China to Expand Registration-based IPO System

– A Brief Introduction to the Proposed Rules

On February 1, 2023, the CSRC published draft rules in relation to the expansion of registration-based system across A-share market and solicited public consultation. On the same day the three mainland stock exchanges, ie., the Shanghai Stock Exchange, the Shenzhen Stock Exchange and the Beijing Stock Exchange also published draft ancillary rules in relation to this major step of reformation. The period of consultation is 15 days and ends on February 16, 2023. This short period of consultation indicated a sense of urgency and suggests that the full implementation would be rolled out fairly soon. This note intends to set out a brief summary of some of the most important changes brought about by the proposed rules.

I. The registration-based system reformation: background and scope

The registration-based system reformation kicked off in November 2018 when it was announced that Shanghai Stock Exchange was to set up the STAR Board which would adopt the registration-based system on a pilot basis. The system was then rolled out to the ChiNext Board of Shenzhen Stock Exchange in August 2020 and also adopted by the Beijing Stock Exchange formed in November 2021. Currently only the Main Board (operated by both the Shanghai and Shenzhen Stock Exchanges) still adopts the traditional approval system.

The draft rules published on February 1, 2022, once adopted, will complete the last step of the reformation, upon which the approval system that has been implemented since the inception of PRC securities market (which, to be more accurate, includes a more rigid "approval system" adopted in the early years and a more market-oriented "verification system" as currently in place) will become history. Under the approval system, not only the IPOs, but also virtually every type of transaction involving share capitals of listed companies, require an approval from the China Securities Regulatory Commission, or the CSRC. All this will be changed by the reformation which, once completed, will revamp the regulatory procedures applicable to not only IPOs but also follow-up offerings, public M&As and other capital transactions of listed companies. Stock exchanges will be put to the frontline of the capital market supervision and be delegated with most of the day-to-day reviewing and vetting of disclosures and transactions, while the CSRC will be released from most of such detailed work and will be providing guidance on critical policy issues and acting as the final gatekeeper via the "registration" process.

The registration-based system differs from the approval system in the following ways:

The basic requirements for public offering and listing are substantially optimized. Under the approval system, listing applicants need to comply with a whole set of rigid requirements relating to their compliance, governance, control and etc. ("offering requirements"), and should also satisfy certain financial tests, before they can publicly offer shares. In line with the spirit of leaving the decision with the market, the offering requirements are substantially abridged under the proposed rules, with only the fundamental ones being kept while the others relegated to matters of disclosure. On the other hand, multiple sets of financial tests are designed for different types of companies, catering to the companies with different industry positioning and development stage, and together creating a more comprehensive and inclusive capital market.
More focus is put on disclosure. As noted by the CSRC, registration-based system does not mean slackening the quality requirements; instead, a robust review is required to push for true, accurate and complete disclosure. In addition, a combination of various measures such as onsite supervision and inspection, investigation in response to complaints and whistle-blowing and law enforcement will be utilized to truly hold the companies and intermediaries responsible for the disclosure.
Adhering to the principle of "conducting the vetting with the door open", the entire vetting process by the stock exchanges and the CSRC, including the standards, procedures, contents, process and results, are made transparent to the market, so that the whole cycle is subject to public scrutiny and supervision.

II. Multi-layered capital market: positioning of different boards

The reformation aims at constructing a multi-layered capital market, with different board catering the needs of different companies, as summarized in the following table:

Market	Positioning
Main Board	Focusing on "big blue chip" companies Mainly support high quality companies that are industry representatives with mature business models, stable operations and relatively large scales
STAR Board	Facing the frontline of worldwide technology, facing the main economic battlefield, and facing the major needs of the state Priority will be given to the application of any enterprise which conforms to national strategies; has key and core technologies; is highly capable in scientific and technological innovation; mainly relies on core technologies for its production and operation; and boasts a stable business model, a high level of market recognition, and a good social image, and maintains a strong growth **Industries accepted:** 1. new generation information technology 2. high-end equipment 3. new materials 4. new energy 5. energy conservation and environmental protection

	6. biomedicine 7. other fields that are in line with the positioning of the STAR Board
ChiNext Board	Implementing the strategy of development driven by innovation, adapting to the general trend of relying more on innovation, creation and originations for development
Beijing Stock Exchange	Implementing the strategy of development driven by innovation, and focusing on real economy

III. Unified vetting procedures for the Main Board, STAR Board and ChiNext Board

The proposed rules include unified rules on offering and underwriting that would apply across the Main Board, STAR Board and ChiNext Board, replacing the individual rules currently in place for the three boards. Beijing Stock Exchange is still governed by its own set of rules given its particular link with the National Equities Exchange and Quotation market, or NEEQ, in particular the fact that companies making an IPO on Beijing Stock Exchange should have already been listed on the Innovation Level of NEEQ for at least 12 months.

Leveraging on the results achieved from the pilot implementation of the registration-based system on the STAR Board and ChiNext Board, the proposed rules are largely based off the current rules of these two boards, and prescribe a two-tiered vetting framework for IPO applications whereby the groundwork scrutiny of whether applicants satisfy offering requirements and listing standards, and review and comment on the disclosures, are to be conducted by the stock exchanges (and the stock exchanges have published their own detailed rules for such vetting procedures), after which the CSRC is to make the final "registration" decision. The registration decision granted by the CSRC has a valid term of 1 year during which the applicant may choose the timing of offering as it sees fit. Compared with the existing rules of these two boards, the proposed rules further emphasize the overall guidance and supervision by the CSRC, and require that the stock exchanges should report to the CSRC in a timely manner when they encounter "material sensitive or unprecedented matters, public sentiment eruptions or thread to material violation of laws." The proposed rules also highlight that the CSRC should pay particular attention to whether the applicant complies with national policies and fits the positioning of the board.

The above two-tiered vetting framework also applies to follow-up offerings by listed companies, including follow-up offerings as part of material asset restructurings whereby listed companies issue shares as consideration in exchange for assets.

In connection with the CSRC's acceptance and review of applications, a small but very welcomed change introduced by the draft rules is that the CSRC will no longer reject or suspend applications handled by intermediaries that are under investigation for potential breaches of laws.

IV. Optimization of offering requirements for the Main Board

The focus of this last step reformation is on the Main Board, and accordingly the optimization of offering requirements and financial tests of the Main Board is one of the biggest highlights. As noted above, the offering requirements relating to the governance, compliance and control have been significantly streamlined, with some substantial requirements abolished and many of the previous "threshold" requirements transformed into disclosure matters. Most notable changes include that it is no longer required that intangible assets should account for no more than 20% of net assets and there should be no un-replenished losses as of the last period, and that the detailed requirements on accounting, tax compliances, external guarantees and concentration of clients are no longer prescribed as "threshold" requirements for listing but have become matters to be dealt with via disclosure (although it is expected that the stock exchanges would still take a very rigid attitude towards these matters). In addition, companies with super voting class of shares are now permitted to list on the Main Board.

On the other hand, the financial criteria for listing on the Main Board are significantly enhanced. For example, currently listing applicants only need to have an accumulated revenue of RMB300 million for the past three years, while under the proposed rules they are required to have an accumulated revenue of RMB1,000 million for the past three years, or revenue of no less than RMB600 or RMB800 million for the past one year alone, depending on which set of standards is chosen. In addition, the proposed rules do not seek to abolish the profitability requirement for Main Board, and all three tests for domestic companies require the applicant to be profitable for at least the past one year before its IPO application. These requirements are substantially higher than the listing standards for the STAR Board, ChiNext Board and Beijing Stock Exchange, accentuating the distinction in positioning of different boards and together forming a diversified and multi-layered capital market. With respect to ownership stability and management stability, the requirements are three years for both for the Main Board, and two years for the STAR Board and ChiNext Board.

Consistent with the current rules in place for the STAR Board and ChiNext Board, the proposed rules for the Main Board prescribe different financial tests for domestic companies, "red chip" companies that are listed offshore, "red chip" companies that are not listed, and companies with super voting class of shares. The following table summarizes the financial tests for the Main Board as before and after the reformation:

Type of Companies	Before	After (choose one of the following tests)	
Domestic companies	• Profitable for each of the past 3 years and with an accumulated net profit of ≥ RMB30 million for the past 3 years • Accumulated net	Net profit + revenue /cash flow	• Net profit for each of the past 3 years is positive • Total net profit for the past 3 years ≥ RMB150 million • Net profit for the past 1 year ≥ RMB60 million • Total net cash flow from

Type of Companies	Before	After (choose one of the following tests)	
	operating cash flow ≥ RMB50 million; or accumulated revenue from the past 3 years ≥ RMB300 million • Share capital before offering ≥ RMB30 million • Intangible asset of the past period accounting for ⩽ 20% of net assets • No accumulated un-replenished losses as of the end of last period		operating activities for the past 3 years ≥ RMB100 million, or the total revenue ≥ RMB1 billion
		Market cap + net profit + revenue + cash flow	• Market capitalization ≥ RMB5 billion • Net profit for the past 1 year is positive • Revenue for the past 1 year ≥ RMB600 million • Total net cash flow from operating activities for the past 3 years ≥ RMB150 million
		Market cap + net profit + revenue	• Market capitalization ≥ RMB8 billion • Net profit for the past 1 year is positive • Revenue for the past 1 year ≥ RMB800 million
Red chip companies already listed overseas	Same as the right column	Market cap	Market capitalization ≥ RMB200 billion
		Market cap + leading technology	• Market capitalization ≥ RMB20 billion • With independent research and development and international leading technology, strong scientific and technological innovation ability, and a relatively advantageous position in the competition within the same industry
Red chip companies not yet listed	• Valuation ≥ RMB20 billion, and revenue for the past 1 year ≥ RMB3 billion, or • High-tech enterprises with independent research and development, internationally leading intellectual property rights or proprietary technologies that can	Market cap + revenue	• Market capitalization ≥ RMB20 billion • Revenue for the past 1 year ≥ RMB3 billion
		Market cap + growth in revenue + leading technology	• Market capitalization ≥ RMB10 billion • Rapid growth in revenue • With independent research and development and international leading technology, a relatively dominant position in the competition within the same

Type of Companies	Before	After (choose one of the following tests)	
	lead the development of important domestic fields, and with obvious technological advantages (there are corresponding tests on the proportion of R&D personnel, the number of patents, R&D investment, and operating revenue)		industry
		Market cap + revenue + growth in revenue + leading technology	• Market capitalization ≥ RMB5 billion • Revenue for the past 1 year ≥ RMB500 million • Rapid growth in revenue • With independent research and development and international leading technology, a relatively dominant position in the competition within the same industry
Companies with super voting shares	Not accepted	Market cap + net profit	• Market capitalization ≥ RMB20 billion • Net profit for the past 1 year is positive
		Market cap + net profit + revenue	• Market capitalization ≥ RMB10 billion • Net profit for the past 1 year is positive • Revenue for the past 1 year ≥ RMB1 billion

V. Reforms in the underwriting and offering mechanism

Under the approval system, there is a "window guidance" applicable to the Main Board that the IPO pricing should not be higher than a P/E ratio of 23, which represents a significant administrative intervention on the market and has been subject to long time criticism. This requirement is abolished in the proposed rules. There are some other fine-tuning of the underwriting and offering mechanisms on the basis of current practices of the STAR Board, for example, IPOs on the STAR Board within a certain scale can now also be priced via a "direct pricing" method instead of having to go through a price inquire procedure, which is now consistent with the other boards, and the types of institutional investors that can participate in offline price inquiries are expanded to include futures companies. On the other hand, an interesting feature of the STAR Board and ChiNext Board IPO underwriting is that the sponsors are required to subscribe for a small number of the IPO shares, and the proposed rules make it clear that this will not be the case for the Main Board.

VI. Transition arrangements

To ensure a smooth transition from the old rules to the new ones, the draft rules propose thoroughly thought-through and friendly transition arrangements. As of February 1, 2023, (i) companies already having obtained CSRC approvals are permitted to continue to complete their transactions under the old rules; (ii) companies having passed the hearing but not yet obtained the final approvals are given the option to choose either to carry on under the old rules or to suspend and wait for the new rules to take effect; and (iii) companies that have already applied for IPO on the Main Board but do not satisfy the new financial tests can still choose to apply the original financial test, but should comply with the other offering requirements under the new rules. Once the final rules are published, the CSRC will stop reviewing IPOs, follow-up offerings and material asset restructurings, and there will be a 10-work-day period during which all pending cases will be transferred to the stock exchanges. The stock exchanges will start accepting fresh applications after this 10-work-day period.

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