

## Client Alert

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## Shanghai Stock Exchange seeks public opinions on the establishment of the Science and Technology Innovation Board and the Pilot Registration System

### Overview

On 28 January 2019, the China Securities Regulatory Commission (the **CSRC**) issued the "*Implementation Opinions on Establishing a Science and Technology Innovation Board and Pilot Registration System on the Shanghai Stock Exchange*" ("**Implementation Opinions**") to implement measures for the establishment of Shanghai International Financial Centre and Shanghai Science and Technology Innovation Centre, to strengthen the capital market infrastructure, and to promote the development of advanced technologies industries and the development of strategic emerging industries.

On 30 January 2019, the CSRC issued the "*Administrative Measures for the management of the Pilot Registration System of Initial Public Offering on the Science and Technology Innovation Board (Trial)*", the Shanghai Stock Exchange ("**SSE**") issued the "*Notice on the Public Consultation about the regulations on the establishment of the Science and Technology Innovation Board and Pilot Registration System and related supporting system*" and a series of related support system draft regulations (together the "**Draft Rules of the Innovation Board**"), and seeks public opinions. The Implementation Opinions and the Draft Rules of the Science and Technology Innovation Board ("**Innovation Board**") has provided a relatively comprehensive regulatory regime on the review of listing application, issuance and underwriting mechanism, trading mechanism and on-going compliance requirements in relation to the Innovation Board.

### Highlights of the Innovation Board and Pilot Registration System

#### Part One: Issuance and Listing

According to the Implementation Opinions and the Draft Rules of the Innovation Board, the highlights of the Innovation Board are:

- 1. Positioning:** The Innovation Board is for new applicants' primary listing only. The listing applicant has to demonstrate outstanding scientific and technological capabilities, reliance on its core technology, possession of a stable business model, receive a high market acceptance and reputation and potential of rapid growth.
- 2. Target Industries:** New high-tech Industries and strategic emerging industries, including new-generation information technology, high-end equipment, new materials, new energy, energy saving and biomedicine,





to develop and foster manufacturing integration of the Internet, Big Data, cloud computing and artificial intelligence.

3. **Target Companies:** Domestic companies that satisfy the positioning requirements of the Innovation Board, companies with weighted voting rights structure ("**WVR structure**"), pre-revenue companies, and red chip companies<sup>1</sup> that issue depository receipts.
4. **Review Mechanism:**
  - **Registration System:** Under the registration system, the SSE is responsible for: reviewing the listing applications on the Innovation Board, delivering its review opinion to the CSRC to implement the registration process after review. The CSRC will supervise the review of the SSE.
  - **Organizational Structure of the Review Board:** The SSE will establish the Innovation Board Share Listing Committee to review and determine the suitability of the listing applicant. When necessary, the newly established Science and Technology Consultation Committee will provide opinion.
  - **Review Method:** By way of Q&A electronically and categories of industries.
  - **Time Limit of the Review:** The SSE shall form a review opinion within 3 months after receiving the application materials, excluding the time for the issuer to modify the registration application materials, answer intermediaries' enquiries, conduct on-site verification, suspend listing review etc. The CSRC will decide whether to approve the registration within 20 working days.
5. **Issuance Conditions:** Conditions of the listing requirements of the Innovation Board that are related to issuer's qualification, the actual controller, legal compliance, directors, executive, core technicians, industry competition and connected transaction etc are similar to the relevant listing requirements in "*The Management of the Initial Public Offering of Shares*". However, for financial conditions, the Innovation Board cancelled the requirements in relation to profitability and non-compensation for losses etc. Instead, the listing applicant should satisfy at least one of the following 5 sets of market capitalisation standards:

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<sup>1</sup> Red chip companies are enterprises that are incorporated outside of mainland China and are controlled by Chinese governmental entities.



	Estimated market capitalisation <sup>2</sup>	Net Profit	Operating income
1. Market capitalisation/ Net Profit Test	Not less than RMB 1 billion	Net profit for the recent two years is positive, and the accumulated net profit was not less than RMB 50 million; or	Not Applicable
		The net profit for the most recent year was positive.	The operating income was not less than RMB 100 million.
2. Market capitalisation/ Income Test A	Not less than RMB 1.5 billion	Not Applicable	The operating income for the most recent year was not less than RMB 200 million, and the proportion of R&D investment for the recent three years accounted for not less than 15% of the operating income.
3. Market capitalisation/ Income Test B	Not less than RMB 2 billion	Not Applicable	The operating income was not less than RMB 300 million in the most recent year, and the net cash flow generated from operating activities in the most recent three years was not less than RMB 100 million.
4. Market capitalisation/ Income Test C	Not less than RMB 3 billion	Not Applicable	In the most recent year, the operating income was not less than RMB 300 million.
5. Market capitalisation/ Business Test	Not less than RMB 4 billion	Not Applicable	Not Applicable
		Major businesses or products that are subject to the approval by relevant national authorities, possess large potential market, achieve phased results, and receive significant amounts of investment funds from well-known investment institutions. Pharmaceutical companies need to obtain at least one Class I phase II new drug clinical trial approval. Other eligible companies must have substantial technological advantages and satisfy the relevant conditions of the Innovation Board.	

<sup>2</sup> Estimated market capitalisation means the total value of the issuer's shares calculated by multiplying the total number of issued shares and the issued price.



## 6. Market-based issuance underwriting mechanism:

- Non-application of the direct pricing (the so-called "23 times price earning ratio" limitation is no longer applicable) and adoption of market-based price setting mechanism. The share issuance price shall be determined by way of inquiry to registered offline professional investors<sup>3</sup>.
- Lowering the placements requirements for strategic investors and introducing subscription arrangement for senior management and core employees.
- Allowing listing applicants and lead underwriters to adopt over-allotment options, non-application of the limitation of initial public offerings of not more than 400 million shares, and promoting stability of share price after listing.

## 7. WVR structure

### Special Listing Conditions

1. The listing applicant must have a WVR structure before listing and such WVR structure must have been operating smoothly for at least one full fiscal year;
2. The market capitalization and financial indicators of the listing applicant must satisfy one of the following standards:
  - the estimated market capitalization is not less than RMB 10 billion;
  - the estimated market capitalization is not less than RMB 5 billion, and the operating income in the most recent year is not less than RMB 500 million.

### Requirements of WVR beneficiaries

1. The beneficiary entity must have a major contribution to the issuer's development or performance growth; Before and after listing, the beneficiary entity must be a director or a controlling shareholder of such entity; and
2. Beneficiaries of WVR must beneficially own collectively at least 10% of the issuer's total issued voting shares.

### Limitations

1. **Proportional Restrictions:** The number of voting rights for each WVR share shall be identical. The voting rights of each WVR share must not exceed 10 times of the voting rights of each ordinary share.

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<sup>3</sup> Professional investors refer to individual and institutional investors who satisfy the requirements of investing experience, credit records, pricing capabilities and other conditions specified in the "Detailed Rules for the Management of Offline Professional Investors of Shares in Initial Public Offerings" issued by the Securities Association of China in 2018.



2. **Issue Restrictions:** After listing, except for a pro rata issue of securities and conversion of capital reserve, the issuer must not issue WVR shares onshore or offshore, and must not increase the proportion of WVR shares. If the proportion of WVR shares increases due to a share repurchase or other corporate actions, the issuer must take appropriate actions to reduce the number of their WVR shares proportionately (such as through conversion of certain WVR shares into ordinary shares) so that the proportion of WVR shares will not be higher than the original level.
3. **Trading Restrictions:** WVR shares must not be traded in the secondary market, but WVR shares can be permanently converted into ordinary shares on a one to one ratio under specific circumstances.
4. **Transfer Restrictions:** If WVR beneficiaries are no longer able to meet the qualifications to hold WVR shares or transfer the WVR shares to a third person, the beneficiaries' WVR in the issuer must cease, and the WVR shares will be permanently converted into ordinary shares upon transfer.
5. **Restrictions on important matters:** When an issuer needs to vote on certain important matters, such as changes to the articles of association or changing the number of voting rights, the number of voting rights of each WVR share shall be the same as the number of voting rights of each ordinary share.

#### Protection of non-WVR Shareholders

1. The proportion of voting rights of ordinary shares shall not be less than 10%.
2. Threshold of shareholding by shareholders to convene an extraordinary general meeting shall not be higher than 10% of the total number of issued voting shares.
3. Threshold of shareholding by shareholders to propose a resolution at a general meeting shall not be higher than 3% of the total number of issued voting shares.

#### **8. Red Chip Enterprises**

- **Listing of shares or depository receipts:** Red Chip Enterprises that satisfy the requirements of "*Circular of the General Office of the State Council on Forwarding the Opinions of the CSRC on Developing the Issuance of Shares or Depository Receipts in Innovative Enterprises*" can apply for listing on the Innovation Board by issue of shares or depository receipts.
- **Protection of onshore depository receipts holders:** For Red Chip Enterprises which are listed on the Innovation Board by issuing shares or depository receipts, their shareholding structure, corporate governance, operation regulation and other features are subject to the company law or rules and regulations at their place of incorporation. Red Chip Enterprises' investor protection standards, including asset income, participation in major decisions, residual property distribution and other rights, should not be lower than the requirements of domestic PRC laws



and the regulations and the requirements of CSRC, and they must ensure that the actual rights of onshore depository receipts holders are the same as the rights of offshore shareholders.

- **VIE structure:** Red Chip Enterprises that have a VIE structure or similar contractual arrangements should fully disclose the implementation and change of VIE structure, and the implementation of measures to protect the legitimate rights of domestic investors under the VIE structure.

## 9. Spin-off

- A sizeable issuer can spin-off independent subsidiaries that can satisfy the requirements of the Innovation Board according to the laws and regulations, and the relevant provisions of the CSRC and the SSE.

## Part Two: On-going compliance requirements after listing

According to the Implementation Opinions and the Draft Rules of the Innovation Board, the on-going compliance requirements for companies listed on the Innovation Board are as follows:

### 1. Selling restriction mechanism:

- **Selling restrictions of the controlling shareholders, actual controllers and core technicians:** In addition to the controlling shareholders and actual controllers, core technicians are also subject to the selling restrictions, i.e., within 36 months after the date of listing, the controlling shareholders, actual controllers and core technicians shall not (i) transfer or authorize others to manage their directly-owned or indirectly-owned shares that are issued before IPO, nor (ii) request the issuer to repurchase those shares.
- **Selling restriction on specific shareholders:** For controlling shareholders, actual controllers, directors, supervisors, senior management and core technicians (together known as "**Specific Shareholders**") who sell their pre-IPO shares through non-public means, the transferee shall not transfer the shares within 12 months from the date of registration of shares.
- **Selling restriction on venture capital fund:** Venture capitalists and other shareholders who are not Specific Shareholders can sell their pre-IPO shares through non-public means.
- **Pre-revenue companies:** Specific Shareholders of pre-revenue companies must not sell their pre-IPO shares before the issuer becomes profitable. The issuer will not be subject to this restriction after listing for 5 years.



## 2. Share Incentive Regime

- **Share incentive limit:** The total number of shares eligible for the share incentive regime is increased from 10% to 20%.
- **Scope of targets:** Allow shareholders who individually or collectively hold more than 5% of the shares of the issuer, actual controllers and their spouses, parents and children to be the beneficiaries of the share incentive regime. These beneficiaries must be directors, senior management or other key personnel of the issuer after listing.
- **Price limit:** Cease to impose price limit on the restricted shares. If the share price is lower than 50% of the market reference price, the independent financial adviser is required to opine on the reasonableness of the pricing assumption and pricing mechanism, and whether the share price is determined at the best interest of the issuer.

## 3. Special rules for secondary market transactions

- **Individual investor threshold:** An eligible individual investor must have (i) a portfolio of an average daily balance of at least RMB 500,000 in its securities account and cash account and (ii) at least 24 months' experience in securities transactions. Investors who cannot meet the eligibility requirements can participate in the Innovation Board by purchasing public funds.
- **Share price fluctuation limits:** In the first five trading days after the IPO, there will be no price fluctuation limit. Starting from the sixth trading days and afterwards, the daily upper and lower price fluctuation threshold will be expanded to 20%.
- **Quantity requirement of a single order:** The maximum number of a single market order is 50,000 shares; and the maximum number of a single restricted price order is 100,000 shares.

## 4. Information Disclosure Regime

- On the ground of the general information disclosure requirements, the new regime focuses on specific characteristics of innovative companies and strengthens disclosures of industry information, core technology, operational risk, corporate governance, and performance fluctuations.
- In addition to the current shareholding reduction pre-disclosure system, Specific Shareholders are required to disclose the issuer's operational situation and risks before selling their shares.

## 5. Delisting Regime

The standard and procedure of the delisting regime of the Innovation Board are more stringent.

- **Procedure-wise:** Direct delisting. The Innovation Board cancels the procedures for trading halt and resumption of listing. An unsuitable issuer would be delisted directly.





- **Standard-wise:** The Innovation Board will no longer use continuous loss as a single delisting standard. Mandatory delisting standard includes but not limited to the following circumstances:
  - **Material violation of the law:** An issuer would be delisted if it issues shares fraudulently, discloses major information illegally, violates public safety rule or conducts other major illegal acts that seriously damage the order of the securities market.
  - **Market Indicators:** An issuer would be delisted if it fails to meet four types of market indicators, such as trading volume, share price, number of shareholders and market capitalisation.
  - **Financial requirements:** An R&D issuer would be delisted if (i) its core business, product or its reliant technology is failed or is prohibited from being used, and (ii) the issuer does not have other businesses or products that can meet one of the five sets of market capitalization indicators.
  - **Compliance requirements:** An issuer would be delisted if it cannot satisfy the following requirements within a specified period: (1) rectify the financial accounting report that have major accounting errors or false records, (2) disclose the annual report or interim report, (3) rectify major defects in disclosure or regulatory operations, (4) resolve share capital issues that results in the issuer not being able to fulfil the listing requirements for 20 consecutive trading days, (5) resolve the issues arising from the most recent financial report that the auditors issued a reserved comment or a negative comment in the audit report.
- Companies that are subject to mandatory delisting as a results of major illegal violations will not be allowed to submit new listing applications. The delisting would be permanent.

## Next Step

The Draft Rules of the Innovation Board have a lot of similarities with Hong Kong's new WVR listing regime effective in April 2018. Clients who are interested in knowing more about the differences between the listing rules in Hong Kong and Mainland China can contact our firm or review our earlier client alerts, including alerts titled "[Innovative companies with weighted voting rights \(WVR\) structures can apply for listing in Hong Kong with effect from 30 April 2018](#)", "[Pre-revenue biotech companies can apply for listing in Hong Kong with effect from 30 April 2018](#)" and "[Pilot innovative companies can submit their CDR listing applications now](#)".

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