listed on Chinese exchanges. However, a joint venture incorporated in China operating in a non-restricted industry where foreign investment is permitted may list on Chinese stock exchanges.

b Financial criteria: unlike the NYSE, NASDAQ and the Hong Kong stock exchange, each financial listing threshold requires the issuer's net profits to be positive.

c Review process: the CSRC still uses an approval (rather than a registration) system that requires substantive review of all issuers. As a result, review times tend to be longer and susceptible to policy considerations.

d Board of supervisors requirement: A-shares listed companies are required to have a board of supervisors consisting of at least three members. Employee representative supervisors may not be less than one-third of the board of supervisors. Directors and senior management may not concurrently be supervisors. The purpose of the supervisor is to oversee the activities of the board of directors and the senior management.

e Competition: the CSRC devotes special attention to analysing potential competition between the issuer, on the one hand, and its controlling shareholder, actual controller or the controlling enterprises of the controlling shareholder or actual shareholder on the other. Generally speaking, mere disclosure of such potential conflicts of interests in the prospectus will be insufficient and no such competition is effectively still a listing requirement while this item was officially removed in a 2015 revision of the listing rules.

f Foreign investment restrictions: if the issuer conducts business in an industry where foreign investment is restricted or prohibited (according to law or in practice), then the issuer may not list in China. The CSRC will not accept indirectly control arrangements such as variable interest entities, unlike the NYSE, NASDAQ and the Hong Kong Stock Exchange.

g Lock-up periods: the listing rules for Chinese IPOs specifically state that the controlling shareholder or actual controller is subject to a three-year lock-up period. All other shareholders are subject to a one-year lock-up period. This differs from other jurisdictions where lock-up periods are primarily determined by the underwriters and not by the listing rules. The length of the lock-up period is also longer compared with Hong Kong, where controlling shareholders are only subject to a six-month lock-up period.

iii Overview of law and regulations

The listing requirements for the Main Board (SHSE and SZSE) are set forth in the Administrative Measures for Initial Public Offerings and Listings of Shares. The listing requirements for ChiNext are set forth in the Administrative Measures on Initial Public Offerings of and Listing of Shares on ChiNext. All listings must comply with the requirements set forth by the Company Law, the Securities Law, and other specific rules and requirements of the applicable exchange.

With respect to the CSRC's application of these rules, recently there have been the following general trends.

Accelerated review

The CSRC's review schedule accelerated, starting in the middle of November 2016. From 11 November 2016 to 6 January 2017, the CSRC has approved 108 IPOs, with a much faster pace than in previous periods.

Although the CSRC has accelerated its review process lately, the listing requirements have not been lowered. From June to September 2016, 24 applicants were denied for deteriorating business performance, which accounted for 42.86 per cent of the total number of applicants during that period. Most of the applicants who were denied were in the traditional manufacturing, oil and gas, and textiles industries.

Restructuring of Chinese companies for the purposes of a Chinese listing

Chinese companies that originally had parent companies outside of China have restructured in order to list in China. One common restructuring involves the removal of offshore entities under the variable interest entity structure.

In February 2015, the CSRC approved Baofeng's IPO application. Baofeng was a landmark case involving a variable interest entity restructuring that was approved by the CSRC. Since May 2015, several Chinese companies with variable interest entity structures, including those that are already listed on a foreign exchange such as Focus Media and Qihoo 360, have restructured with an eye towards a future listing in China.

The restructuring of variable interest entities for businesses that operate in a restricted or prohibited sector (according to law or in practice) involves the buyout of foreign shareholders who may not (as a result of such restrictions or prohibitions) hold equity stakes in the Chinese issuer. In the context of a Chinese company that is already listed on a foreign exchange, this process requires the privatisation of the present issuer.

In light of the CSRC's accelerated review schedule and its relaxation of thresholds (at least on paper), more Chinese companies with offshore structures may choose to restructure in order to list in China.

Preferences for certain applicants

On 9 September 2016, the CSRC promulgated the Opinions on the Strategy for Capital Markets to Function and Serve Disadvantaged Districts. These measures provide accelerated review for enterprises located in disadvantaged districts of the country.

The eligibility requirements are as follows:

a (1) being registered and having an operating address in a designated district and (2) having at least three years of business records and tax payments; or

b (1) being registered in a designated district; (2) paying at least 20 million yuan in income tax in the past year; and (3) committing not to change its registered address for more than three years after its IPO.

Two recent examples of successful listings involve Tibet GaoZheng Explosive Co, Ltd (less than 11 months) and Tibet Aim Pharm Inc (less than nine months). The accelerated review times are far shorter than the ones for ordinary applicants, who sometimes have to wait more than two years for a final decision.

These recent success stories have prompted more applicants to change their registered or operating addresses to eligible districts for the purposes of qualifying under the measures. However, it should be noted that these measures may be subject to discretionary interpretation by the authorities, requiring stakeholders to carefully track regulatory developments.

III THE OFFERING PROCESS

i General overview of the IPO process

Listing in China involves steps that are common in other jurisdictions (due diligence, document preparation including the prospectus), as well as steps that are unique to China (pre-listing review, conversion from a limited liability company to a company limited by shares, CSRC approval). Below is a brief overview of the IPO process in China. The time frames set forth in the chart reflect common practice. Specific time frames for individual applicants may vary from the ones set forth in the chart.

Step	Particulars	Timetable
Due diligence	The sponsor, auditors, legal advisers and other stakeholders conduct due diligence of the issuer, set IPO terms (such as the target amount to be raised), advise the issuer on the IPO process and assist the issuer in complying with IPO requirements	T-90 days*
Restructuring	The issuer is restructured into a company limited by shares (as required under law); stakeholders prepare a restructuring plan, audit and appraise the issuer's assets, and prepare sponsor agreements and the issuer's articles of association; the issuer executes the restructuring plan and establishes relevant internal departments in accordance with listing rules	T-45 days
Pre-filing review	The local counterpart of the CSRC provides the issuer with pre-listing guidance	T-15 days
Filing	The sponsor files the IPO application documents with the CSRC; once the CSRC states the application documents are complete, the CSRC decides whether to accept the filing within five business days	T
Review and Approval by the CSRC	(1) Acceptance of the application (2) Pre-disclosure (3) Feedback (4) Face-to-face meeting (5) Reply to the CSRC's feedback (6) Pre-disclosure updates (7) Preliminary review (8) Selective examination of disclosures (9) Acceptance by the issuance review committee (10) Reply by the issuance review committee (11) Seal (12) Miscellaneous (13) Approval and issuance	
Preparation by the exchange	(1) Approval from the CSRC (2) Negotiation with traders about stock abbreviation, stock code, etc. (3) Submission of documents to the relevant exchange (4) Amendment registration with the Administration for Industry and Commerce (5) Listing and trading on the relevant exchange	

Step	Particulars	Timetable
Offering	(1) Publish the prospectus (2) Offline price enquiries (3) Offline subscriptions (4) Publish online announcements, online offerings (5) Online roadshow (6) Online subscriptions (7) Payment of capital commitment (8) Capital verification (9) Lottery (10) Release of capital commitment (11) Share registration	 T'-1** T'-1 T' T'+1 T'+2 T'+3 T'+4 T'+5
Listing	(1) Publish the prospectus (2) Listing application (3) Listing review (4) Supplementary listing application (5) Approval (6) Notice (7) Announcement (8) Listing	 T"-3*** T"-3–T"+7 T"+7 T"+7–T"+14 T"+14 L-5–L-1 L

* T means the date when the CSRC accepts the IPO application. Days are calendar days.
** T' means the date of online subscriptions. Days are calendar days.
*** T"means the date that the relevant exchange accepts the listing application. L means the listing date. Days are calendar days.

ii Pitfalls and considerations

Under the current IPO process, the CSRC will conduct a thorough, substantive review of all IPO application documents. In recent years, the CSRC has raised mainly the following issues with respect to unsuccessful applicants:

a failure to satisfy qualification requirements;
b failure to satisfy profitability requirements;
c conflict of interest issues involving the controlling shareholder, actual controller or other enterprises controlled by such controlling shareholder or actual controller;
d issues involving use of proceeds;
e disclosure issues;
f corporate governance issues;
g compliance issues;
h finance and accounting issues; and
i defective reports issued by advisers. This is not an exhaustive list of reasons, and one factor may not necessarily be decisive in an application's denial. However, they serve as a useful guide for prospective issuers.

iii Considerations for foreign issuers

As stated above, an issuer must be a company limited by shares incorporated in China. Accordingly non-Chinese corporate bodies may not list on Chinese exchanges. In 2011, there were reports that the SHSE would create a board for qualified foreign issuers, while there have not been follow-up reports, specific timelines or plans in relation to such board. However, these restrictions do not prevent joint ventures with foreign ownership who do not operate in a restricted or prohibited industry from listing in China.

IV POST-IPO REQUIREMENTS

Listed companies in China are subject to continuous disclosure requirements, including regular and *ad hoc* reporting. Generally, regular reporting includes the annual report, biannual report and quarterly reports. *Ad hoc* reporting is required when listed companies encounter significant events or shareholding changes (e.g., over 5 per cent shareholding, change in shareholding of directors or senior management). Tender offer rules also apply for shareholders who acquire more than 30 per cent of the issuer's shareholding after listing.

V OUTLOOK AND CONCLUSION

The wheels are in motion for China's IPO system to gradually transition away from an approval-based system and towards a registration-based system. This transition, coupled with more relaxed thresholds, will permit more new-age enterprises to tap China's capital market. These developments are in line with China's gradual transition away from traditional manufacturing towards high-technology enterprises such as the internet, media, telecommunications, entertainment, biomedicine and biotechnology, clean technology and advanced equipment. At the same time, heightened transparency requirements, more sophisticated supervision and improved quality of listed companies will better protect investors and give them more confidence in China's capital markets.

Appendix 1

ABOUT THE AUTHORS

CHEN YANG

Han Kun Law Offices

Ms Chen's practice focuses on mergers and acquisitions, capital markets transactions and venture capital and private equity. She has helped clients design company structures, conducted due diligence investigations and drafted related legal documents. Ms Chen has represented many Chinese and international companies in a wide variety of cross-border transactions in different industries such as real estate, the internet, information technology, energy, education and entertainment.

ZHI BIN

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Mr Zhi specialises in domestic and offshore listings, restructuring and reorganisation, mergers and acquisitions, venture capital and private equity and foreign investment. He is knowledgeable about the PRC industry policies and experienced in capital operation, financial planning, and investment and project management. The clients represented by Mr Zhi include large-scale state-owned enterprises and state-owned commercial banks, multinational corporations, and leading fast-growing enterprises. His practice covers a wide range of industrial sectors such as banking, insurance, infrastructure construction, mining, energy, healthcare, biotechnology and pharmaceuticals.

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