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China's Version of NASDAQ?

Shanghai Stock Exchange to create Sci-Tech Innovation Board

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Capital markets; foreign investment

The China Securities Regulatory Commission (**CSRC**) recently published guidelines for a new Sci-Tech Innovation Board (**STI Board**) that will be created at the Shanghai Stock Exchange (**SSE**).[1] The board will feature innovative scientific and technological enterprises, and some analysts claim that the STI Board might be able to compete with the Hong Kong Stock Exchange, NASDAQ, and perhaps even the New York Stock Exchange (**NYSE**).[2] In any event, this is one of the more major reforms that China's stock markets have seen over the past 30 years. It will be easier to list innovative enterprises on the STI Board, as eligible companies can be listed by filing the required documentation with the SSE; the CSRC will be responsible only for the securities registration. But will the STI Board really be a Chinese version of NASDAQ? This client alert examines some of the new features of the STI Board and some of its more important listing procedures.

The new CSRC and SSE rules

On January 30, 2019, the CSRC published a series of new rules regarding the proposed STI Board: 1) Implementation Opinion on Establishing the Sci-Tech Innovation Board and Pilot Registration-Based Review System (**Implementation Opinion**) (关于在上海证券交易所设立科创板并试点注册制的实施意见); 2) Draft Rules on the Registration of Initial Public Offerings on the STI Board (Trial) (**Draft Registration Rules**) (科创板首次公开发行股票注册管理办法(试行)); and 3) Draft Rules on the Ongoing Supervision of Listed Companies on the STI Board (Trial) (**Draft Supervision Rules**) (科创板上市公司持续监管办法(试行)) (the Draft Registration Rules and Draft Supervision Rules are together referred to as the "**Draft CSRC Rules**"). Public opinion is being solicited until February 28, 2019.

Also on January 30, 2019, the SSE published six draft operating rules (**Draft SSE Rules**) that regulate review processes, listing procedures, offerings and underwritings, trading, the listing committee, and the consulting committee.[3] Public opinion is being solicited until February 20, 2019. The Draft SSE Rules and Draft CSRC Rules will be finalized and promulgated based on the Implementation Opinion.

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[1] The terms "PRC" and "China" are used interchangeably in this client alert and neither includes Hong Kong, Macau, or Taiwan.
[2] Samuel Shen, Meg Shen, and Lee Chyen Yee, "China Unveils Draft Regulations for Nasdaq-Style Technology Board," *Reuters*, January 30, 2019, https://www.reuters.com/article/us-china-techboard-launch/china-unveils-draft-regulations-for-nasdaq-style-technology-board-idUSKCN1PO1QL.
[3] The Draft SSE Rules are available at: http://www.sse.com.cn/lawandrules/publicadvice/c/c_20190129_4716796.shtml.

Background

The STI Board is welcome news to foreign companies that wish to participate in China's capital markets, as the 2018 Draft Foreign Investment Law (**2018 Draft Law**) now allows foreign-invested enterprises (**FIEs**) to participate in financings in China through IPOs, corporate bonds, or any other means allowed under PRC Law.[4] The STI Board is also welcome news to domestic companies that are currently planning IPOs or that have already gone public overseas (**Target Companies**). The STI Board could be a good way for these companies to raise capital in China.

The STI Board legislation also fulfills a promise made by President Xi Jinping in his opening remarks to the 2018 China International Import Expo in Shanghai. President Xi said that the SSE would, independently from the other main boards, create an STI Board whose review system for initial public offerings (**IPOs**) was based on a new registration process. The current IPO process in mainland China, in contrast, requires the CSRC's approval.

This V&T Client Alert provides an overview of the Draft CSRC Rules, Draft SSE Rules, and also discusses how Target Companies may complete financings or make investments on the STI Board.

Characteristics of the STI Board

China's Central Economic Working Conference set a goal in December of 2018: Establish a "compliant, transparent, open, vigorous, and resilient" stock market that will attract domestic and international investments.[5] The STI Board is a step towards meeting that goal, as it employs a variety of mechanisms that have been used on NASDAQ and the Hong Kong Stock Exchange (**HKSE**), but which have not previously been allowed on China's stock markets. Five characteristics of the STI Board are of particular interest: 1) the IPO listing process is more efficient; 2) it is more attractive to unicorn companies; 3) it is more transparent; 4) it is more stable; and 5) it is more secure.

1. IPO process more efficient

- <u>Pilot registration-based review system</u>

  The SSE is now responsible for reviewing if a company is eligible to list on the STI Board; the CSRC is responsible only for the registration of securities. This new two-layer vetting system is more efficient. The IPO approval process on

[4] A V&T client alert regarding the 2018 Draft Law is available at: http://www.vtlaw.cn/ueditor/php/upload/file/20190111/1547199925360037.pdf.

[5] Jingshu Ma, "A Brief Report on the 2018 Central Economic Working Conference," *Shanghai Securities News*, December 22, 2018, http://news.cnstock.com/paper,2018-12-22,1099971.htm. The Central Economic Working Conference (中央经济工作会议) is the highest-level governmental conference whose focus is China's economy. It is convened annually by the Central Committee of the Communist Party and the State Council, and it follows the policies set by the Politburo Standing Committee.

China's other main boards is slower because: 1) the CSRC makes both listing eligibility and securities registration decisions; and 2) PRC law does not place a time limit on the CSRC's review process. The notorious "China IPO Logjam" of 2015 is said to have been caused by these two factors.[6]

In both the Draft CSRC Rules and Draft SSE Rules, there is a statutory time limit of six months during which the SSE must complete its review of an IPO. This time limit includes the time required for multiple rounds of questions and answers between the applicant and SSE. There is also a statutory time limit of 20 working days during which the CSRC must decide whether or not to grant the securities registration. Finally, the applicant must complete its public listing on the STI Board within six months of a successful securities registration.

- Appellate review committee

If the SSE rejects an IPO application, an applicant can file a motion with an appellate review committee to have the application reconsidered. The application for review must be submitted within five working days after a rejection letter has been received from the SSE. The appellate review committee must begin reviewing the review application within 20 working days; however, the Draft SSE Rules do not mention a time limit for processing the review application.

We suspect that an appellate review application will be processed like a new IPO application and that it might take the SSE six months to render a final decision. It is possible that working rules will be implemented that clarify this issue.

2. More attractive to unicorn companies

A unicorn company is a privately held startup valued at more than US$ 1 billion. Many of these enterprises are vanguards that invent new technologies and business models.[7] The STI Board hopes that it will attract Chinese unicorn companies to list on the STI Board. A few former Chinese unicorn companies that are now too large to still be considered unicorns are called "super unicorns": Tencent, Alibaba, Baidu, and JD.com are in this category. They have already listed on stock exchanges in the US or Hong Kong because, until the new STI Board rules have been passed, Chinese law does not allow certain share voting practices that are allowed in the US and Hong Kong. For example, in the US, a founder may maintain control over a company by issuing shares that have the right to cast more than one vote.

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[6] James T. Areddy, "Chinese Companies are Trapped in IPO Logjam," *Wall Street Journal*, December 8, 2015, https://www.wsj.com/articles/chinese-companies-are-trapped-in-ipo-logjam-1449530154.
[7] Jianbin Gao and Yuqing Guo, "The New Chinese Unicorns: Seizing Opportunity in China's Burgeoning Economy," PWC China, October 31, 2018, https://www.pwc.com/gx/en/technology/publications/assets/pwc-chinese-unicorns.pdf.

- Dual-class shares

  The Draft SSE Rules for the first time in China allow "dual-class shares" that possess different voting rights. One class of shares that has limited voting rights can be offered to the general public, while another class of shares that possesses more voting power can be issued to founders and company executives. This allows founders and executives to maintain control over a company. Such a mechanism has long been considered in China, but it has never before been implemented due to a long-standing principle of PRC Company Law: one share, one vote. PRC Company Law was, however, revised on October 26, 2018, and Article 131 now provides a legal basis for dual-class shares.[8]

  Companies that wish to issue dual-class shares must, however, satisfy several conditions, including:

  - Timing: Dual-class shares may be issued only prior to an IPO;
  - Trading limitations: Dual-class shares may not be publicly traded;
  - Financial requirements: 1) estimated market capitalization may not be below RMB 10 billion; or 2) estimated market capitalization may not be below RMB 5 billion and revenue for the most recent financial year may not be below RMB 500 million;
  - Voting rights: Voting rights must be the same across each class of shares, and the voting rights of special shares may not exceed 10 times the voting rights of the common shares; and
  - Special protections for major corporate matters: Each share, no matter what class, is allowed only one vote per share when the following matters are voted upon: 1) amendments to company articles; 2) changing the voting rights of special classes of shares; 3) hiring or terminating an independent director or auditor; and 4) merging or dividing a company or changing the type of business entity.

- Flexible listing requirements

  The Draft SSE Rules are more flexible than previous listing rules, as two newly established SSE committees will have the discretion to take the following factors into account: market capitalization, revenues, net profits, cash flow, core technology, and any other factor that the SSE considers relevant.[9] Thus, a company that is not yet profitable may now be eligible to apply for an IPO on the STI Board; this is not allowed on China's other main stock markets. The remaining factors also mention various baselines whose purpose is to facilitate the listing of innovative scientific and technological companies.

[8] Gongsi Fa (公司法) [PRC Company Law] (promulgated by Standing Committee of the National People's Congress, December 29, 1993, effective July 1, 1994, most recently revised October 26, 2018), article 131.
[9] The two new committees are the Sci-Tech Board Listing Committee and Sci-Tech Innovation Consulting Committee.

- Companies that have a quasi red chip corporate structure (**Red Chip Companies**)[10]

  Many Chinese unicorn companies, and almost all Chinese publicly listed companies on the HKEX, NYSE, and NASDAQ are Red Chip Companies. The CSRC issued a regulation in March 2018 whose purpose was to encourage Red Chip Companies to list on China's capital markets: Red Chip Companies may now for the first time raise funds through Chinese Depository Receipts (**CDRs**) or IPOs.[11] The Chinese regulatory authorities also indirectly acknowledged the legitimacy of the variable interest entity (**VIE**), a series of contractual arrangements that allow a foreign investor to invest in a Chinese sector that would otherwise be closed to foreign investment, such as the internet sector. The Draft SSE Rules furthermore provide detailed implementing rules for the regulation of Red Chip Companies and VIEs. This will make it possible for many Red Chip Companies to list on the STI Board.

3. More transparent

Full disclosure is the key to the new registration-based review system. The information disclosed must contain all material information that may affect an investor's decision to invest. The Draft CSRC Rules also impose regulatory sanctions on companies if the information they provide materially impedes the understanding of the investors.

All relevant information of a company being listed may also be taken into account. The SSE will review listing applications on a case-by-case basis instead of using a cookie cutter approach. Companies that wish to list should therefore fully disclose their core advantages. For example, if a company that wishes to list is not yet profitable, its prospectus may discuss other relevant factors, such as the stability of its management team, its research and development efforts, private financings completed prior to the listing application, its business strategy, the continuity of its business operations, and when it expects to turn a profit, among other factors.

Information disclosed to the SSE is now subject to more strict verification. The SSE may conduct an on-site verification of a company that is seeking to be listed if: 1) the company is randomly selected by the SSE for verification; or 2) the applicant has failed to provide reasonable explanations for material issues.

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[10] A "quasi red chip" corporate structure refers to an offshore holding company that holds Chinese subsidiaries. The holding company is often incorporated in the Cayman Islands, and it often indirectly holds the Chinese subsidiaries through other intermediate holding companies in the British Virgin Islands and Hong Kong. The Chinese subsidiaries are wholly foreign-owned enterprises, or WFOEs.

[11] Guanyu Kaizhan Chuangxin Qiye Jinei Faxing Gupiao Huo Cuntuo Pingzheng Shidian De Yijian (关于开展创新企业境内发行股票或存托凭证试点的若干意见) [Opinion of the China Securities Regulatory Commission on Launching the Pilot Program for Innovative Enterprises Domestically Issuing Stocks or Depository Receipts] (promulgated by the CSRC, and effective on March 22, 2018), article 4.

The IPO application package for predisclosure requires the filing of more documents than the SSE currently requires of companies that wish to list on other main boards.[12] The SSE now requires that an IPO application package for the STI Board contain: 1) a verified prospectus; 2) a sponsor confirmation letter for the IPO; 3) a PRC legal opinion; and 4) an accounting report. And during the time period between the submission of the IPO application and the public listing, the applicant must disclose in a timely fashion any material discrepancy that may arise in the IPO application documents.

4. More stable

- Greenshoe options

  Draft SSE Rules allow underwriters and issuers to use "greenshoe options" to purchase up to an additional 15% of company shares at the offering price. Greenshoe options are thought to help boost investor confidence and to stabilize stock prices. One of the thresholds for exercising greenshoe options on the other Chinese boards is that more than 400 million shares must be issued at the time of the IPO. The STI Board has eliminated this threshold.

- Relaxed daily trading limits

  Stock prices are unregulated for the first five days after an IPO on the STI Board. Five trading days after the IPO, price fluctuations are then limited to a range 20% above or below the closing price of the previous trading day. The other Chinese main boards, however, limit price fluctuations to no more than 10% above or below the previous closing price after the first day of trading.

5. More secure

- Delisting

  Unlike the delisting mechanisms found on the other main Chinese boards, the delisting process of the STI Board no longer describes the suspension and resumption of listings, it simply provides a delisting process for companies no longer qualified to list on the STI Board. The Draft SSE Rules say that a company may be delisted when: 1) it is in material violation of a law, as when a violation adversely affects national security; 2) its market capitalization falls below RMB 300 million for 20 consecutive trading days; 3) its financial performance is poor, as when it loses the ability to continue business operations; or 4) it is noncompliant, as when it does not comply with information disclosure requirements.

[12] 2019 Niandu Zhongguo Zhengjianhui Faxing Jianguanbu Shouci Gongkai Faxing Gupiao Shenhe Gongzuo Liucheng (2019 年度中国证监会发行监管部首次公开发行股票审核工作流程) [2019 CSRC Working Rules for IPO Review] (promulgated by the CSRC, and effective on February 1, 2019), article 2. "Predisclosure" refers to the preliminary disclosure of certain information and documents during the IPO review process following the initial submission of an IPO application package with the CSRC.

If a listed company is disqualified for financial reasons, the Draft SSE Rules state that a two-step delisting process should be used: 1) a warning is first issued regarding the potential delisting; and 2) if the listed company still fails to qualify financially in the following year, the SSE will commence the delisting process. The Draft SSE Rules also provide a transitional period for companies that are being delisted in order to protect the interests of investors. Companies that have been delisted from the STI Board due to material violations of the law are forbidden from resubmitting their listing applications. However, companies delisted from the STI Board for other reasons are allowed to resubmit their listing applications to the SSE.

- Investor protections

The Draft SSE Rules contain a chapter called “Investor Qualifications to Trade on the STI Board.”[13] The regulatory authorities take an investor’s personal assets, financial knowledge, and ability to tolerate risk into account at least two times per year. An individual investor who wishes to trade on the STI Board must also: 1) maintain a securities account that contains at least RMB 500,000 for 20 trading days prior to trading on the STI Board; and 2) have been trading stocks for more than 24 months. The SSE may also specify other requirements.

Additional restrictions apply to certain groups of shareholders (**Special Shareholders**). During any 12 month period, Special Shareholders are not allowed to sell more than 1% of a company’s total shares listed on the STI Board to the public. Special Shareholders are also prohibited from selling shares before an IPO if the company is not profitable.[14] Controlling shareholders, ultimate beneficial owners, and key persons are not allowed to sell shares for 12 months before an IPO, and there is a lockup period of 36 months after an IPO.

V&T comments

The establishment of the STI Board at the SSE is a top priority for the Chinese government in 2019. The Chinese government also hopes that the STI Board may help strengthen two other important government initiatives: the Belt and Road Initiative and Made in China 2025.

- A NASDAQ-style board

[13] Shanghai Zhengquan Jiaoyisuo Kechuangban Gupiao Jiaoyi Tebie Guiding Zhengqiu Yijiangao (上海证券交易所科创板股票交易特别规定征求意见稿) [Draft Special Regulations for Stock Trading on the Science and Technology Innovation Board of the SSE] (published by the SSE on January 30, 2019, public opinion being solicited until February 20, 2019), chapter 2.

[14] Kechuangban Shangshi Gongsi Chixu Jianguan Banfa (Shixing) (科创板上市公司持续监管办法(试行)) [Draft Rules on the Ongoing Supervision of Listed Companies on the STI Board (Trial)] (published by the CSRC on January 30, 2019, and public opinion being solicited until February 28, 2019), article 16. Special Shareholders include controlling shareholders, ultimate beneficial owners, directors, supervisors, senior management, and other key persons.

A major purpose of the STI Board is to deregulate China's capital markets, so it adopts many mechanisms that have been proven successful on NASDAQ. The registration-based review system for IPOs is central to the proposed reforms, as are the more flexible listing criteria, relaxed trading limits, and other features that appeal to high-tech startups. The stringent information disclosure requirements of the STI Board strengthen the registration-based review system, and the Chinese government expects that other Chinese boards will eventually implement similar systems to persuade unicorn companies to list on them. The goal is that China's capital markets will help support the development of core technologies.

Foreign mainstream media, however, gave the STI Board a lukewarm reception when it was first announced. As Reuters noted, "It will not be the first time that China has come up with a new listing avenue in the hope of creating tech companies as successful as U.S. giants, such as Google and Amazon.com Inc. Shenzhen's tech-heavy ChiNext board became a hotbed of speculation and soared to dizzying heights after its 2010 launch, but has had a lacklustre performance since 2015. Beijing's New Third Board, an over-the-counter market for start-ups, also suffered a similar fate."[15]

Others report that Chinese high-tech companies currently planning to list overseas are not changing their plans.[16] One reason is that China continues to maintain strict foreign exchange controls, which can make it difficult for Chinese companies to receive funds from entities overseas or to invest in them. If a Chinese company lists on NASDAQ, however, it is easier to invest in other overseas entities. China's strict foreign exchange controls therefore remain a disincentive for Chinese companies to list on the STI Board, and there is no sign that these restrictions will be eliminated in the near future.

Although the ChiNext Board and New Third Board have not performed as well as NASDAQ, the Chinese authorities are optimistic that the STI Board will persuade some Chinese unicorn companies to list domestically, as this new board will be more flexible and attractive than the other Chinese boards.

- Welcome news for companies in certain fields

  The Draft CSRC Rules recommend that companies in the following industries be favored for IPOs on the STI Board:

  - New generation information technologies;
  - High-tech equipment;

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[15] Samuel Shen, Meg Shen, and Lee Chyen Yee, "China Unveils Draft Regulations for Nasdaq-Style Technology Board," *Reuters*, January 30, 2019, https://www.reuters.com/article/us-china-techboard-launch/china-unveils-draft-regulations-for-nasdaq-style-technology-board-idUSKCN1PO1QL.

[16] Enoch Yiu and Shidong Zhang, "'Not Impressive': China's Ambitious Stock Market Reform Meets with Lukewarm Reaction," *Southern China Morning Post*, February 1, 2019, https://www.scmp.com/business/banking-finance/article/2184520/not-impressive-chinas-ambitious-stock-market-reform-meets.

- New materials, new energy, and environmental protection;
- Bio-tech and med-tech; and
- Other innovative industries that correspond to the national strategy, like big data, cloud computing, and artificial intelligence.

- <u>The STI Board and ChiNext Board of the Shenzhen Stock Exchange</u>

  ChiNext is a NASDAQ-style board of the Shenzhen Stock Exchange. It is open to companies of all sizes that meet the listing criteria, and it focuses on innovative growth companies. The innovative areas include technology, management, and business models, among others. The STI Board, however, is primarily addressed towards small and medium-sized high-tech companies and is meant to supplement, not compete with, the ChiNext Board.

- <u>Red Chip Companies listed overseas</u>

  At this stage, it would not be easy for Red Chip Companies listed overseas to list on the STI Board. The financial requirements are high, and the PRC maintains very strict foreign exchange policies. [17] Because Red Chip Companies listed abroad invariably raise funds offshore, detailed implementing rules regarding foreign currencies would still be required to facilitate a listing on the STI Board, although in principle the free conversion of currencies has already been enabled for CDRs.

This V&T client alert will be updated after the Draft CSRC Rules and Draft SSE Rules have been promulgated.

Contact

If you have any questions about this client alert, or if you would like to discuss how recent changes in Chinese law may affect your business, please call or write:

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[17] Guanyu Kaizhan Chuangxin Qiye Jinei Faxing Gupiao Huo Cuntuo Pingzheng Shidian De Yijian (关于开展创新企业境内发行股票或存托凭证试点的若干意见) [Opinion of the China Securities Regulatory Commission on Launching the Pilot Program for Innovative Enterprises Domestically Issuing Stocks or Depository Receipts] (promulgated by the CSRC, and effective on March 22, 2018), article 3. Red Chip Companies listed overseas must have a market capitalization of above RMB 200 billion if they wish to list on the STI Board.