Key Policies Driving U.S.-Listed Chinese Companies' Renewed Interest in Mainland China and Hong Kong Financial Markets

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Bing Xue and Yang Chen of Han Kun Law Offices examine why Chinese companies are heading home to list on the A-share market or HKEX and discuss key listing requirements and conditions for red-chip enterprises listing on the STAR Market and HKEX Main Board including the vetting process.

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1. Background

U.S.-listed Chinese companies are increasingly looking toward Hong Kong and mainland China for secondary listings or to relist entirely. This new wave of Chinese capital moving to home markets is partly the result of U.S. government policy actions, both taken and proposed, which have diminished the attractiveness of U.S. capital markets. For example, the U.S. Senate in May 2020 passed the *Holding Foreign Companies Accountable Act* (S.945), which would prohibit the securities of a foreign issuer from being traded on U.S. markets where the issuer fails to satisfy, for three consecutive years, the inspection requirements of the U.S. Public Company Accounting Oversight Board.

Another factor at play is certain accommodative regulatory policies adopted in Hong Kong and mainland China, particularly those targeting new economy unicorns with so-called "red-chip" structures. In March 2018, the China Securities Regulatory Commission (CSRC) introduced new policies allowing red-chip enterprises that meet specific requirements to issue China depository receipts (CDRs, which is a concept similar to the American Depositary Receipt (ADR), allowing eligible non-Chinese companies to indirectly issue securities in China) or to issue shares for listing on the A-share market. The introduction of CDRs is a giant step for the further internationalization of Chinese securities markets, which have also explored "shortcuts" for Chinese red-chip companies to return to the A-share market without the traditional, complex requirements of delisting and removing red-chip structures. In April 2018, the Hong Kong Stock Exchange (HKEX) enacted noteworthy reforms, one of which was to allow the listing of companies with weighted voting rights, an approach that has opened doors for many overseas listed Chinese companies and those planning to go public.

Multiple Approaches for Homecoming

There are four traditional approaches for U.S.-listed Chinese companies to return to home markets in mainland China or Hong Kong:

(1) maintain the U.S. listing status of the Chinese company and have the U.S.-listed company apply as the issuer for an A-share or HKEX listing;

(2) maintain the U.S. listing status of the Chinese company and apply for A-share or HKEX listing through a spin-off;

(3) delist from the U.S. market and remove the red-chip structure, relist on the A-share market; and

(4) delist from the U.S. market, maintain the red-chip structure, relist on the A-share market or HKEX.

In analyzing the choice of listing between the A-share market and Hong Kong, the focus will be on the fourth approach mentioned above because the registration-based A-share listing system allows overseas enterprises to maintain their red-chip structures when applying for listing in China.

> Under current listing rules, the STAR Market sets higher standards and more stringent requirements in terms of financial thresholds and compliance compared to those for HKEX listing

2. Shanghai vs Hong Kong

Traditionally, the market valuations of listed companies in the same industry are relatively higher on the A-share market than in Hong Kong, which is advantageous for realizing enterprise value and financing.

For the STAR Market, the following issues are noted for reference:

(1) Stringent Listing Criteria

Under current listing rules, the STAR Market sets higher standards and more stringent requirements in terms of financial thresholds and compliance compared to those for HKEX listing, which will be addressed below.

(2) Restrictions on Red-chip Structures

The STAR Market has greenlighted the listing of China Resources Microelectronics Limited (688396.SH) and Semiconductor Manufacturing International Corporation (688981.SH), despite both companies being foreign-registered companies with red-chip structures that had direct shareholding structures at the time of listing. The first CDR listing application with a typical variable-interest entity (VIE) structure, Segway-Ninebot, is still undergoing CSRC review. Pending the CDR listing approval of Segway-Ninebot, uncertainties remain regarding the listing of VIE-structured companies on the A-share market.

(3) Foreign Exchange Controls

Under China's foreign exchange control regime, authorities adopt the principle of case-by-case review for matters relating to a red-chip enterprise's use of foreign exchange from the sale of current shares. Prior to applying for a domestic listing, a previously unlisted red-chip enterprise is required to formulate a scheme for submission to the CSRC relating to the use of foreign exchange derived from the sale of current shares and other related matters. The CSRC will then seek opinions from the relevant competent authorities for the scheme. Foreign exchange controls bring uncertainty to the free disposition of shares of red-chip enterprises.

> The lock-up period for the STAR Market is longer than that of HKEX

(4) Lock-up Period

The lock-up period for the STAR Market is longer than that of HKEX. For the STAR Market, a 36-month lock-up period generally applies to controlling shareholders and *de facto* controlling shareholders, while other shareholders are generally subject to a 12-month lock-up period. For HKEX, the lock-up period is significantly shorter, generally six months, while there are also certain restrictions as to controlling shareholders.

3. Comparing Listing Criteria between Shanghai and Hong Kong

For comparison purposes, the following notes on key listing requirements and conditions for red-chip enterprises listing on the STAR Market and HKEX Main Board are provided. The conditions and requirements for the Hong Kong Main Board listings in the table below refer to those applicable to listing applications made pursuant to Chapter 8 of the Hong Kong Main Board Listing Rules.

Item	STAR Market	HKEX Main Board
Financial test	Fulfill at least one of the following financial and market capitalization eligibility requirements: Ø **Test 1: Market value and dominant position** ▪ Market value: estimated market value of no less than Rmb10 billion ▪ Dominant position: rapid increase in operating income, independent research and development, internationally leading technology, and in a relatively dominant position in the industry Ø **Test 2: Market Value + Revenue + Dominance** ▪ Market value: estimated market value shall be no less than Rmb5 billion. ▪ Revenue: operating income in the latest year shall not be less than Rmb500 million ▪ Dominant position: rapid increase in operating income, independent research and development, internationally leading technology, and in a relatively dominant position in the industry Ø **Test 3: Valuation + Revenue** ▪ Valuation: Rmb20 billion ▪ Revenue: operating income in the latest year is not less than Rmb3 billion	Compliance with one of the following three financial tests: (Note: these tests each contains common requirements which are separately cited below) Ø **Test 1: Profit test** ▪ Profit attributable to shareholders: at least HK$20 million in the last fiscal year; and at least HK$30 million accumulated in the last two fiscal years ▪ Market value: at least HK$500 million at the time of listing Ø **Test 2: Market capitalization/revenue/cash flow test** ▪ Market Value: at least HK$2 billion at the time of listing ▪ Revenue: at least HK$500 million in the latest audited fiscal year ▪ Cash flow: cash inflow from operating business for the previous three accounting years in total is not less than HK$100 million Ø **Test 3: Market capitalization/revenue test** ▪ Market capitalization: at least HK$4 billion at the time of listing ▪ Revenue: at least HK$500 million in the latest audited accounting year

Track Record	Continuing operations for more than three years	Trading record of not less than three fiscal years
Waiver regarding Financial Tests or Track Records	——	Ø Under the market capitalization/revenue test, HKEX will accept the admission of new applicants with a shorter trading record period under substantially the same management as required under the rule 8.05(3) (a) and (b) if the new applicant is able to demonstrate that: ▪ the directors and management have sufficient (at least three years) and satisfactory experience in the business and industry described by the new applicant; and ▪ the management shall remain roughly unchanged in the latest audited fiscal year. Ø HKEX may accept a shorter operating record and /or amend or waive profitability or other financial indicator requirements in the following circumstances: ▪ mining companies; or ▪ newly established project company.
Controlling Continuity	There is no change in controlling shareholders for the last two years. There is no significant dispute that could result in a change of the controlling shareholder.	At least one complete accounting year must remain unchanged prior to listing.
Management Continuity	There must not be any significant adverse change in directors and senior managers during the past two years, and there must not be any significant adverse change in core technical personnel for the last two years.	More than half of the management (including executive directors and senior managers of the listed company) must remain unchanged for at least three accounting years (i.e. during the performance period) before listing.
Industry and Business	Focusing on supporting high-tech and strategic emerging industries in the areas of the new generation of information technology, high-end equipment, new materials and new energy, energy conservation, environment protection, and biomedicine. Promoting the deep integration of internet, big data, cloud computing, artificial intelligence and manufacturing.	It must be the issuer and business that the HKEX considers suitable for listing. If all or most of the assets of the issuer or its group (except investment companies and securities brokerage companies) are cash or short-term securities, it will not be considered as suitable for listing.

Share Capital	The total share capital after issuance shall not be less than 30 million shares.	——
Listing Method	Initial public offering and listing: public offering of shares to the public (including offering to online investors and allotment to off-line investors)	Public offering of new shares, selling shareholders selling old shares, allotting shares to designated persons (institutional investors and professional investors), listing by introduction; if the public may have significant demand for the securities to be listed, the HKEX may not approve the listing of the company by way of pure allotment
Public Float	Minimum 25% of the issuer's total issued share capital at the time of listing; minimum 10% if the total issued share capital exceeds Rmb400 million	In general, the public shareholding rate is required to reach 25%; if one class of the company's shares has been listed on other regulated markets, the total public shareholding rate must be at least 25%, while the public holding rate of the class of shares listed in Hong Kong must be at least 15%, and its market value must not be less than HK$125 million; if the issuer's market value is more than HK$10 billion, the public shareholding rate may be accepted as between 15% and 25%.
Qualifications	The directors, supervisors and senior managers have not been subject to administrative punishment by the CSRC in the past three years, and there is no case that the directors, supervisors and senior managers have been put on file for investigation by the judicial authority for suspected crimes or the CSRC for investigation on suspicion (without affirmative conclusion) of violation of laws or regulations.	Directors should have suitable character, experience and integrity and be able to demonstrate a standard of competence commensurate with their position as supervisors.
Financial Tests Requirements for Enterprises with Weighted Voting Rights Arrangement	The financial tests requirements are the same with those of red-chip enterprises.	The issuer must prove to the HKEX that it is qualified and suitable for listing with weighted voting rights structure. In addition, it must meet the mandate requirements on market value: the expected market value should be at least HK$40 billion; or the expected market value should be at least HK$10 billion; and the revenue in the latest accounting year should be at least HK$1 billion.

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4. Key Issues in the Vetting Process

1) STAR Market

a) Ownership Transparency

The STAR Market requires that an applicant's controlling shareholder and other shareholders, which it controls, to have fully paid in their share capital and for their ownership structures to be clear. This includes no changes to the applicant's controlling shareholder in the past two years and no significant dispute that could result in a change of the controlling shareholder.

The STAR Market will usually pay attention to whether share capital ownership is clear and whether there exist contractual arrangements that may adversely affect the clarity of share capital, such as nominee and entrusted shareholding. If such arrangements exist, the STAR Market may require rectification, especially where the controlling and *de facto* controlling shareholders hold equity through nominees or entrustment. In addition, the STAR Market will also focus on go-private transaction processes of overseas listed Chinese companies and whether issues affecting ownership transparency exist, such as ownership disputes or other matters.

b) Compliance

The STAR Market will review the compliance of red-chip structured enterprises applying for listing on the STAR Market from the following aspects: (1) whether the listing applicant needs to meet requirements in the past three years, the issuers (including important subsidiaries) and their controlling shareholders and *de facto* controlling shareholders have not committed major illegal acts in various regulatory aspects; (2) for red-chip enterprises, the STAR Market will also focus on the legal requirements of the place of registration of the red-chip enterprises to confirm whether they need to obtain any approval or filing for listing on the STAR Market; and (3) as for privately-held Chinese companies, the STAR Market will further review whether the go-private process conforms to the requirements of the laws and regulations of the United States, China, and other applicable laws and regulations, and whether the company has been punished or investigated by the U.S. securities regulatory authorities.

c) Equity Incentives for Chinese Employees

The STAR Market usually focuses on the following issues: (1) during the go-private process, whether employee incentive plans were handled properly in accordance with Chinese laws and regulations; and (2) whether employee equity incentive plans are implemented through entrusted shareholding. As mentioned above, it remains uncertain whether the STAR Market will accept entrusted shareholding arrangements. The employee incentive structure may be subject to adjustment during the re-listing process.

d) Horizontal Competition

The STAR Market usually considers the issue of horizontal competition of the issuer. It is necessary for there to be no horizontal competition, which could have a significant adverse effect on the issuer between the issuer and the controlling shareholder, *de facto* controlling shareholder, or other enterprises controlled by the *de facto* controlling shareholder. For this purpose, a significant adverse effect is presumed to exist in principle where a competitor's similar revenue or gross profit accounts for more than 30% of the issuer's principal business revenue or gross profit.

e) VIE Structure

Due to foreign investment restrictions, some overseas-listed Chinese companies (and their subsidiaries) cannot directly hold equity interests in their domestic operating entities. VIE structures are widely adopted to circumvent foreign investment restriction-related issues. On April 30, 2020, the CSRC issued the *Announcement on Arrangements Relevant to the Domestic Listing of Innovative Pilot Red-Chip Enterprises* (关于创新试点红筹企业在境内上市相关安排的公告), which specifies that "if a red-chip enterprise with a VIE structure applies to issue shares, the CSRC will seek opinions from State Council's department in charge of the industry in which the red-chip enterprise's domestic entity actually carries on business as well as the National Development and Reform Commission and the Ministry of Commerce, and review the application in accordance with laws and regulations."

So far, there has been no precedent for VIE-structured red-chip enterprises to directly issue shares and successfully list on the STAR Market (to date, the first CDR application has yet to be approved for listing). There is uncertainty as to VIE-structured Chinese companies listing on the STAR Market. It is recommended that companies with VIE structures consult with the competent governmental authorities in advance and determine their listing plans based on full consideration of such guidance.

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2) Hong Kong Main Board

a) Shareholders

As opposed to A-share listings, HKEX accepts trust, proxy and nominee arrangements of the shareholders for listing on the HKEX Main Board.

b) Share Incentive Schemes

Main Board listing applicants may adopt pre-IPO and post-IPO share incentive schemes. Post-IPO share option schemes need to comply with Chapter 17 of the Hong Kong Main Board Listing Rules.

c) Non-compliance

HKEX expects new applicants to have implemented enhanced internal control measures to prevent the recurrence of material non-compliance issues, and also to disclose, among others, the rectification measures in their prospectuses.

d) Competing Business

According to the HKEX Guidance Letter (HKEX-GL100-19), if the new applicant's business competes or is likely to compete, directly or indirectly, with those of the controlling shareholder group, there will be conflict of interest between the parties. The greater the possibility of actual or potential conflicts of interest, the greater the need for enhanced conflicts of interest management measures to ensure management independence. Non-competition undertakings are not mandatory, but may be helpful to ensure continued delineation of the controlling shareholder group from the competing business or limit the extent of competition between the new applicant and the controlling shareholder group after the listing and it is one way to address potential conflict of interest between the controlling shareholder group and the new applicant (see HKEX IPO Vetting Team, 'HKEX Guidance Letter).'

HKEX will deem an applicant to have a conflict of interest with its controlling shareholder where the applicant competes or is likely to compete with an entity within the controlling shareholder's group. Where such a competitive relationship exists, HKEX cites the need for greater interest conflict control measures and recommends, but does not require, non-competition undertakings between the applicant and its controlling shareholder.

e) VIE Structure

According to HKEX Listing Decision (HKEX-LD43-3), all listing applicants without exception must narrowly tailor their VIE structures regardless of materiality of the business, in terms of revenue or profit or otherwise, to the listing applicant. This means that VIE structures may only be used to the extent necessary to address any limits on foreign ownership, except where: (i) additional eligibility standards are imposed; and (ii) where the approving regulatory authority confirms that it will not or cannot give approval even if the listing applicant fulfilled the additional eligibility standards, due to lack of procedures or guidance for granting the approval, or for policy reasons (see HKEX, 'HKEX Listing Decision').

HKEX generally requires all listing applicants to limit the use of VIE structures only to the extent required based on foreign ownership restrictions. Certain other exceptions to the use of VIE structures may apply, such as where the structure is necessary for control based on other requirements and it is confirmed the approval authority in China would not grant approval based on equity ownership.

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