BLOOMBERG
CORPORATE LAW
JOURNAL

VOL. 1 | SPRING 2006 | NO. 2

CAPITAL MARKETS

CHINA-BASED COMPANIES ACCESSING THE U.S. CAPITAL MARKETS

BEEN THERE, DONE THAT – BUT DO WE HAVE THE RIGHT FOCUS TO CREATE PUBLIC COMPANIES WITH A SOLID LEGAL FOUNDATION FOR LONG-TERM SUCCESS?

By Paul W. Boltz and Robert Woll***

What a short but exciting trip it has been. A mere fourteen years have passed since the first listing in the U.S. of a company having all of its assets in China (Brilliance China Automotive Holdings, Ltd. on the New York Stock Exchange in 1992) and the first overseas listing by a Chinese corporation (Tsingtao Brewery on the Main Board of the Stock Exchange of Hong Kong in 1993), and routine listings of China-based companies on the New York Stock Exchange, Nasdaq and over-the-counter markets. This is a good time for a brief review of the key challenges facing these companies, both in the initial public offering (IPO) process itself and in the longer term as public companies on the U.S. markets.

---

* *Paul Boltz is a partner based in Morrison & Foerster's Hong Kong office. He has practiced corporate and international securities law in the U.S., Hong Kong and China, with a particular focus on representing companies and investment banks in Asia for U.S. registered and Regulation S/Rule 144A securities offerings. Mr. Boltz also has extensive experience with venture capital transactions and private equity fund formation and investments, including advising clients on forming onshore private equity funds in China. Mr. Boltz is a frequent speaker and writer on corporate governance issues in Asia, and regularly advises companies listed in the U.S. on regulatory and corporate matters.*

** *Robert Woll is a partner at Morrison & Foerster, based in the firm's Hong Kong office. He advises clients primarily on M&A and private equity transactions, international capital market offerings and other cross-border financings. He has devoted substantial efforts to assisting China-based emerging growth companies with venture capital financing, IPO and M&A transactions. His practice also includes the organization of private equity and venture capital funds targeting China, India and other Asian markets. Mr. Woll regularly speaks and publishes on such topics as the development of China's capital markets, private equity transactions in China and the financing of China-based emerging growth companies.*

In the first waves of state-owned enterprises (SOEs) listing in the U.S. during the 1990s and the 'mini-wave' of China-based companies listing on Nasdaq during the dotcom boom, the overwhelming consideration of the issuers and their advisors was simply finding ways to overcome novel regulatory and legal hurdles to get the IPOs done at all. The SOEs wrestled with very fundamental issues of separating the assets they wanted to list from those designated to be held by the state, asset valuation concerns and the need to get what were often first-of-kind approvals from the State Council, various Chinese ministries and the China Securities Regulatory Commission (or, in the early days, the People's Bank of China). In the subsequent mini-wave on Nasdaq (NetEase, Sina and Sohu), concerns about how to form onshore/offshore parent company structures to facilitate listing and allow foreign investment in the Chinese Internet industry, which was deemed prohibited at the time (now restricted), dominated the process.

Many of these issues remain significant hurdles in offshore IPOs today. The key difference, however, between the current environment and the IPOs cited above is that now there are tried-and-tested methods of effectively dealing with most of the principal issues. Equally important, a seasoned body of lawyers, auditors and government officials, who understand and can apply these methods to different companies, has arisen. Perhaps the most classic example is the Internet/wireless value-added corporate structure devised in the late 1990s to address regulatory restrictions on investment in this sector, whereby a domestic Internet/wireless company forms an offshore parent company and becomes a wholly foreign owned enterprise (WFOE) of that parent. At the same time, in order to comply with People's Republic of China (PRC) restrictions on foreign investment, the WFOE places its principal operating business in a separate company that is wholly owned by PRC individuals who are associated with the WFOE. The parent company and the WFOE control the newly-formed Internet/wireless company through a series of contracts and pledge arrangements. At conception, this structure was considered by some observers to be risky and overly complicated for investors in a Nasdaq IPO, but it has nonetheless become the industry standard, with more than fifteen companies on Nasdaq utilizing it.

As the market matures from the almost 'wild west' period of innovation and improvisation in the 1990s and 2000, it is worth pausing for a moment to consider whether issuers, underwriters and legal counsel have moved too far in the opposite direction to an almost cookie-cutter approach to IPOs by China-based companies which does not serve the long-term interests of these companies. Some aspects of these IPOs have become so routine – particularly in the context of private companies – that it is common to see mid-level and junior attorneys managing the project by mimicking what was done in the last deal to go to market, using a "cook book" approach (Cayman Islands parent company (check); off-theshelf share incentive plan (check); pro-board of directors charter documents (check), etc.).

Following precedents in this context is not, of course, inherently wrong. Quite to the contrary, this approach can result in a deal/corporate structure and prospectus that will be familiar to regulators and investors, and potentially pave the way for a relatively efficient IPO process. Nonetheless, given the enormous diversion of management time, high fees for advisors and intense stock price volatility to which many U.S.-listed, China-based companies have been subject as a result of post-IPO problems, issuers may be better served by looking beyond the basic steps to get the IPO done to what it takes to create a robust platform for long-term success following the IPO. The steadily rising stream of class action litigation, SEC investigations and various types of internal investigations into corporate misconduct involving U.S.-listed, China-based companies would signal that fresh thinking may be warranted.

The purpose of this article is not to advocate for wholesale changes in the U.S. IPO process for China-based companies, but rather to highlight just a few of the areas where more pro-active, forward looking action by an issuer's management and board, with assistance from outside legal counsel and auditors, could have a significant impact in the years after the IPO. The following discussion focuses on issues that are of particular relevance to private companies that list in the U.S. through an offshore holding company, which includes essentially all China-based companies on Nasdaq and several companies on the New York Stock Exchange.[1] As a general matter, SOEs are often subject to company-specific and sector-specific political/governmental policy issues that are a function of the particular government ministry or ministries which oversee the SOEs,[2] though certain of the topics below may be relevant to SOEs as well.

- **Corporate Governance/Succession Planning.** As is the case elsewhere in the world, for many private companies in China, filling key vacancies in senior management is often a primary task in the period before the kick-off of the IPO (and sometimes the search continues even after the kick-off). Assembling a complete management team is particularly problematic in China, however, due to the shortage of management talent that is experienced with

---

1. The pace of SOE listings in the U.S. has slowed in recent years, with the last major such listing having occurred in 2003 (China Life's listing on the New York Stock Exchange). The reasons for this slow-down have been attributed to a number of factors, including the dwindling number of SOEs that are of sufficient size and quality to justify a U.S. listing, the growing perception that the benefits of a U.S. listing can be outweighed by the high compliance costs (particularly Section 404 under the Sarbanes-Oxley Act) and the increasing ability of the Stock Exchange of Hong Kong to support major offerings such as the US$8 billion IPO by China Construction Bank in October 2005.

2. For example, the speed at which SOEs can complete their IPOs, the identification of the assets and operations that will be part of the entity to be listed and the composition of the issuer's management and board of directors are often decisions made within the political realm, rather than based purely on business considerations.

public companies. Moreover, there is often an enormous gap in experience and attitudes among members of senior management and between senior management and a company's staff. For example, it is not uncommon for one or a few members of management to have had some experience working for a major public corporation, with the rest of management (often founders) having worked for domestic Chinese companies. In that case, members of management can have very contradictory views of the roles of management, the board of directors and outside advisors such as legal counsel and auditors. Anyone who regularly deals with U.S.-listed, China-based companies will probably have come across the situation where one member of management wants to consult outside legal counsel to discuss a sensitive disclosure issue, while other members will not want to incur the cost and perceived hassle of consulting counsel for an issue that is "just a routine matter that all Chinese companies deal with."

Thus, while filling key management positions is critical to the success of an IPO, it is equally important to sensitize all members of management to core corporate governance issues, such as the importance of adhering to internal controls and procedures, the meaning of fiduciary duties, when board and shareholder approvals are required, the long-term priorities of the board, the practical meaning of transparency and basic disclosure and corporate governance principles under the U.S. securities laws. Many China-based companies preparing for a U.S. IPO receive some form of training in this regard from legal counsel and/or auditors. Yet, this training often takes the form of a check-the-box exercise (*e.g.,* how many independent directors does the issuer need at IPO and thereafter?), rather than a more comprehensive review of corporate governance as a whole. In addition, the education process should be augmented with a commitment by management and the board of directors to act as if the company is already public during the pre-IPO period to the extent reasonably possible. This includes holding formal board meetings with written agendas and with presentations as necessary by outside advisors, applying the somewhat abstract concept of fiduciary duty to specific situations faced by the board of directors, identifying what the board expects from management in terms of business updates and operational reports, and reporting internal control weaknesses to the board or a designated committee and to outside auditors.

The value of such practices is heightened by the fact that U.S.-listed, China-based companies often do not have in-house counsel with any experience with U.S. laws due to lack of available talent or, in some cases, an unwillingness to pay for such talent. These companies thus lack a point person to supervise legal compliance and to identify important legal issues and determine whether they should be elevated, for example, to the board of directors or outside counsel or auditors. In addition, many such companies form the offshore parent company which ultimately lists in the U.S. only shortly before the IPO. As a result, a company's management and staff in that situation will have little or no experience dealing with the legal requirements of the parent company's jurisdiction of incorporation (typically the Cayman Islands, in the case of China-based companies quoted on Nasdaq). Without pro-active guidance from outside legal counsel and auditors in the pre-IPO period to address these China-specific issues, the combination of varied management backgrounds/sophistication regarding corporate governance, and the absence of internal knowledge of U.S. and other applicable laws, can lead some China-based companies to lurch from crisis to crisis immediately after the IPO.

One final piece which is often overlooked during an IPO is succession planning for senior management. As mentioned above, there is a shortage in China of experienced managers, and the difference in experience and skills between a China-based company's senior management and lower-tier managers can be significant. In that case, a company's board of directors may not be able to promote from within to fill vacancies in senior management, even on a temporary basis. This can leave the company not only with significant operational and leadership gaps, but also with compliance problems (*e.g.*, in the case of the departure of the CEO or CFO, who will sign the Sarbanes-Oxley mandated certifications which are attached to annual reports filed with the SEC?). It is therefore critical that boards of directors keep succession planning on their long-term agenda.

- **Corporate Policies and Procedures.** Just as it is important to have directors, management and staff who understand corporate governance principles and legal requirements applicable to U.S. public companies, it is critical that companies have a written framework of policies and procedures which are tailored to the ways in which China-based companies actually operate. For example, it is customary for most U.S.-listed, China-based companies to communicate their quarterly results solely through a press release with selected financial information, rather than through a quarterly report on Form 10-Q. Such press releases are a key part of those companies' periodic public disclosure, and boards of directors should consider whether additional procedures should be built into an audit committee charter to ensure the releases are thoroughly reviewed in a timely manner. Similarly, for companies that have senior management members who are inexperienced with best practices for public company policies and procedures and that lack sophisticated in-house counsel, clearly written procedures for internal auditors can be useful, even though they are not required to complete an audit or the IPO itself.

China-based companies also often engage in numerous related party transactions, and it is customary in an IPO for outside legal counsel to spend significant time drafting disclosure about such transactions and for outside auditors to determine how to account for them.[3] It is much less customary, however, for companies to evaluate at IPO whether they should adopt related party transaction approval procedures and controls so that management and the board of directors can systematically review such transactions on a timely basis.[4]

- **Investor Relations and Public Announcements.** As with in-house counsel, locating experienced investor relations personnel in China can be difficult for many companies. Third party investor relations firms which can provide assistance in this regard are expanding in Hong Kong and China, but nonetheless, there are often quality control gaps in this area when the company has no staff internally who can effectively supervise these activities. For example, in some cases when bad news is reported about a U.S.-listed, China-based company, the company's first reaction is to rush out an announcement denying any problems before having fully analyzed the situation. There are also examples of companies becoming caught up in providing insider information to appease angry shareholders who are emailing company management.

  Given that poor handling of shareholders and public announcements can negatively affect a company's share price and potentially create significant liability exposure, it is in the company's best interest for management to:
  - commence searching for appropriate investor relations personnel even before the IPO is complete,
  - learn the basic principles of public disclosure (for example, what types of things not to say in a press release and avoidance of selective disclosure to individual shareholders). All too often insufficient attention is given to this

3. This focus on disclosure is in stark contrast to the requirements of the Stock Exchange of Hong Kong, which evaluates the substantive merits of related party transactions during the IPO review process and generally requires shareholder approval of those transactions.

4. Such procedures can also assist the board of directors satisfy Nasdaq Marketplace Rule 4350(h) which provides that related party transactions must be approved by the audit committee or another body of independent directors. The New York Stock Exchange Listing Rule 307.00 contains an analogous provision. These procedures and controls can also facilitate compliance with substantive prohibitions under the Sarbanes-Oxley Act, such as the Section 402 prohibition against making personal loans to officers and directors except in very limited circumstances.

subject, as management focuses on what to say during the "road show" for the IPO and outside legal counsel emphasizes controlling and limiting most forms of public disclosure to avoid U.S. securities law violations, and

- give advance copies of public announcements to outside legal counsel and/or auditors when the announcements involve material legal or accounting issues.

- **Equity Compensation.** U.S.-style equity compensation plans have become common among U.S.-listed, China-based companies, but it is equally common for too little attention to be paid to the specifics of how the plan will be administered in compliance with Chinese laws, regulations and regulatory "guidance." For example:
  - *Foreign Exchange Controls*. Currently, there is no law or regulation establishing a procedure for individuals in China to obtain approval for converting Renminbi into U.S. dollars (or any other foreign currency) and making offshore remittances to exercise stock options or purchase shares of foreign companies. There are a number of possible alternatives to deal with this restriction, including cashless exercises of stock options, but companies need to be educated about them so they can select the alternative(s) which work best for the company and its equity award grantees.
  - *Chinese Securities Law.* The securities laws in China do not currently prohibit individuals in China from being granted options, restricted stock or other awards for which the underlying equity securities are issued by foreign companies or from purchasing stock of foreign companies. There are, however, restrictions on "public offerings" of securities in China. The definition of public offering was amended recently to include, among other things, an offering of securities to more than 200 people. As this definition is relatively new, if a company is considering including more than 200 employees in China in an equity compensation plan, it would be prudent to review this issue as early as possible and possibly contact the relevant governmental authorities.
  - *Taxation.* The Chinese government imposes a progressive income tax of up to 45% on employees when they exercise stock options. It is important to note that the company which granted the award has a direct obligation to make the necessary tax withholdings on behalf of its employees as a withholding agent. This creates a tension between the company, which wants to satisfy its withholding obligation, and the grantee, which wants to avoid the tax to the greatest possible extent. Companies are often approached by grantees and third parties with various plans to avoid these taxes, the legality of

which is sometimes questionable. Timely advice from outside legal counsel and auditors on these issues can prevent the company from becoming entangled in morale-sapping arguments with its employees over tax withholding.

- **Future Dual Listing.** Traditionally, if a China-based company wanted to list in the U.S. and another jurisdiction, it would do so simultaneously at IPO. The typical example is an SOE, such as China Mobile, which lists at the same time on the New York Stock Exchange and the Main Board of the Stock Exchange of Hong Kong (SEHK). In that case, the company would address the respective listing requirements of both exchanges at IPO.

  Recently, however, O2Micro International Limited, a Cayman Islands company with major China operations that has been quoted on Nasdaq for more than five years, subsequently effected a dual primary listing on the Main Board of the SEHK.[5] It is too soon to tell whether other China-based single listed companies will make a similar move, but companies preparing for a U.S. IPO may wish to consider whether they should take certain measures that would make such a secondary listing easier to effect. For example, listing American depositary receipts, instead of ordinary shares, in the U.S. can resolve price level disparities that exist between certain exchanges,[6] as well as the settlement of shares moving from one exchange to another. There are also specific SEHK rules applicable to stock option plans that conflict with customary practice for Nasdaq-quoted companies, which would have to be addressed in a subsequent listing in Hong Kong. Given that most Nasdaq-quoted companies originating from China only have a single listing and that the appetite for China issuers by investors on the SEHK is significant, these companies would benefit from giving some thought upfront during the U.S. IPO process to the mitigation or removal of any unnecessary roadblocks to a subsequent dual listing in Hong Kong.

CONCLUSION

In an environment that is developing as quickly as China, the concept of "best practice" is a fluid concept — particularly in the context of U.S. IPOs by China-based companies, which are inherently complex due to the multi-jurisdictional nature of the legal issues and sometimes conflicting business practices between China and the U.S. Nonetheless, the

---

5. This was also the first ever listing by a Nasdaq-quoted company on the Main Board of the SEHK.

6. For example, shares on the SEHK typically trade below US$1, while shares on the Nasdaq National Market must by rule trade above that level or risk delisting. American depositary receipts (ADRs) can address this issue by adjusting the number of ordinary shares represented by each ADR so that the per ADR price is well above US$1 for Nasdaq-purposes, but the per ordinary share price on the SEHK would be below US$1.

market for such IPOs has clearly matured to the point where shareholders, directors and management of pre-IPO companies should be asking their advisors not only "Can you complete my IPO quickly?" but also "Can you assist us in putting together the pieces necessary for the company to thrive in the long term after IPO?" It is, therefore, incumbent on all parties participating in the IPO process to constantly re-evaluate where they can add another layer of value to companies that goes beyond the immediate hurdle of finishing the IPO.