

Suggestions for China's Registration-Based IPO Reform¹

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Abstract: At a recent CF40 closed-door seminar, experts probed into China's registration-based IPO reform and the newly-released *Draft Administrative Measures for the Registration of Initial Public Offerings* and proposed policy suggestions for the registration-based IPO system design and the draft rules.

I. SUGGESTIONS TO THE SYSTEM DESIGN FOR CHINA'S COMPREHENSIVE REGISTRATION-BASED IPO REFORM

1. Build a fair and reasonable liability system for intermediaries

A fair and reasonable liability system underpins the integrity and diligence of intermediaries essential to the registration-based IPO reform. Experts' suggestions in this regard include:

First, distinguish between several liability and joint liability. Under the current system, the sponsor of an IPO plays, to a large extent, the part of a "general contractor." It should be clearly stipulated that sponsors shall bear their sole liabilities alone, while additional liabilities associated with their roles at law firms or accounting firms shall be determined by whether they have fulfilled their due responsibilities.

Second, distinguish between restrictive liabilities and legal liabilities. Due to cost and time limitations, even large, experienced, and high-quality intermediaries could

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make mistakes which is just inevitable. Regulators should adopt a long-term view and a more inclusive mindset and hold intermediaries accountable in a targeted manner rather than with a comprehensive approach. Greater emphasis should be placed on individual liabilities in terms of qualification, while institutional liabilities must be stressed when it comes to civil compensation in accordance with the institutions' gain. The stock issuer and other involved parties shall be held accountable for illegal acts including malicious frauds and fabrications.

Third, distinguish between mismanagement and malicious fraud. International experience suggests that more attention should be paid to market exits on a regular basis in a market-based manner after the registration-based system is put in place in order to foster a market where the fittest survive. Worsened financial position or even the collapse of a company as a result of the macroeconomic environment or policy changes, or the company's mismanagement is no reason to hold intermediaries accountable, as this must be distinguished from collapses due to artificial financial frauds.

2. Establish clearly-defined, transparent, and stable regulatory rules and expectations

First, enhance qualification review while respecting the decisive role of the market. The registration-based reform is to give the helm back to the market. The registration-based IPO system addresses information asymmetry between the issuers and the investors while drawing a clear boundary for the role of the regulators. While enhancing qualification review, regulators should not provide any endorsement – they should give the helm back to the market instead. In case of any irregularities by companies registered at the China Securities Regulatory Commission (CSRC), issuers, intermediaries, and regulators shall all take their due, clearly-defined responsibilities, and regulators should not overreach.

Second, keep a proper pace and a stable market. Implementing a registration-based IPO system does not mean companies can seek IPO at their own will; instead, IPOs should proceed at a proper pace and scale. A key supporting measure is market exits on a regular basis: smooth exit mechanisms can keep the

number of applications and the speed of new IPO rollouts under proper control in order to relieve the expansionary pressure on the market, spur healthy competition, improve the market structure, provide space for good companies to grow and promote the long-term, high-quality development of the Chinese stock market.

Third, stabilize expectations and build a law-based market. Expectations can only be stable in an open, transparent, and law-based environment. No implicit barriers should be artificially put in place unless laws and regulations require them.

3. Enhance protection for individual investors

Improve investor protection in a market-based manner. The capital market should uphold a “caveat emptor” concept where individual investors are risk-aware. “Protection” for them should crystalize as better systems for individual investors to defend their own rights, such as the legal counsel system and the reversion of the burden of proof, etc. Market participants need to stay patient during the reform with an inclusive embrace and resolve any problem in a market-based way.

IPO pricing shall give greater play to institutional investors to reduce the risks facing individual participants. The implementation of the registration-based IPO system could be followed by more broken issues, raising higher requirements on the pricing and risk management abilities of investors. As a result, individual investors with limited research ability and risk tolerance will participate less. At present, IPOs on the main board still incorporate individuals as a subject of price inquiry. Still, experts suggest that professional institutions should be the main participant in IPO pricing to reduce individual investors’ risk exposure.

II. SUGGESTIONS TO THE DRAFT RULES ON REGISTRATION-BASED IPO

1. Clearly define related legal liabilities and ensure consistency with the Criminal Law of the People's Republic of China

To ensure consistency with other laws so that the Supreme People's Procuratorate and the Supreme People's Court can provide authoritative judicial interpretations, the Draft should stay aligned with the Criminal Law of the People's Republic of China in terms of provisions on legal liabilities associated with registration-based IPOs, including those as a result of “issuers or intermediaries concealing important facts or fabricating material false statements in securities issuance documents” and “registration application documents and disclosures containing false recordation, misleading representation and material omission”.

2. Detailed provisions and clarified statements are important to make the rules more predictable

First, clearly define the time frame for the entire registration application process to provide stable expectations for market participants.

Second, Section 3 in the Draft adopts a principle-based approach to defining the trading boards. However, there should be more detailed provisions and more quantitative standards when defining the main board. It is stipulated in Section 23 of the Draft that “the CSRC shall, upon receiving registration application documents collected at stock exchanges, pay attention to whether the issuer is qualified in accordance with China’s national industrial policies and listed on the proper trading board.” In the market economy, various sectors and industries should be mutually-dependent and mutually reinforcing; the capital market should also provide widespread and balanced support for the real economy.

Third, clarify the powers and responsibilities of the CSRC and stock exchanges. For example, Article 5 of the Draft contains an expression of “initial public offering and listing,” combining initial public offering and exchange listing together. It is suggested to separate the two as initial public offerings do not necessarily have to be listed on an exchange but can also be listed on a regional equity market. The distinction between the two can help clarify unclear responsibilities between the CSRC and exchanges.

3. Enrich key contents and strengthen rules and laws on developing an open, fair,

and just market

Though Articles 36 to 38 of the Draft are provisions over market participants, including issuers, sponsors, lawyers, and certified public accountants, legal liabilities for violations need to be stipulated more clearly. Moreover, there should be more content around rules and laws to ensure an open, fair, and just market, for example, more comprehensive stipulations on issues such as legal liability, small and medium investors' protection, delisting, etc.

4. SUGGESTIONS FOR OTHER DRAFT RULES

First, appropriately relax the requirement for refinancing. It is proposed in the Measures for the Registration of Securities Issuance by Listed Companies (Exposure Draft) that "listed companies are allowed to issue shares to specific targets with a total financing amount not exceeding 300 million yuan and not exceeding 20 percent of the company's net assets at the end of the most recent year". For blue chip stocks listed on the main boards, the financing ceiling of 300 million yuan is rather low. It is proposed to appropriately raise the ceiling of the refinancing scale of listed companies on the main boards under the simple review framework to match the actual capital needs of such companies.

Second, relax M&A requirements. According to the Rules for Review of Asset Restructuring of Listed Companies (Exposure Draft), only one set of financial criteria is set for restructuring and listing on the main board. In contrast, IPO on the main board contains multiple sets of criteria featuring different combinations of "net profit + revenue/cash flow under market capitalization". Considering that standards for restructuring and listing should be more inclusive than that for IPO, it is suggested to consider setting multiple sets of financial standards with reference to restructuring and listing on the growth enterprise market. In addition, it is recommended to support cross-board M&A, transfer among different markets, and mergers among A-share listed companies.

Third, relax requirements for companies listed overseas to return to China's main board. The Implementation Measures for the Supervision of Domestic Issuance of Shares or Depositary Receipts and Listing of Pilot Innovative Enterprises (Revised

Exposure Draft) clarifies for the first time the market capitalization and financial indicators that red chip enterprises should meet for listing on the main board. In order to better attract high-quality red chip enterprises listed abroad to return to the main board, it is suggested to reduce requirements on industry, business features, and revenue growth rate; listing standards designed for red chip enterprises should not be used to restrict blue chip companies.