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NEW TECH BOARD AND REGISTRATION-BASED IPO SYSTEM OFFICIALLY LAUNCHED IN CHINA

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In early March in 2019, the China Securities Regulatory Commission (“**CSRC**”) and Shanghai Stock Exchange ("**SSE**") unveiled a set of detailed rules ("**IPO Rules**") on the Science and Technology Innovation Board ("**New Tech Board**"), which paved the way for the launch of a new security trading platform on SSE. The IPO Rules expressly encourage the public listing of companies that: (1) possess critical technology and breakthrough achievements in line with national strategy; (2) are active in high-tech industries and strategic emerging industries, such as information technology, high-end equipment, new materials, new energy, eco-friendly technology and biomedicine or; (3) have a focus on the integration of internet, cloud computing, big data, artificial intelligence and high-end manufacturing.

We set out below the highlights of the New Tech Board, and the implications for sci-tech companies and institutional investors.

Key issues

- Detailed IPO Rules on the Science and Technology Innovation Board are launched
- Highlights of New Tech Board
- Implications for Sci-Tech companies
- Implications for institutional investors

HIGHLIGHTS OF NEW TECH BOARD

- Registration-based IPO system

The New Tech Board has introduced a registration-based IPO system as a pilot programme. Compared to the approval-based system currently adopted by the A-share market, the SSE and CSRC will, under the registration system, conduct a formality review of the application without substantively assessing the value of the shares or profits for investors. The registration-based IPO system is expected to significantly streamline and expedite the review procedure. For instance, the SSE will formulate its review opinion and submit the same to the CSRC within three months upon the acceptance of application, and the CSRC will render its final decision within 20 business days.

- Eligibility Requirements

The IPO Rules introduce diversified financial indicators when assessing eligibility, with the anticipated market value (i.e. the total number of shares after listing multiplied by the listing price) being the core financial indicator. It may be possible for a PRC-incorporated applicant which has not become profitable but with a sufficiently high market value to be listed. In contrast, the Main Board, SME Board and ChiNext all require a profitability track record (i.e., the applicants must have made profit for at least one year).

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“Red-chip" companies (i.e. offshore incorporated companies with its main business in the PRC) are also allowed to issue shares or depository receipts on the New Tech Board if certain qualification requirements under both the IPO Rules and the Opinions on Launching the Pilot Program of Domestically Issuing Stocks or Depository Receipts by Innovative Enterprises ("**SC Opinions**" issued by State Council on 22 March 2018) are satisfied.

For red-chip companies with a Variable Interest Entity ("**VIE**") structure, the IPO Rules require applicants with contractual control structure to fully disclose the detailed arrangements and provide updates in their annual reports. This appears to be a positive signal from the China regulators in recognizing VIE-structured companies as being suitable for listing on the New Tech Board. However, the SC Opinions (which also apply to red-chip companies, as confirmed by the IPO Rules) also set out that the listing application of VIE-structured enterprises shall be reviewed by the CSRC in a prudent manner on a case-by-case basis, which seems to suggest that regulators intend to leave some leeway at this stage.

- Differential Voting Rights

The IPO Rules allow companies with a differential voting rights ("**DVR**") arrangement to be listed on the New Tech Board under certain conditions. Previously, as companies with different classes of shares were not accepted by the A-share market, many enterprises (especially privately-owned enterprises) had to resort to the overseas capital market in order to achieve certain requirements such as maintaining founders' control. The IPO Rules could now be a remarkable step in matching the flexibility adopted by the more advanced capital markets overseas.

- Lock-up period

The lock-up period is generally 36 months from the listing date for controlling shareholders and actual controllers, and 12 months from the listing date (plus 6 months following departure) for key technical staff employed by the listing applicant. Under the IPO Rules, the lock-up period could be further extended for those issuers with negative net profits at the time of listing.

- Stock Incentive Plan

Another development worth highlighting is that stock incentive plans established prior to listing can survive through IPO. In other words, a prospective issuer will not be required to terminate or vest the option prior to listing in order to ensure certainty in shareholdings. The New Tech Board only requires certainty of shares held by controlling shareholders, or those other shareholders under common control with the controlling shareholders (or ultimate controllers). The IPO Rules recognize stock incentive plans that were established prior to listing to the extent that they are in line with the listing rules and have been duly disclosed.

The SSE also confirms that employee stock option plans ("ESOP") can be considered as one shareholder, without adopting the "look-through" approach , so long as: (1) the members of the ESOP could achieve a "closed circle" (i.e. shares subject to the lock-up period, and share transfer only possible within the ESOP pool) or; (2) an ESOP established in the form of a limited liability partnership has been duly registered with the Asset Management Association of China (which in practice may not be easy to complete in the current environment).

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Compared to the equity incentive rules currently applicable to the Main Board listed companies, the New Tech Board takes a more relaxed approach on the ESOP mechanism. This includes: (1) expanding the scope of qualified holders by including shareholders with more than 5% stake, actual controller and their respective spouses, parents and children (as long as those people are serving as the directors, senior management or other key employees), which would be otherwise excluded from the ESOP pool in a Main Board listed entity; (2) increasing the maximum share capital available for the equity incentive quota (from 10% of the total issued share capital to 20%) and; (3) giving more flexibility on the exercise price (exercise price below 50% of market price is permissible to the extent such low price is justifiable).

IMPLICATIONS FOR SCI-TECH COMPANIES

- Given the recent unsatisfactory performance of the H-share market, the desirable valuation, and inflated PE ratio of A-share listed companies may increase the attractiveness of the New Tech Board. In addition, the preferential government support and the heated focus from investors will make the New Tech Board a competitive option for listing.
- Red-chip structure may no longer be a cost-effective regime if: (1) financing could be injected at the onshore level; (2) the investors could achieve an easy exit through this new trading platform and; (3) the equity incentive plan could be maintained at the New Tech Board.
- However, for enterprises with an existing red-chip structure, (although it does not seem mandatory to collapse the "red-chip" structure under the IPO Rules) the compatibility of A-share listed company with existing overseas investors remains unclear, especially in respect of currency conversion and the applicable capital gain taxes.

IMPLICATIONS FOR INSTITUTIONAL INVESTORS

- The New Tech Board, as another exit path for investors, will likely contribute to the continuous growth in concentration on technology and innovative industries in recent years.
- A registration system with more predictability on the application process could potentially reignite the investors' interest in the Chinese stock markets.
- The current system design (for example, expanded price fluctuation range of up to20%) and the potential adoption of market maker mechanism) illustrates the intention and effort of the China regulators to boost liquidity on this new platform.
- Detailed rules on tax and foreign exchange for red-chip structured listed companies are still pending.
- Lastly, but importantly, there is lack of clarity as to whether the New Tech Board would be opened up for foreign investors. Currently, subject to approval, foreign investors are permitted to participate or invest in entities listed on the Main Board, SME Board or ChiNext through the QFII scheme or strategic bulk investment.

[1] Under the PRC law, the number of shareholders in a company limited by shares shall be no more than 200. Previously, if an ESOP platform is holding shares in the listing applicant, CSRC will look through the ESOP platform to the individual option holder level, and calculate the number of individuals holding options together with the direct shareholders of the listing applicant, to check if the total number of shareholders are above 200. This used to be an issue for A-share listing, especially for the sci-tech enterprises granting incentive plans to a wide group of employees to compete for talents.

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