

Corporate & Commercial

Listing of a PRC Business – Red Chip or H-share?

Planning, executing, and managing an initial public offering (“**IPO**”) of People’s Republic of China (“**PRC**”) businesses can be a challenging task. In the past, harsh regulatory requirements of PRC authorities had made listing of PRC businesses in Hong Kong very difficult, whether by red chip or H-share listing. However, such hurdles have been relaxed in recent years which have made listing of PRC businesses in Hong Kong easier and have also caused the distinction between red chip and H-share listing to diminish.

What is meant by “red chip” and “H-share”?

PRC businesses listed on The Stock Exchange of Hong Kong Limited (“**HKEx**”) include “H-share companies” and “red chip companies”. H-share companies are joint stock companies incorporated in the PRC which have received approval from the China Securities Regulatory Commission (“**CSRC**”) to list in Hong Kong, whereas red chip companies refer to the companies which are incorporated outside the PRC (usually in Hong Kong, the Cayman Islands or Bermuda) but with most of their business in the PRC, and which are usually controlled by PRC entities. Listing a PRC business is generally more complicated than other listings in Hong Kong as relevant PRC approvals may be required for the reorganisation and listing process.

Circular 10 – A hurdle to overcome for red chip listings

Historically, the PRC regulatory process for the reorganisation and listing of red chip companies was simpler than that for H-share issuers. Nevertheless, following the introduction of the “Regulations Concerning the Merger and Acquisition of Domestic Enterprises by Foreign Investors” (commonly known as “**Circular 10**” or the “**M&A Rules**”) in August 2006, the listing process for red chip companies has become increasingly complicated.

Circular 10 was promulgated by the Ministry of Commerce (“**MOFCOM**”), the State-owned Assets Supervision and Administration Commission, the State Administration of Taxation, the State Administration for Industry and Commerce, CSRC and the State Administration of Foreign Exchange (“**SAFE**”) on August 8, 2006. It came into effect on September 8, 2006 and was amended by MOFCOM on June 22, 2009. By virtue of Circular 10, MOFCOM’s approval is required at various stages of a red chip listing, including:

1. the establishment of a special purpose vehicle (“**SPV**”) outside the PRC by a PRC domestic enterprise for the purpose of an overseas listing of the interest in a PRC domestic enterprise; and
2. the acquisition of the businesses or assets of a PRC domestic enterprise by the SPV.

In addition, Circular 10 reinstated the requirement to obtain CSRC approval for a proposed red chip listing, which was previously removed when CSRC’s practice of issuing a no-objection letter was phased out in 2003. Moreover, under the framework of Circular 10, companies that successfully list overseas must repatriate proceeds within a pre-determined time frame to the PRC. Even if an enterprise obtains listing approval, failure to complete the overseas listing within 12 months of such approval would result in the enterprise reverting to its original shareholding structure.

It was originally perceived that the stringent requirements and restrictions under Circular 10 would curb the overseas listing of those PRC enterprises whose red chip structures were not consummated before the implementation date of Circular 10 (that is, September 8, 2006). However, in past years, we have witnessed various ingenious reorganisation plans adopted by different PRC enterprises to oust the application of Circular 10 on their listings in Hong Kong, for example, the so-called “slow walk” or “option” arrangement and the variable interest entity (“**VIE**”) structure. While these options are not free from regulatory risk, it is expected that the transactional structures for red chip listings will continue to be developed and refined.

Foreign exchange registration for red chip listings

Since 2005, SAFE has issued a series of circulars concerning round-trip investments by SPVs, directing that certain types of round-trip investments are required to be registered with SAFE. In particular, the Circular on Relevant Issues concerning Foreign Exchange Administration of Offshore Financing and Round-Trip Investment by Domestic Residents Through SPVs (commonly known as “Circular 75”), which became effective on November 1, 2005 (and which has now been repealed and replaced, as set out below), had been the major regulation governing the foreign exchange administration of Chinese investors’ round-trip investment for almost a decade. Circular 75 imposed registration requirements on the setting up of offshore SPVs by PRC domestic residents for the purpose of acquiring PRC equity and assets, which is a key step in red chip restructuring. As some provisions of Circular 75 were quite vague, there had been different interpretations among different local SAFE offices, posing significant hurdles and risks to red chip restructuring for offshore IPOs.

In July 2014, SAFE issued the SAFE Circular Relating to Foreign Exchange Administration of Offshore Investment, Financing and Round-Trip Investment by Domestic Residents Through SPVs (“**Circular 37**”), which repealed and replaced Circular 75. Circular 37 simplifies and

clarifies the foreign exchange registration requirements and procedures for PRC residents seeking offshore investments and financing, thereby bringing more certainty to the feasibility and timetable of red chip restructuring.

Key changes brought by Circular 37 to foreign exchange registration for red chip listings are summarised as follows:

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| <p>Who has to register</p> | <p>Under Circular 75, it was uncertain as to whether foreign ID holders were required to attend foreign exchange registration. Under Circular 37, “domestic resident individuals” are now defined as PRC citizens who hold PRC ID cards, service IDs or armed police IDs, and foreign individuals who do not have legal PRC ID documents but habitually reside in the PRC for reason of economic interests.</p> <p>By virtue of the implementation guidelines of Circular 37 (the Implementation Guidelines) published by SAFE, an individual who legally holds both a PRC and foreign ID (including holders of Hong Kong, Taiwan and Macau IDs) will be treated as a foreign individual and is thus not subject to the registration obligation under Circular 37.</p> <p>The Implementation Guidelines further provides that evidence of offshore permanent residence cannot be used to establish foreign identity for SAFE registration purposes. In other words, PRC citizens who have permanent residence in another country without holding a formal foreign ID (for example, a green card holder) may still be required to complete foreign exchange registration for their offshore investments or financing.</p> |
| <p>Timing of Registration</p> | <p>Circular 75 required the application to be made prior to the PRC resident establishing or gaining control of the SPV. Circular 37 now provides that domestic residents can form a SPV first but shall not make any capital contribution before completing the initial foreign exchange registration, with the exception of paying registration fees for the SPV formation.</p> |

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| First-Level-Only Registration | <p>Under Circular 75, a domestic resident was required to register all SPVs it owns or controls. Pursuant to Circular 37, a domestic resident only needs to register the first level of SPV owned or controlled by it. This simplifies the registration process and reduces the compliance burden on domestic residents.</p> |
| Repatriation of Offshore Profits | <p>Circular 75 required the repatriation into the PRC of all profits, dividends and proceeds from SPVs within 180 days upon receipt. Circular 37 eliminated this requirement.</p> |
| Registration of Employee Incentive Plan | <p>Prior to Circular 37, foreign exchange registration could only be made for equity incentive plans of offshore listed companies. PRC employees who had employee stock options in a non-listed foreign company were unable to properly realise such rights and remit money relating to such options to foreign companies, nor could they legally exchange their income from selling the stock option into Renminbi.</p> <p>Circular 37 allows senior management and employees of PRC companies directly or indirectly controlled by SPVs to conduct foreign exchange registration with regard to any equity incentive plans granted by non-listed SPVs. Hence, PRC employees may participate in pre-IPO share option schemes of offshore SPVs legally.</p> |
| Specified Penalties for Violations | <p>In contrast with Circular 75, Circular 37 sets out specific penalties for various violations. In particular, Circular 37 expressly provides that prior to the implementation of Circular 37, if a PRC resident has already contributed capital to a SPV without a proper foreign exchange registration, the PRC resident should explain the reasons for failing to register and make remedial registration. SAFE will determine whether to accept the remedial registration and impose administrative penalties on any violation of foreign exchange regulations.</p> |

Relaxation of the “4-5-6 requirements” – a new era for H-share listing

Pursuant to the CSRC’s rule issued in July 1999, enterprises must have RMB400 million of net assets, raise US\$50 million of funds, and have an after-tax profit of not less than RMB60 million before they can apply for listing on overseas main boards, including Hong Kong’s. These are commonly referred to as the “4-5-6 requirements”. During the IPO boom year of 2007, it was widely reported that CSRC had adopted an unofficial policy of approving an H-share listing only if the amount to be raised exceeded US\$1 billion or if the company was willing to do a dual-listing in the mainland. As a result, the trend over the past few years has been for mega-PRC enterprises to conduct “A + H dual listings” on the Shanghai and Hong Kong stock exchanges. For less sizable PRC businesses, they are more commonly listed in Hong Kong by way of red chip listings.

Further to Supplement IX to the Closer Economic Partnership Arrangement (CEPA) which was signed on June 29, 2012, the CSRC promulgated the Guidelines for Supervising the Application Documents and Examination Procedures for the Overseas Stock Issuance and Listing of Joint Stock Companies (No. 45 [2012] of the CSRC) to lift the “4-5-6 requirements” and simplify the approval procedures for overseas listings. The relaxation took effect on January 1, 2013. As CSRC is loosening its grip on overseas IPO applications, H-share listings are opening up to smaller issuers. From January 2013 to October 2014, there have been 23 new H-share issuers on the Main Board of the Stock Exchange, one of which has a market capitalisation of only around HK\$160 million.

Red chip or H-share?

With the abolition of the “4-5-6 requirements”, the distinction between red chip and H-share listing is diminishing. Here is a summary of the comparison between red chip and H-share listing on the HKEx:

| | Red chip | H-share |
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| Listing vehicle | No specific requirements. Any recognised/acceptable jurisdiction can serve as the listing vehicle. The most common listing vehicles are Cayman Islands and Bermuda companies. | Must be a PRC joint stock company. |

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| Key legal obstacle | The listing group needs to undergo restructuring to inject domestic assets/business into an offshore structure, which may be restricted by Circular 10 and Circular 37. | Approval from the CSRC is required. |
| Financial tests | Same. Previous 4-5-6 requirements applicable to H-share listing have been abolished. | |
| Restriction on circulation | Subject to lock-up requirements, all securities can be freely circulated. | Domestic shares held by founders cannot be circulated outside PRC without CSRC approval. The regulatory authorities are exploring full circulation of H-shares. |
| Lock-up period | Pursuant to the Listing Rules, controlling shareholders cannot sell any of their shares 6 months from the date of listing; and within the 6 months thereafter, controlling shareholders cannot sell their shares to the extent of losing the controlling status. | Apart from the requirements under the Listing Rules, according to PRC Company Law, shares issued before listing cannot be transferred within one year from the date of listing. |
| Issue after listing | Pursuant to the Listing Rules, a listed company cannot issue new shares within six months after listing. Generally speaking, approval from PRC authorities is not required for issue of shares after listing. Future financing is more flexible. | Apart from the requirements under the Listing Rules, an H-share listed company requires approval from the CSRC every time when it issues new shares. |

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| Ease of Future Financing | Subject to the lock-up restrictions, controlling shareholders generally can charge their shares for their own borrowings. | The shares held by controlling shareholders are domestic shares, which are not freely tradeable on the stock exchange. Lenders are less likely to accept domestic shares as security for lending. |
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Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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