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PRC SECURITIES LAW 2020: PROMOTING MORE EFFICIENT AND TRANSPARENT CAPITAL MARKETS IN CHINA

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This article introduces and analyses the legislative background and some major changes of the PRC Securities Law 2020, including the full implementation of the registration-based IPO regime, stricter penalties for illegal activities (eg fraudulent issuance, misrepresentation, and false information disclosure), as well as the improvement of the investor protection regime for a disclosure-centred regulatory system.

BACKGROUND OF LEGISLATION

China established its first stock market, the Shanghai Stock Exchange (SSE), on 19 December 1990. At the time, only eight companies including Feilo Acoustics and Shanghai Shenhua Holdings were listed. Thirty years later China now has the second largest capital market in the world, second to the US, with over 3,600 publicly listed companies, 156 million investors, and more than 130 securities companies or stockbrokers.[1] So far, Chinese companies have raised a total of CNY3.16trn and CNY10.58trn respectively for their initial public offerings and secondary public offerings. China has fostered a so-called multi-level capital markets system consisting of the SSE and Shenzhen Stock Exchange (SZSE) main boards, the SZSE small and medium-sized cap board, the SZSE growth enterprises market, as well as the latest SSE sci-tech innovation board (star market).[2]

In 1998, China introduced its first piece of securities markets legislation – the People's Republic of China (PRC) Securities Law which laid down comprehensive regulatory rules for securities issuance and trading. It took effect from 1 July 1999. Over the past two decades, despite the rapid growth of China's capital markets, the legislation has only gone through one major revision in 2005, along with minor amendments in 2004, 2013 and 2014. Due to the rapid growth of China's capital markets, the regulatory system built upon the PRC Securities Law was considered not comprehensive and effective enough to deal with the increasingly popular and complicated securities issuance and trading activities. China's lawmakers planned to fully revise the PRC Securities Law in April 2015 when it issued the first consultation draft. After four years of preparation and public debates, on 28 December 2019, the second revision of the PRC Securities Law was passed by the Standing Committee of the National People's Congress, which is the Chinese Parliament.[3] The Law came into effect on 1 March 2020 and has been considered the biggest overhaul of China's securities regulatory regime since the Law was firstly enacted in 1998. The revision has changed over 100 articles in the PRC Securities Law and promulgated two new chapters on information disclosure and investors protection. The revised legislation has 226 articles covering securities issuance, investor protection, information disclosure, irregularity punishment and intermediary management, among others.

THE FULL IMPLEMENTATION OF THE REGISTRATION-BASED IPO REGIME

Currently, the China Securities Regulatory Commission (CSRC) and two major stock exchanges in mainland China – the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) – have been using the "approval-based IPO system" to select qualified companies to obtain a listing in either Shanghai or Shenzhen.[4] It reflects the interventionist approach of Chinese financial regulators, as listing candidates have to pass a stringent financial censor to obtain administrative approval for their IPOs by the CSRC's Public Offering Review Committee. The "approval-based IPO system" has been criticised as inefficient and sometimes corruptive. Under such a regime, IPO opportunities are not always given to good companies in need of capital, which often forces Chinese companies to seek a listing outside mainland China on the New York Stock Exchange, NASDAQ, or Hong Kong Stock Exchange (a route taken by Tencent, Alibaba, JD.com and NetEase).

In contrast, the new "registration-based IPO regime" will remove the excessive power of the securities regulator in deciding the outcome of IPOs, as IPO applicants meeting the formalities and pre-set standards will obtain a listing without the extra censorship and approval from the regulator. Clearly, the new market-oriented IPO system will improve the efficiency of capital allocation as it reduces the social and economic costs of share issuance and shortens the turnover time of selling shares publicly. It allows capital-starved Chinese companies to obtain funding more quickly, whilst offering Chinese and international investors better and more investment choices.

The "registration-based IPO regime" was firstly tested on the latest star market (sci-tech innovation board) of the SSE. In July 2019, 25 high-tech companies started trading on the star market and they posted an average gain of 140% on the first trading day.[5] The PRC Securities Law 2020 has restated the adoption of the registration-based IPO for the Shanghai and Shenzhen stock exchanges, and its specific scope and implementation steps will be further defined by the State Council.[6] Following the trial of the "registration-based IPO regime" on the star market, the experiment is likely to be expanded into other segments of Chinese capital markets, and will finally be introduced to the main boards of SSE and SZSE.

In June 2020, the Chinese regulator announced the adoption of the registration-based IPO system by the ChiNext board of SZSE, which is the country's Nasdaq-style board that mainly hosts growth enterprises and innovative start-ups.[7] In October 2020, China's Vice Premier Liu He chaired a special meeting of the Financial Stability and Development Committee of the State Council where he emphasised the need to adopt further reform and open-up China's financial system, including the full implementation of the registration-based IPO system.[8]

THE STRICTER PENALTIES FOR FINANCIAL FRAUD AND OTHER ILLEGAL ACTIVITIES

The PRC Securities Law 2020 has greatly increased the penalties for the violation of securities law. For example, for the fraudulent issuance of securities, the fine was previously capped at 5% of the total funds raised, but it has now been increased to 100% of the raised funds.[10] When listed companies violate the information disclosure requirements, the upper limit of fines has increased from RMB600,000 to RMB10m.[11] Apart from fines, the PRC Securities Law 2020 has clarified the presumption of fault and the joint liability of the issuer's controlling shareholder and actual controller whenever there is a case of fraudulent issuance or illegal information disclosure. The new penalties are said to level the playing field for Chinese stock markets and other major stock exchanges in the world, as it is now more in line with the practice of other jurisdictions like the US.

The law has been changed in response to the recent financial frauds committed by Chinese companies, such as the high-profile cases of *Luckin Coffee* and *Kangmei Pharmaceutical*, prompting the new Securities Law to impose a tough crackdown. Dubbed as the Starbucks of China, Luckin Coffee has built a successful coffee empire owning over 4,500 cafes across China. In 2019, within less than two years of opening its first coffee shop, Luckin floated its shares on the NASDAQ in the US. However, in 2020 it was reported that Luckin Coffee had deliberately fabricated over $300m of retail sales through the use of related-party transactions.[12] The company tried to conceal the fraud by inflating its expenses by more than $190m, through the creation of a fake operations database and changed its bank records and accounting books. Luckin Coffee was fined $180m by the US Securities and Exchange Commission for conducting accounting frauds. Kangmei Pharmaceutical was found by regulators to have engaged in one of China's largest financial frauds totalling US$12.6bn.[13] From 2016-

TABLE 1: APPROVAL-BASED IPO SYSTEM vs REGISTRATION-BASED IPO SYSTEM[9]

	INSTITUTIONAL BACKGROUNDS	LISTING STANDARDS	PRE-LISTING SUBSTANTIAL EXAMINATION OF LISTING STANDARDS	POST-LISTING FINANCIAL SUPERVISION FROM SECURITIES REGULATOR	MARKETISATION LEVEL	IPO EFFICIENCY
APPROVAL-BASED IPO	Stock markets are in the early stage of development as retail investors dominate trading	High. The applicant has to: (i) provide public and accurate information; and (ii) pass strict checks of financial criteria in terms of revenue and profitability	(i) Securities regulator and (ii) securities brokers or investment banks have to assess the listing companies against strict listing standards	Weak. Securities regulation focuses on pre-listing substantial financial checks	Low	Low
REGISTRATION-BASED IPO	Stock markets are more developed with more institutional investors	Low. The applicant has to provide public and accurate information	(i) securities brokers or investment banks. *Securities regulator will only check the formalities of the applicants' materials.	Strong. Securities regulation focuses on the enforcement of post-listing information disclosure requirements	High	High

2018, Kangmei inflated its revenue by 29bn yuan and its operating profit by 4.1bn yuan. It also inflated cash positions by a total of 88.7bn yuan in its 2016 and 2017 annual reports and its 2018 interim report.

THE STRENGTHENING OF THE INVESTOR PROTECTION REGIME

The PRC Securities Law 2020 has incorporated a new chapter (Chapter 6) to set out the investor protection mechanism which has made several progressive arrangements. First, the new legislation distinguishes between ordinary investors and professional investors, based on their asset amount, the amount of financial assets, investment knowledge and experience, professional ability and other factors, to make targeted arrangements for investor rights protection.[14] If investors are classified as ordinary investors by the Securities Law, they will enjoy a higher level of protection. For instance, when there is a dispute between ordinary investors and the securities companies in which they invest, the securities companies will undertake the proof of burden to demonstrate that their actions have complied with relevant laws and regulations and they have not undertaken any misleading and fraudulent practices. If not, the securities companies will be liable for the losses of the investors.

Moreover, the PRC Securities Law 2020 has established a collection system (delegation) for shareholder rights in listed companies in order to protect minority shareholders and improve corporate governance. The board of directors of the listed company, the independent directors, the shareholders holding over one percent of the total voting shares, and the investor protection institutions, can act as the collector on their own or entrust the securities companies and securities service agencies, to make a public request to all shareholders of the listed company in order to represent them to attend the shareholder general meeting and to make proposals on behalf of shareholders, to represent them in order to exercise voting rights and other rights.[15]

There are also new provisions concerning bondholder meetings and the bond trustee system as well as the new cash dividend allocation system of listed companies.[16] Amongst the new measures, it is worth noting that, in order to facilitate the registration-based IPO system, the new legislation has explored a new securities civil litigation system. The PRC Securities Law 2020 has formally introduced the class action for the first time in Chinese capital markets whereby an investor protection institution can act as the litigation representative.[17] An investor protection institution mandated by 50 or more investors can register the qualified investors with the People's Court, unless any investor explicitly refuses to be registered, which, according to the Supreme People's Court's statement in the press conference, serves as an "opt-out" legal regime for the securities class action. The integration of the "opt-in" representative litigation with the "opt-out" class action is undoubtedly a major innovation in Chinese legislation. However, it still remains to be tested in China's judicial practice due to the lack of relevant litigation experience.

CONCLUSIVE REMARKS

The PRC Securities Law 2020 has endorsed the full implementation of the registration-based IPO regime, which is conducive to the long-term growth of healthy, dynamic, and efficient capital markets in China. It requires more stringent post-listing information disclosure for public companies to ensure that investors will be able to make informed investment choices. Moreover, the Law has introduced better protection for retailed investors in terms of the special treatment of ordinary shareholders, the delegation of shareholder rights, as well as the US-style class action regime. It has also increased the penalty for share issuers and other entities who commit securities fraud and misrepresentation. Clearly, the market-oriented law reform will unleash the growth potential of Chinese stock markets and create more business opportunities for investors, investment bankers, and international financial lawyers who deal with Chinese capital markets. ■

1 *Xinhua*, 'From zero start, China now has the second largest capital market in the world' (8 October 2019), available at http://www.xinhuanet.com/fortune/2019-10/08/c_1210303693.htm, accessed 8 January 2020.
2 Lerong Lu and Ningyao Ye, 'Promoting High-Tech Innovations through Capital Markets Law Reform: Deciphering the Sci-Tech Innovation Board of the Shanghai Stock Exchange' (2020) 35 JIBFL at 140.
3 *Global Times*, 'New Securities Law takes effect, targets overseas activity' (1 March 2020), available at http://www.globaltimes.cn/content/1181185.shtml, accessed 8 January 2020.
4 Supra note 2, at 141.
5 Shuli Ren, 'Chinese Investors Are Playing a Game of Hot Potato' *Bloomberg* (23 July 2019), available at http://www.bloomberg.com/opinion/articles/2019-07-23/china-s-nasdaq-style-star-market-risks-burning-out-quickly, accessed 8 January 2020.
6 PRC Securities Law 2020, Art 9.
7 *Xinhua*, 'Registration-based IPO reform of ChiNext a boon for innovative enterprises' (17 June 2020), available at http://www.xinhuanet.com/english/2020-06/17/c_139146066.htm, accessed 8 January 2020.
8 *Global Times*, 'IPOs to enter era of full registration, delisting process to be normalized' (1 November 2020), available at http://www.globaltimes.cn/content/1205330.shtml, accessed 8 January 2020.
9 The chart is compiled by the author.
10 PRC Securities Law 2020, Art 181.
11 PRC Securities Law 2020, Art 197.
12 Alistair Gray, 'Luckin Coffee to pay $180m in accounting fraud settlement', *Financial Times* (16 December 2020, Online).
13 Xie Yu, 'Why is Kangmei Pharmaceutical, found to have committed one of China's biggest financial frauds, rallying?', *South China Morning Post* (24 August 2019, Online).
14 PRC Securities Law 2020, Art 89.
15 PRC Securities Law 2020, Art 90.
16 PRC Securities Law 2020, Art 91, 92.
17 PRC Securities Law 2020, Art 95.

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L-QIF: A NEW FUND POSSIBILITY FOR THE SWISS FINANCIAL INDUSTRY

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