THE Initial Public Offerings Law Review

Second Edition

Editor
David J Goldschmidt

THE LAWREVIEWS

THE INITIAL PUBLIC OFFERINGS LAW REVIEW

SECOND EDITION

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PREFACE

Welcome to the second edition of *The Initial Public Offerings Law Review*. This publication introduces the reader to the main stock exchanges around the globe and their related IPO regulatory environments, and provides insight into the legal and procedural IPO landscapes in 21 different jurisdictions. Each chapter gives a general overview of the IPO process in the region, addresses regulatory and exchange requirements, and presents key offering considerations.

The global IPO landscape is ever-changing. While several of the oldest stock exchanges, such as the New York Stock Exchange and London Stock Exchange, are still at the forefront of the global IPO market, the world's major stock exchanges now are scattered around the globe and many are now publicly traded companies themselves. IPOs take place in nearly every corner of the world and involve a wide variety of companies in terms of size, industry and geography. 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.

Virtually all markets around the globe have experienced significant volatility in recent years; however, 2017 marked a resurgence for many IPO markets. The number of 2017 IPOs and total proceeds raised were led by the Asia-Pacific exchanges, with many other regions also experiencing improvement over recent years. Despite the increase in available private capital, which has enabled issuers to remain private for longer periods of time, there is continued optimism for 2018 in terms of both global deal count and proceeds. The strong global IPO pipeline includes many well-known companies across a range of industries, and it is anticipated that these companies will seek to list on a variety of stock exchanges around the world.

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, it is important that the company and its management are aware from the outset of the legal requirements as well as potential pitfalls that may impact the offering. Moreover, once a company is public, there are ongoing jurisdiction-specific disclosure and other requirements with which it must comply. This second edition of *The Initial Public Offerings Law Review* introduces the intricacies of taking a company public in these jurisdictions and serves as a guide for issuers and their directors and management.

David J Goldschmidt
Skadden, Arps, Slate, Meagher & Flom LLP
New York
March 2018

Chapter 2

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.

This chapter focuses on A-shares listings. For the purposes of this chapter, 'China' excludes Hong Kong, Macau and the Taiwan region.

According to the 2016 Annual Report of the China Securities Regulatory Commission (CSRC), at the end of 2016, 1,660 companies were listed on the Main Board of the SHSE and the SZSE, 882 companies were listed on the SME Board and 570 companies were listed on ChiNext. The total market capitalisation of these listed companies was 39.34 trillion yuan, which was 68.23 per cent of China's total 2016 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, though waiting periods began to shorten in 2017.

II GOVERNING RULES

i Main stock exchanges

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

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

Main Board (SHSE and SZSE)

The Main Board of the SHSE primarily attracts established blue-chip companies such as state-owned enterprises. Recently, however, the Main Board of the SHSE has attracted private companies from industries other than traditional state-owned blue-chip 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) that are dual listed in China and an overseas exchange (usually the Hong Kong Stock Exchange). Chinese companies are not prevented from pursuing dual listings after listing on a domestic stock exchange, though this would require approval from the CSRC.

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 sectors, due to regulatory restrictions and practice that effectively prevents controlling 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.

<table>
<tr><th>IPO requirements</th><th>Main Board and SME Board</th><th>ChiNext</th></tr>
<tr><td>Issuer qualifications</td><td>A company limited by shares that is duly incorporated and validly existing in China.</td><td>A company limited by shares that is duly incorporated and validly existing in China.</td></tr>
<tr><td>Business records</td><td>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).</td><td>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).</td></tr>
<tr><td>Profitability</td><td>• 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);
• 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
• no unrecovered losses at the end of the most recent accounting period.</td><td>• 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
• annual aggregate net profit of not less than 50 million yuan in the past year.</td></tr>
<tr><td>Assets</td><td>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 per cent.</td><td>Net assets at the end of most recent accounting period ≥20 million yuan and no uncovered losses.</td></tr>
<tr><td>Capital</td><td>Pre-listing capitalisation ≥30 million yuan; or post-listing capitalisation ≥50 million yuan.</td><td>Post-listing capitalisation ≥30 million yuan.</td></tr>
<tr><td>Major business</td><td>No significant changes in the past three years.</td><td>Only one major business; no significant changes in the past two years.</td></tr>
<tr><td>Directors and senior management</td><td>No significant changes in the past three years.</td><td>No significant changes in the past two years.</td></tr>
<tr><td>Actual controller</td><td>No change in the past three years (note: the definition of 'actual controller' is based on several legally prescribed factors that are applied to each individual case based on the facts and circumstances of such case).</td><td>No change in the past two years.</td></tr>
<tr><td>Internal control</td><td>• Effective internal control systems in all significant respects; and
• an unreserved internal control report issued by a certified accountant</td><td>• 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</td></tr>
<tr><td>Competition</td><td colspan="2">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. The definition of 'controlling shareholder' and 'actual controller' are based on several legally prescribed factors that are applied to each individual case based on the facts and circumstances of such case.

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.</td></tr>
<tr><td>Related party transactions</td><td>No unreasonable related party transactions; related party transactions must be at arm's length and must not manipulate profits.</td><td>Related party transactions must not significantly influence the issuer's independence or be unreasonable.</td></tr>
<tr><td>Fund management</td><td>Rigorous fund-management procedures; the issuer's fund 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.</td><td>Not a listing requirement, but required to be disclosed in the prospectus.</td></tr>
<tr><td>Tax</td><td>Taxes paid in accordance with law; no heavy reliance on tax preferences.</td><td>Not a listing requirement, but required to be disclosed in the prospectus.</td></tr>
</table>

IPO requirements	Main Board and SME Board	ChiNext
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 will 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 will 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	• In the past 36 months, no unauthorised direct or indirect public offering of shares or if any of the above illegal practices are still currently in existence; and • no other material non-compliance in the past 36 months.	• In the past three years no unauthorised direct or indirect public offering of shares or if any of the above illegal practices are still currently in existence; and • 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.	None.

Compared with the NYSE, Nasdaq and the Hong Kong Stock Exchange, Chinese 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 Hong Kong, United States or Cayman Islands parent companies) cannot be listed on Chinese stock 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 enterprises controlled by the controlling shareholder or actual shareholder on the other. Generally speaking, mere disclosure of such potential competition in the prospectus will be insufficient and the absence of such competition is effectively still a listing requirement, even though this item was officially removed in the 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 indirect control arrangements such as variable interest entities, unlike the NYSE, Nasdaq and 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 generally 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 regard to the CSRC's application of these rules, there have been the following general trends.

Accelerated review

The CSRC's review schedule accelerated, starting in the middle of November 2016. In 2017, the CSRC's issuance examination committee reviewed 488 IPO applications, a much faster pace than in previous periods.

Reduced success rate of applications

Although the CSRC has accelerated its review of prospective applications, its recent practice of only selecting high-quality applicants that meet its listing standards has reduced the overall success rate of applications.

In 2016, the CSRC's issuance examination committee reviewed 266 applications, of which 241 were successful, resulting in a pass rate of 90.6 per cent. However, in 2017, the CSRC's issuance examination committee reviewed 488 applications (83 per cent more than the previous year), of which 380 were successful, resulting in a pass rate of 77.87 per cent. In particular, from 17 October 2017 (the date when the new issuance examination committee took office) to 28 December 2017, the pass rate for IPO applications was at just 57.78 per cent, significantly lower than before.[2] On 7 November 2017, the CSRC's issuance examination committee denied five out of six applications. On 28 November 2017, the CSRC's issuance examination committee denied all three applications.

2 Prior to 17 October 2017, the issuance examination committee consisted of two different committees, one for the Main Board and the SME Board, and one for ChiNext. From 17 October 2017 onwards, these two committees were combined into one committee.

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 in what was regarded as a landmark case, involving a variable interest entity restructuring. Since May 2015, several Chinese companies with variable interest entity structures that were formerly listed abroad have privatised and restructured for onshore re-listings through an IPO or reverse merger. In December 2017, the CSRC's mergers and acquisitions examination committee conditionally agreed to Qihoo 360's reverse merger listing on the Main Board of the SHSE. Qihoo 360's reverse merger listing was valued at over 50 billion yuan (US$7.57 billion).

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 China-based 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 generally high valuations, some 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) having paid 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.

Jiyou New Material Co, Ltd (182 days),[3] Tibet GaoZheng Explosive Co Ltd (less than 11 months) and Tibet Aim Pharm Inc (less than nine months) are three recent examples of successful listings of issuers who received accelerated review due to their location in disadvantaged districts. This accelerated review period is much shorter than the ones for ordinary applicants, who sometimes have to wait for two years or more for a final decision.

These recent success stories have prompted a few potential 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 shareholders to carefully track regulatory developments. On 29 December 2017, the CSRC responded to the Proposal on the Extension of the CSRC's IPO Preference to Disadvantaged Districts that such preferences for applicants

3 Review period calculations in this section start on the date the issuance examination committee accepts the application and end on the date the issuance examination committee approves the application.

from the disadvantaged districts will be extended to 2025, and the Opinions on the Strategy for Capital Markets to Function and Serve Disadvantaged Districts will remain effective for a certain period.

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, the 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 conducts pre-listing guidance work.	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	• Acceptance of the application • Pre-disclosure • Feedback • Face-to-face meeting • Reply to the CSRC's feedback • Pre-disclosure updates • Preliminary review • Select examination of disclosures (if any) • Attend the issuance examination committee meeting • Reply to the issuance examination committee's questions or requirements (if any) • Sealing of IPO application-related documents • Post-meeting review by the issuance examination committee • Obtain official approval and issuance	
Preparation by the exchange	• Approval from the CSRC • Negotiation with traders about stock abbreviation, stock code, etc. • Submission of documents to the relevant exchange • Amendment registration with the Administration for Industry and Commerce • Listing and trading on the relevant exchange	
Offering**	• Publish the prospectus • Offline price enquiries • Offline subscriptions • Publish online announcements, online offerings • Online subscriptions • Frozen of capital commitment • Capital verification • Lottery • Release of capital commitment • Share registration	 T'-1*** T' T' T'+1 T'+2 T'+3 T'+4

Step	Particulars	Timetable
Listing******	• Publish the prospectus • Listing application • Listing review • Supplementary listing application • Approval • Notice • Announcement • Listing	 T”-1***** T”-1-T”+6 T”+6 T”+6-T”+10 T”+10 L-5-L-1 L

* T refers to the date when the CSRC accepts the IPO application. Days are calendar days.
** There is some difference between the specific time frames of the SZSE and SHSE, and this part sets forth the common practice for the SZSE as an example.
*** T’ refers to the date of online subscriptions. Days are calendar days.
**** There is some difference between the specific time frames of the SZSE and SHSE, and this part sets forth the common practice for the SZSE as an example.
***** T” refers to 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 sustainable profitability requirements;
c competition involving the controlling shareholder, actual controller or other enterprises controlled by such controlling shareholder or actual controller;
d use of proceeds-related issues;
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 stock 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 most significant change in China's domestic IPO market in 2017 was the lower success rates of applicants. We have noticed recently that the CSRC does not merely focus on an applicant's financial performance and sustainable profitability, but also will pay more attention to its internal controls and the transparency, authenticity and accuracy of its disclosures. This transition will play an important role in diversifying the types of companies listed on Chinese stock exchanges, improving the quality of listed companies, and better protecting investors, which will increase confidence in China's capital markets.

Appendix 1

ABOUT THE AUTHORS

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Ms Chen's practice focuses on capital markets, mergers and acquisitions and venture capital and private equity. She has helped clients establish company structures, conduct due diligence investigations and draft related legal documents. Ms Chen has represented many Chinese and international clients in a wide variety of cross-border transactions in different industries such as TMT, education, real estate and energy.

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Mr Zhi specialises in Chinese and non-Chinese listings, restructuring and reorganisation, mergers and acquisitions, venture capital and private equity and foreign direct investment. He applies his knowledge of and experience with Chinese industry policy to assist clients in capital operations, financial planning, investment and project management. His clients include large state-owned enterprises and commercial banks, multinational corporations, and leading high-growth 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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