Top Tips for Doing Capital Markets Deals (China)

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A Practice Note setting out top tips from local counsel for doing capital markets deals in China. It highlights issues of which lawyers from outside China should be aware when doing capital markets work in China. This Note mainly focuses on equity transactions.

China (PRC) is the world's second largest economy. Securities exchanges in China are among the largest in the world both by total market capitalisation and by initial public offering (IPO) activities. Although these exchanges mainly cater to domestic issuers and investors, many China-based companies also actively access international capital markets, attracting global investors. Therefore, capital markets lawyers from outside China may often find themselves involved in capital markets deals in China or involving China-based companies.

The best advice for foreign lawyers varies depending on the type of transaction or the industry sector of the deal. This Note aims to outline top tips that may apply to equity transactions in China, although some information may apply to capital markets transactions generally (including debt transactions).

The main laws governing capital markets activities in China are:

- The *Company Law of the PRC 2018* (2018 Company Law), which was recently amended in 2023 with the revised version to take effect from 1 July 2024 (see Legal Update, NPC Standing Committee Amends Company Law).
- The *Securities Law of the PRC 2019* (2019 Securities Law).

In addition, foreign investment laws and regulations are important in cross-border transactions.

The primary securities regulator in China is the China Securities Regulatory Commission (CSRC).

The main equity markets in China are:

- The Shanghai Stock Exchange, including the Main Board and the Sci-Tech Innovation Board (STAR Market) (which mainly supports high-tech and strategic emerging industries).
- The Shenzhen Stock Exchange, including the Main Board and ChiNext (which mainly supports growing innovative and entrepreneurial companies).
- The Beijing Stock Exchange, which supports innovative small and medium-sized enterprises.

Notes on Scope and Glossary

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China and PRC

The geographic scope of China varies depending on the context where the term is used. While Hong Kong, Macau, and Taiwan are considered to be part of China for political purposes, each has a separate legal system governing its commercial activities. Accordingly, it is customary to clarify in cross-border transactional documents involving China that references to China exclude these three territories. Hong Kong and Macau are special administrative regions of China. In particular, Hong Kong (as a British colony until 1997) is an international financial center governed by corporate and financial laws that are more similar to those of the UK than of mainland China. For example, Hong Kong has its own currency (the Hong Kong dollar) that is not subject to the currency exchange regulation applicable to mainland China's official currency, the renminbi (RMB). Also, the requirements and processes for securities listings in Hong Kong and mainland China are significantly different. Importantly, many provisions of PRC laws and regulations, particularly those related to corporate finance, treat Hong Kong as if it were a foreign jurisdiction.

Therefore, capital markets professionals generally regard mainland China and Hong Kong as two distinct jurisdictions. Contracts, prospectuses, and other legal documents often specifically define China or the PRC to mean mainland China only, with the following or similar wording:

> "'China' or the 'PRC' means the People's Republic of China, excluding, for the purposes of this [prospectus/agreement/OTHER DOCUMENT] only, Hong Kong, Macau and Taiwan."

In this Note, the terms China and the PRC are used interchangeably to mean mainland China only, unless the context suggests otherwise.

China-Based Companies

Chinese companies (or more accurately, China-based companies) can generally be divided into two types according to where the company group's holding entity (that is, the entity whose shares are to be sold to investors and listed on a securities exchange) is incorporated or organised.

Domestic Companies

When a company's holding entity is a PRC domestic company, it generally does not aim to seek listings outside China (except in Hong Kong) or attract foreign investors in domestic public equity markets, partly due to the complexity associated with foreign investments in PRC companies. Almost all companies listed on PRC domestic securities exchanges are domestic companies.

PRC domestic companies can list the following types of shares depending on the listing venue and trading currency:

- **A-shares.** A-shares are domestically listed shares traded in RMB. They represent the vast majority of the PRC domestic public equity market. Companies listing A-shares generally must be domestically registered companies limited by shares. However, a red-chip company (see Red-Chip Companies for its definition) may be eligible for listing in the A-share market if it meets certain elevated financial standards.

- **B-shares.** B-shares are domestically listed shares traded in a foreign currency. The trading volume of B-shares is much smaller than that of A-shares.

- **H-shares.** H-shares are shares of a domestic company listed on the Hong Kong Stock Exchange.

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Red-Chip Companies

If a company intends to rely on foreign investments (such as venture capital financing by foreign funds) or seek a listing on a foreign securities exchange, it typically establishes its holding entity in an offshore jurisdiction, most commonly the Cayman Islands or the British Virgin Islands. A company that is incorporated overseas but primarily operates in China is known as a **red-chip** company. (This term originally referred to companies listed in Hong Kong with this type of structure, but it has since been used more generically to include any China-based company with an offshore holding entity.) For a red-chip company, the offshore holding entity primarily serves as a financing vehicle only. Business operations in China are typically conducted by PRC entities owned or controlled by the holding entity.

Top Tips for Foreign Lawyers

Foreign Investment Is Subject to Certain Restrictions

The new *Foreign Investment Law of the PRC 2019* (2019 Foreign Investment Law, with effect from 1 January 2020) simplified China's foreign investment regime and loosened restrictions on foreign investment. However, foreign investment in PRC companies is still subject to greater scrutiny than domestic investment, particularly in certain sectors.

Restrictions by Industry Sector

The degree of restrictions on foreign investment depends on whether the invested company operates in an industry sector that is prohibited or restricted under the *Special Administrative Measures for Market Access of Foreign Investment (Negative List) (2021 Version)* (2021 Foreign Investment Negative List). If an industry sector is not included in the 2021 Foreign Investment Negative List, foreign investment gets "national treatment," meaning that the same market access rules apply to domestic and foreign investments.

The 2021 Foreign Investment Negative List contains 31 sector-specific restrictive or prohibited administrative measures. Foreign investment is prohibited outright for some sectors, including, among other things:

- Exploration, mining, and processing of rare-earth elements, radioactive minerals, and tungsten.
- Wholesale and retail of tabaco products.
- Compulsory education and religious education.
- Postal companies and domestic express letter delivery businesses.
- News, publishing, media broadcast, and other culture-related businesses.

For other sectors, foreign investment must be made with a domestic joint venture partner, subject to certain limitations (for example, foreign investment not having a controlling interest or not exceeding a specific percentage cap).

For more information on the 2021 Foreign Investment Negative List, see Article, China issues 2021 nationwide and FTZ negative lists.

Implications for Red-Chip Companies

The restrictions described above only apply to foreign investment in PRC domestic companies. Foreign investors can freely invest in the offshore holding entity of a red-chip company. This is the primary reason for a company to use the red-chip structure.

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On the other hand, because the offshore holding entity is a non-PRC entity, its ownership of PRC operating companies is also considered foreign investment, regardless of who ultimately owns the offshore holding entity. That is, even if the offshore holding entity is controlled or wholly owned by PRC citizens, it is still regarded as foreign investment. This means red-chip companies are subject to China's foreign investment restrictions like all other foreign companies. Additionally, the red-chip structure may trigger the concern of roundtrip investment (see Practice Note, China's Unified Foreign Investment Law: Impact on Transactions: Roundtrip Investment).

VIE Structure: A Controversial Solution

Since around 2000, many red-chip companies have been using variable interest entity (VIE) structures to circumvent foreign investment restrictions. The key feature of a VIE structure is that the foreign investor (which is the offshore holding entity in the case of a red-chip company) relies on contractual arrangements rather than direct equity investment to acquire and control the operating company in China. It exploits a loophole in PRC foreign investment law, which regulates direct equity investment but does not expressly regulate contractual control arrangements.

VIE structures are controversial. Their legitimacy under PRC law has always been in doubt. Due to the various inherent risks associated with VIE structures, they are also viewed with skepticism by foreign regulators (such as the US Securities and Exchange Commission; see Practice Note, Recent Policy Changes Affecting China-Based Issuers).

For more information on the use of VIE structures in China, see Practice Note, Variable Interest Entity (VIE) Structures in China.

Direct Foreign Investment Requires Foreign Exchange Registration

In addition to restrictions on foreign investment, China also imposes strict control on foreign exchange. All activities relating to payments and receipts of foreign currencies and the conversion of foreign currencies from or into RMB are regulated in China. For more information on China's foreign exchange control policy, see Practice Note, Foreign Exchange Control in China.

When a domestic company in China receives foreign direct investment, it must carry out foreign exchange registration with one of the banks designated by the State Administration of Foreign Exchange (SAFE). A domestic company cannot open a foreign currency bank account to receive any capital contributed in a foreign currency by its foreign investors without this registration. Foreign exchange registration is required only for foreign investment in a domestic company. Therefore, a red-chip company (which is an offshore entity) does not need to register with a SAFE-designated bank when it receives investment from foreign investors. However, a domestic operating company must register if it receives investment from its red-chip parent company.

Overseas Offerings and Listings by China-Based Companies Require Clearance by PRC Regulators

On 17 February 2023, the CSRC issued the *Trial Measures on the Administration of Overseas Securities Offerings and Listings by Domestic Enterprises 2023* (2023 Enterprise Overseas Listings Measures) and five supporting guidelines (together, the Overseas Listings Rules), which took effect on 31 March 2023.

Before the adoption of the Overseas Listings Rules, overseas securities offerings and listings by a red-chip company ultimately controlled by PRC individuals did not require the approval of the CSRC. CSRC approval was required only for overseas offerings and listings by:

- A PRC domestic company (for example, in connection with the listing of H-shares in Hong Kong).
- A red-chip company ultimately controlled by a PRC entity (such as the State-Owned Assets Supervision and Administration Commission or a domestically listed company).

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Now, under the Overseas Listings Rules, all China-based companies (including red-chip companies with or without VIE structures) must make record-filings with the CSRC in connection with overseas securities offerings and listings. Although the required procedure is called "record-filing," for an IPO in an overseas jurisdiction, it is essentially a regulatory review process, although it is less extensive than a formal review for a domestic listing. The review process can take several months, during which the prospective issuer responds to comments from the CSRC. The review timeline is particularly uncertain if VIE structures are involved, as the CSRC needs to consult the opinions of relevant industry regulators before it renders its decision.

For more information on the Overseas Listings Rules, see Legal Update, CSRC Issues Revised Rules on Overseas Listings by Domestic Companies.

In recent years, China has tightened regulation of privacy and cybersecurity, including in the context of overseas listings. Under the *Measures for Cyber Security Review 2021* (2021 Cybersecurity Review Measures, with effect from 15 February 2022), any online platform operator with access to personal information of over 1 million users must clear a cybersecurity review by cybersecurity regulators before undertaking an overseas listing (which does not include a listing in Hong Kong for purposes of this regulation). (See Practice Note, Cybersecurity Review of Network Products and Services in China: Broadened Application Scope.) Because the threshold of 1 million users is not high given the scale of the Chinese economy, this requirement applies to many China-based companies operating in the internet and related sectors.

Foreign Investment in a Domestic Company Often Involves Bifurcated Closing

For an investor of a PRC domestic company, its shareholder status is recognised in two ways:

- **Internal validity.**This means the shareholder status is recognised by the company itself and other shareholders. Internal validity can be demonstrated by the company's internal register of shareholders, share certificates, or proof of payment for shares.
- **External validity.** This means the shareholder status is recognised by third parties. External validity requires registration with the State Administration for Market Regulation (SAMR). After registration, the information reported by the company (including its shareholding structure and key persons) can be accessed by the general public.

To complete the registration with the SAMR, a foreign investor must provide authenticated documents proving its valid existence in the jurisdiction of its organisation. Authentication used to be a weeks-long process involving consular certification. On 7 November 2023, China became a signatory to the *1961 Hague Convention Abolishing the Requirement of Legalisation for Foreign Public Documents*. Since then (apart from a couple of country-specific effective dates), for documents from another signatory jurisdiction (including most jurisdictions commonly involved in foreign investment cases in China, such as the United States, the Cayman Islands, and the British Virgin Islands), apostilles instead of double consular certification are accepted in China, which has greatly simplied the authentication process. See Legal Update, Apostille Convention Entering into Force in China on 7 November 2023.

When a foreign investor invests in a PRC domestic company, both foreign exchange registration (see Direct Foreign Investment Requires Foreign Exchange Registration) and SAMR registration are required for full validity of the investor's shareholder status. SAMR registration of the updated shareholding structure reflecting the proposed foreign investment is a prerequisite of foreign exchange registration. However, a foreign investor should not remit the investment funds until the completion of foreign exchange registration. Therefore, the regulatory requirements in China create the need for a bifurcated closing process. Rather than a simultaneous exchange between shares and payment, the following steps are taken sequentially:

- The company issues shares to the foreign investor (without receiving payment).

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- The company completes SAMR registration with its updated shareholding structure reflecting the new foreign investment.
- The company completes foreign exchange registration.
- The foreign investor pays the share purchase price to the company.

Strategic Investment in A-Shares by Foreign Investors Must Meet Qualification Requirements

The A-share market in China used to be open to domestic investors only, but it has been gradually opened to foreign investors by way of strategic investment, the Qualified foreign institutional investor (QFII) scheme, and several cross-border stock connect programs. For more information, see Practice Note, China's Unified Foreign Investment Law: Impact on Transactions: Impact on Foreign Investment in A-Shares.

Strategic investment in A-shares by foreign investors may occur if:

- A foreign investor participates in a private investment in public equity (PIPE) transaction in which A-shares of a domestically listed company are offered.
- A company with foreign investors is acquired by a domestically listed company in an exchange offer, in which A-shares of the domestic company are offered to the foreign investors in exchange for their shares in the acquired company.

Under the *Administrative Measures for Foreign Investors' Strategic Investment in Listed Companies 2015* (2015 Foreign Strategic Investment Measures), a foreign strategic investor can invest in A-shares of a domestically listed company only if all of the following conditions are satisfied:

- The foreign investor owns at least USD100 million or manages at least USD500 million in offshore assets.
- The foreign investor initially acquires at least 10% of the total issued shares of the domestically listed company.
- There is a lock-up period of at least three years.

In addition, the foreign investor must obtain the approval of the Ministry of Commerce (MOFCOM), which can be time-consuming.

In 2020, MOFCOM issued a revised draft amendment to the 2015 Foreign Strategic Investment Measures soliciting public comments. The draft amendment, if implemented, would significantly relax the requirements for foreign strategic investment in domestically listed companies, including:

- Reducing the minimum shareholding threshold from 10% to 5%.
- Reducing the lock-up period from three years to 12 months.
- Replacing the pre-investment MOFCOM approval requirement with an information reporting requirement.

The draft amendment has not been officially implemented. However, in practice, PRC regulators have started to allow foreign strategic investment if the relaxed requirements under the draft amendment are satisfied. The newly enacted 2019 Foreign Investment Law provides partial legal basis for the more relaxed regime.

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