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Authors Dr Lerong Lu, Lecturer in International Financial Law, King's College London. Email: lerong.lu@kcl.ac.uk

Ningyao Ye, PhD Candidate in Financial Law, School of Law, University of Leeds. Email: lwny@leeds.ac.uk

PROMOTING HIGH-TECH INNOVATION THROUGH CAPITAL MARKETS LAW REFORM: DECIPHERING THE SCI-TECH INNOVATION BOARD OF THE SHANGHAI STOCK EXCHANGE

This International Briefing introduces and analyses China's latest reform of capital markets law in light of its recent launch of the sci-tech innovation board (star market) to facilitate the fundraising of technological and innovative businesses. The briefing evaluates the functions and justifications for the star market, and assesses the latest regulatory frameworks including registration-based IPOs, listing standards, information disclosure, and investor suitability.

INTRODUCTION

In order to support the development of high-tech industry, China has been reforming its capital markets laws and securities regulations to provide more accessible and affordable financing options for its tech entrepreneurs. Traditionally, China's capital markets have not been very friendly towards high-tech companies as they have strict rules regarding profitability and share ownership, which prevent most companies from listing in the domestic market. However, things have changed dramatically in recent times. The China Securities Regulatory Commission (CSRC) has started to allow some foreign-listed Chinese tech companies to issue Chinese Depositary Receipts (CDR) that can be traded on Shanghai and Shenzhen stock exchanges.¹ Moreover, China and the UK have jointly launched the Shanghai-London Stock Connect (SLSC) enabling eligible Shanghai and London-listed companies to issue depositary receipts to access each other's stock markets.² The SLSC allows Chinese tech companies to tap the UK's stock market and have wider access to international investors. Against this backdrop, this

International Briefing discusses and analyses the science and technology innovation board of the Shanghai Stock Exchange, including its functions, justifications, and relevant legal and regulatory issues.

THE FUNCTIONS OF THE SCI-TECH INNOVATION BOARD

The science and technology innovation board (which is commonly referred to as the "sci-tech innovation board" or "star market") has been the latest regulatory reform in the Chinese capital markets to aid the fundraising of tech enterprises. The total market capitalisation of the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) is RMB 45.6trn (\$6.43trn), which is around 56% of China's GDP. However, the total market cap of US stock markets is \$36trn, equivalent to 180% of the US' GDP.³ This means that the Chinese capital market still has great growth potential to match the scale of its economy and to meet the financing needs of its businesses.

In November 2018, President Xi Jinping made a keynote speech at the opening ceremony of the 1st China International Import Expo in Shanghai where he announced the launch of the sci-tech innovation board.⁴ It is a brand-new trading platform at the SSE with various experimental capital market reforms including the registration-based system for IPOs. On 13 June 2019, the sci-tech innovation board was officially opened at the Shanghai Lujiazui Forum. On 22 July 2019, the first group of 25 companies, including China Railway Signal & Communication, Anji Technology, and Shanghai MicroPort Endovascular MedTech, were admitted to trading at the board. On the debut date, the 25 companies saw an average share price rise of 139.55% and an average Price-to-Earnings (PE) ratio of 120, and the total trading volume for the first five days exceeded RMB140bn.⁵ On 8 August 2019, the second group of companies obtained a listing on the star market, including Amlogic, the semi-conductor maker, and Shanghai Friendess Electronic Technology Corp Ltd.

The sci-tech innovation board fills a gap in China's capital markets by combining the advantages of both exchange trading platforms and off-exchange trading venues in China. The SSE and SZSE main boards, the SZSE small and medium-sized cap board, and the SZSE growth enterprises market are formally regulated exchange trading platforms with high market liquidity as almost any Chinese citizens can take part in the trading since there is no investment threshold. However, all of the above markets have strict and onerous listing rules and any IPO applicants at the SSE and the SZSE have to obtain the administrative approval from the CSRC and securities exchanges, apart from meeting relevant standards in company law and securities regulations. On the contrary, it is relatively easy for businesses to get a listing in the over-the-counter (OTC) platforms like the

National Equities Exchange and Quotations (NEEQ) and regional equity markets since they use the registration-based IPO system. Nonetheless, both markets suffered the problem of low liquidity as they have extremely high thresholds for individual investors which prevents most Chinese citizens from trading at such forums. Investors need to have at least RMB5m (\$706,000) to be eligible to take part in the trading at the NEEQ. Accordingly, sci-tech innovation board combines the advantages of both exchange and OTC trading by providing tech companies with easy access to a highly liquid market that attracts middle-class investors in China. It has differentiated itself from other existing markets and boards in terms of market layers, listing standards, and operating rules.

WHY DID CHINA LAUNCH THE SCI-TECH INNOVATION BOARD?

There are two main reasons for the establishment of the sci-tech innovation board. First, the new trading platform is said to support the growth of high-tech industries by granting them more financing resources. In the past, Chinese tech companies were mostly reliant on foreign private equity (PE) funds and overseas capital markets to raise funds. Promoting technological innovation has become a top priority for the Chinese government in recent years as the country has fostered a massive high-tech industry. China is the largest patent-filing country making 1,381,594 patent applications in 2017, compared with 606,956 applications in the US and 318,479 applications in Japan.⁶ China has launched the “Made in China 2025” initiative aimed at upgrading its industry capacities to produce more high value-added products and services.⁷ The initiative set out specific goals for ten prioritised industries in need of substantial fund backing:

- robotics;
- new generation information technology;
- aviation and aerospace equipment;
- maritime equipment and hi-tech ships;
- railway transport;
- new energy and energy-saving vehicles;
- energy equipment;
- agricultural equipment;
- new materials; and
- biopharma and hi-tech medical devices.

Second, the launch of sci-tech innovation board is of strategic importance to promote Shanghai as a leading international financial centre. In 2018, the total transaction volume of the city’s financial markets reached RMB 1,645.8trn (\$232.54trn), up 15.2% from the previous year.⁸ There are 1,605 financial institutions in Shanghai, among which 30% are foreign institutions. Shanghai is the economic centre of Yangtze River Delta region, one of the most developed areas in China. Based on its strong economic foundation and financial strength, Shanghai is predicted to become one of the top international financial centres in the 2020s, competing with rivals such as New York, London, Hong Kong and Singapore. According to

the Global Financial Centre Index (GFCI), Shanghai was ranked as the 5th largest financial centre in the world.⁹

THE REGULATION OF THE SCI-TECH INNOVATION BOARD

On 1 March 2019, the CSRC issued “Sci-tech innovation board initial public offering share registration administrative measures (trial implementation)” and “Sci-tech innovation board listed companies continuous supervision measures (trial implementation)” laying down basic rules for the listing and trading activities at the sci-tech innovation board. Subsequently, the CSRC and the SSE promulgated a series of regulatory rules, the main points of which are highlighted below.

Approval-based IPO v registration-based IPO

At present, both the SSE and the SZSE have adopted a so-called “approval-based” IPO system under which listing applicants are subject to strict financial censor and administrative approval by the CSRC’s public offering review committee. The basis of China’s securities regulation rests on the pre-listing financial checks rather than post-listing information disclosure. IPO applicants have to pass at least three rounds of administrative reviews to obtain final approval from the securities regulator. On average, an IPO application takes 589 days.¹⁰ Sometimes the CSRC freezes new IPOs completely as it can refuse to grant approvals in order to control the supply of new shares and stabilise share prices and the share index in a bear market. The “approval-based” system is criticised as being inefficient and opaque, as the regulator has excessive power in deciding the outcome of IPO applications. Therefore, China has been gradually transitioning towards a more market-oriented “registration-based” IPO system. In December 2015, the standing committee of the National People’s Congress, the Chinese parliament, authorised the implementation of registration-based IPOs.¹¹ This provides a legal basis for the trial of registration-based IPOs in the star market. This is the first time that there will be a “registration-based” system in China’s stock exchange, reducing governmental intervention in the capital market. The CSRC will no longer conduct substantial examination over the issuing companies as long as their investment bankers, accountants, and lawyers provide the necessary legal and financial documentation in accordance with the relevant regulations. The “registration-based” system has reduced the costs of IPOs while shortening the time frame. However, it requires a higher level of information disclosure for issuers following the IPO to protect the interests of investors.

More diverse listing standards

The sci-tech innovation board has loosened the listing standards for tech and innovative companies. It has broken the old rules of China’s A-share market that listing companies must make a profit as the board allows high-tech businesses to go public when they are still making losses. Instead, it will comprehensively consider multiple factors regarding the listing applicants, such as market cap, profit, revenue, research and development (R&D) expenditure, cash flow,

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and technological achievement. The IPO applicants have to meet one of the following standards:¹²

- the predicted market cap is no less than RMB1bn and the company has made positive profits over the past two years with an accumulated profit amount of no less than RMB50m, or the predicted market cap is no less than RMB1bn and the company has made positive profits for one year with an accumulated profit amount of no less than RMB100m;
- the predicted market cap is no less than RMB1.5bn, the revenue of the previous year is no less than RMB200m, and the R&D Expenditure of the past three years should be no less than 15% of the accumulated revenues of the past three years;
- the predicted market cap is no less than RMB2bn, the revenue of the previous year is no less than RMB300m, and the accumulated net cash flow of the previous three years should be no less than RMB100m;
- the predicted market cap is no less than RMB3bn and the revenue of the previous year is no less than RMB300m; and
- the predicted market cap is no less than RMB4bn and the main business or product has obtained regulatory approvals from the relevant authorities which have a large potential market and have made staged achievements. Pharmaceutical companies need to have at least one core product that has obtained approval to carry out Phase-II clinical trials. Companies in other sectors should have significant technological advantages and satisfy relevant criteria.

The sci-tech innovation board no longer relies on traditional indicators, such as net asset and profit level, to assess a company's feasibility to obtain a listing. Thus, it offers listing opportunities to tech companies whose businesses are still at an early stage but have great potentials to thrive. However, this might result in a difficulty for investment banks to determine a proper valuation for listing companies. It creates extra risks for prospective investors as the conventional valuation methods like PE ratio or Price-to-Book (PB) ratio will be less effective.

Red-chip companies, VIE and dual-class shares

The sci-tech innovation board welcomes the listing of red-chip companies which are incorporated in a foreign jurisdiction but have main business interests in mainland China.¹³ Red-chip companies are allowed to issue either new shares or CDRs to trade in Shanghai. It is common for red-chip companies to adopt variable interest entities (VIEs) which are banned on the main board of the SSE.¹⁴ Furthermore, tech and innovative businesses widely use dual-class shares with weighted voting rights to help business founders maintain control of their businesses even if they only have a minority of shares. External venture capital or PE investments often dilute the ownership of entrepreneurs. Segway-Ninebot Ltd, which produces two-wheeled personal transporters and robotics, has filed an application to apply for the first CDR listing at the sci-tech innovation board.¹⁵

Daily stock price fluctuation limits

The SSE and SZSE have been implementing a daily price limit of 10% on common stocks listed on the main boards. It is a market stabilisation mechanism preventing the share price from fluctuating fiercely within one trading day and gives investors more time to react to the market change. Regarding the latest sci-tech innovation board, there will be no price limits during the first five trading days when a company goes public. After that, the daily cap of price fluctuation will be 20%, giving more space for market price change.

Market exit

The sci-tech innovation board has introduced strict market delisting rules for underperforming companies. There are several situations leading to the delisting of a public company, such as the fraudulent issuance of shares, the violation of information disclosure requirements, and if a company violates laws in relation to national security, public safety, ecological safety, production safety and public health security. The company can also be delisted by the exchange if it fails to meet the supervisory standards regarding share transactions and key financial indicators. For instance, the SSE will delist companies encountering the following situations:¹⁶

- the accumulated trading volume for 120 consecutive trading days is less than two million shares;
- the closing price for 20 consecutive trading days is less than the par value of the share;
- the market cap for 20 consecutive trading days is less than RMB300m;
- the number of shareholders for 20 consecutive trading days is less than 400; and
- other situations specified by the Shanghai Stock Exchange.

Strengthened information disclosure rules

Obviously, the "registration-based" IPO system and other market-oriented trading rules call for stronger information disclosure obligations once a company floats its shares. Listed tech and innovative companies are asked to fully disclose any risk factors that might have significant adverse impacts on the company's core competitiveness, operation activities, and future growth.¹⁷ If the issuers have not made profits, they should fully disclose the reasons for not making profits, and its impact on the company cash flow, business development, talent recruitment, the stability of the entrepreneurial team, R&D investment, strategic investment, and growth sustainability.

Investor suitability

Individual investors must have at least a two-year trading experience, and hold financial assets worth no less than RMB500,000 for 20 trading days, to open an account to trade shares at the sci-tech innovation board.¹⁸ This stops investors with a lower risk appetite from directly participating in the trading. If investors do not meet the above thresholds, they can still invest in the star market indirectly through purchasing units in mutual funds. The newly issued shares at the star market will be sold to institutional investors which enjoy a certain

priority over individual investors. At least 50% of off-line issuance will be firstly allotted to mutual funds, social security funds, pension funds, enterprise annuity funds, and insurance firms. ■

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Finland

Author Helena Viita is a partner at Roschier

THE USE OF ARBITRATION CLAUSES IN FINANCE DOCUMENTS: THE SUPREME COURT OF FINLAND CLARIFIES THE SCOPE OF ARBITRATORS' AUTHORITY

With the UK's potential resignation from the European Union (Brexit) there has been increasing discussion on the use of arbitration clauses in finance related agreements. Traditionally, arbitration has not been as popular a choice of dispute resolution mechanism in finance related agreements as in some other commercial contracts. However, the uncertainties revolving around the implications of Brexit on the enforcement of London based court rulings, such as the question of substitutive regulation for the recognition and enforcement of English court rulings after the Brussel Regulation (EU) 1215/2012 will cease to apply in the UK, is expected to result in a growing use of arbitration clauses in the financial sector.

Whilst the overall impact of Brexit on international arbitration is yet to be realised, the direct impact is expected to remain minimal, particularly as the UK is part of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958, according to which the recognition and enforcement of an arbitral award given in a foreign country shall, as a rule, be recognised in another contracting state. The recognition and enforcement of a foreign arbitral award may be refused only on very limited grounds, such as where, *inter alia*, the subject matter of difference is not capable of settlement by arbitration under the national laws of the country in which the recognition and enforcement is sought. This means, for example, that should arbitrators exceed their authority contrary to national law when giving an arbitral award, such award may be refused recognition and enforcement in another country.

In July 2019, the Supreme Court of Finland handed down a new precedent defining the scope of arbitrators' authority in the Finnish legal system. The new case law confirms the way in which arbitration clauses in Finnish law governed security agreements are to be perceived. With the increasing discussion on the more wide-ranging application of arbitration clauses in finance related agreements, the precedent in question stands as a good reminder of the variety of aspects to bear in mind when making the shift from litigation to arbitration in the banking and financial sector.

CASE STUDY: THE SCOPE OF ARBITRATORS' AUTHORITY

The case concerned a question on whether an arbitral tribunal had exceeded its authority by giving an arbitral award in a dispute between a beneficiary of security and the bankruptcy estate of the security provider. Whilst bankruptcy estates are usually bound by any arbitration agreement the debtor may have entered into before bankruptcy, the general principles protecting third parties may