Accelerating Reform in China's Equity Market: Share Buybacks and Majority Shareholder Share Increase

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The China Securities Regulatory Commission's (**CSRC's**) launch on April 29 2005 of Issues Relevant to Pilot Reform Projects Regarding the Separation of Equity Ownership and Trading Rights of Listed Companies Circular (Pilot Reform Projects), regarding the release of non-tradable shares into the open market, drew considerable attention from investors worldwide. More recently, on June 16 2005, the CSRC promulgated simultaneously the Administration of the Buyback by Listed Companies of Their Public Shares Procedures (Trial Implementation)(the **Procedures**) and the Issues Relevant to Increases in the Holding of Public Shares by the Controlling Shareholders of Listed Companies after the Reform Regarding the Separation of Equity Ownership and Trading Rights Circular (the **Circular**). The Procedures specify the relevant issues regarding the buyback of public shares of listed companies, while the Circular makes it clear that the controlling shareholders of listed companies can increase their holdings of public shares.

Although the Procedures do not explicitly refer to the separation of equity ownership and the Circular fails to touch on the substantial content set out in the Pilot Reform Projects, you can read between the lines to deduce their end-goals. Indeed, it is clear that the main purpose of the CSRC's latest regulatory releases is to maintain confidence in the market through the duration of the Pilot Reform Projects by allowing share buybacks and allowing majority shareholders to further their control through the open market.

BACKGROUND OF THE PROCEDURES AND THE CIRCULAR

It is necessary to get to know the history of reform in China's securities market before looking at the Procedures and the Circular.

The shares of most of China's listed companies are divided into two categories: non-tradable and tradable. The non-tradable shares refer to those not listed on a stock exchange for public trading, while the tradable shares refer to those listed on a stock exchange for public trading. By the end of 2004, the aggregate shares of China's listed companies were 714.9 billion, of which 454.3 billion, or 64%, were non-tradable.

Although both non-tradable and tradable shares have the same par value, the costs of obtaining tradable shares are much higher than that for non-tradable shares. Indeed, there are distinct trading methods and prices between the two categories of shares.

The prime goal of the Pilot Reform Projects is to "resolve the circulation issue of the non-tradable shares of the listed companies" by circulating them - thereby enhancing the equity market. In this sense, the launch of the Pilot Reform Projects has served as a prelude to the reform of China's listed companies. Thus far, a group of four listed companies and another of 42 listed companies have been chosen to participate in the Pilot Reform Projects. The CSRC has indicated that it will "resolve the issue of alternative disposal of shares step-by-step".

BALANCING THE INTERESTS OF MAJOR PLAYERS THROUGH SHARE BUYBACKS AND CONTROLLING SHAREHOLDER SHARE INCREASES

The major players in the Pilot Reform Projects mainly include the listed companies themselves, the shareholders of non-tradable shares, and the shareholders of tradable shares. It is vital to the reform initiative as to whether or not the interests among these three players can be balanced. Certainly, the CSRC's release of the Procedures and the Circular will help, to some extent, to balance these interests through share buybacks and majority shareholder share increases.

Balancing the Interests of Shareholders of Tradable Shares

Upon completion of the Pilot Reform Projects, non-tradable shares will be transformed into tradable shares. As such, the tradable shares market will be expanded greatly and the holders of such shares will experience equity dilution. In order to eliminate the negative impact of this dilution, compensation through additional shares has been given to the tradable shareholders. Despite attaching compensation packages to the Pilot Reform Projects, investors have reacted negatively to the reform initiative with the Shanghai and Shenzhen Stock Exchanges in a steady decline. The substantial reason for this is: (i) tradable shareholders remain concerned about the expansion of tradable shares under the reforms; and (ii) tradable shareholders are concerned about the sufficiency of their compensation packages. The share buyback and majority shareholder share increase initiatives will alleviate tradable shareholders anxieties about the former and will provide supplementary measures to resolve the latter.

The 1994 PRC Company Law made provisions in relation to the buyback of shares by a joint-stock company - i.e., a joint-stock company is able to purchase its own shares, thereby reducing its registered capital. However, different to this, buybacks prescribed under the Procedures only entitle the purchase of tradable shares by listed companies and do not apply to non-tradable shares.

According to the Procedures, a listed company shall cancel relevant shares and reduce its registered capital after its purchase of tradable shares. As a result, the direct consequence of a buyback is that the self-owned capital of a listed company flows directly into the tradable share market, whilst the total number of tradable shares will decrease. On the one hand, this increases the capital supply for the tradable share market, whilst on the other it decreases the amount of tradable shares and eases shareholders' worries about the expansion of the market. Furthermore, share buybacks will increase the inherent value of each tradable share, which will help such shareholders seek better prices when negotiating with non-tradable shareholders.

The provisions in relation to majority shareholder share increases under the Circular will lead directly to the protection of tradable shareholder interests. For such shareholders, after the Pilot Reform Projects, the controlling shareholders of a listed company may increase public shares through the tradable share market, but cannot re-sell them within six months of completing such an increase. This will help to alleviate the expansion pressure on tradable shares and assist in stabilizing the market.

In addition, according to the Circular, controlling shareholders of a listed company which intend to increase their holding of tradable shares must at the same time make a public announcement of this and the reform plan of the listed company. The CSRC allows tradable shareholders, furthermore, when negotiating compensation packages to request non-tradable controlling shareholders to put forward in advance any share increase plan. Since such an increase plan will be publicized in the securities market, the interested parties may be able to oversee non-tradable shareholders in actually implementing their increase plan.

Balancing the Interests of Shareholders of Non-tradable Shares

Most of China's listed companies are controlled by non-tradable shareholders. In practice, the success of the Pilot Reform Projects depends mainly on the compensation packages paid by these shareholders to the non-tradable shareholders. Accordingly, it is important to balance the interests these non-tradable shareholders in these reform initiatives.

From the publicized plans of the companies participating in the Pilot Reform Projects, non-tradable shareholders are to compensate tradable shareholders in the form of non-tradable shares. On June 17 2005, the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) clearly stated in its Reform Regarding the Separation of Equity Ownership and Trading Rights of State-controlled Listed Companies Guiding Opinions that the controlling shareholder of a state-controlled listed company should determine the minimum shareholding in such a company after the integration of tradable and non-tradable shares. Non-tradable shareholders are understandably concerned about the impact of this. Failure to resolve this issue in a proper manner will certainly affect the participation of non-tradable shareholders in the Pilot Reform Projects. The share buyback and controlling shareholder share increase initiatives will, however, provide market-driven mechanisms to resolve this issue.

Since the Procedures limit buybacks to tradable shares, and such shares must be cancelled after the buyback, the ratio of non-tradable shares will increase upon the completion of the buyback. Majority non-tradable shareholders may thus be able to maintain their control through the combination of buyback and reform. In addition, because the supplier of the capital in a buyback is the listed company itself, for the shareholders of the non-tradable shares that wish to maintain the controlling power, capital pressure will not become a hindrance in implementing the reforms. The increase of tradable shares by shareholders of non-tradable shares may directly maintain their controlling power. According to the Administration of the Takeover of Listed Companies Procedures issued by the CSRC on September 28 2002, if the increase in shares owned in a listed company by an investor reaches 30%, an offer to purchase all the shares shall be made to all the shareholders of the listed company. For the shareholders of non-tradable shares that need to decrease their shares as required under the Pilot Reform Projects, the cost is obviously too high if it is necessary for them to issue such an offer after such reform. Correspondingly, in order to alleviate their worries, the Procedures specify that if the obligation of purchase by offer is triggered by an increase of shares within two months of the reform plan being adopted by the controlling shareholders at the shareholders' meeting of a listed company, the shareholders may be exempted from such an obligation.

Balancing the Interests of Listed Companies

In China's current securities market, the prices of shares of many listed companies are lower than the net assets per share, meaning that such shares' value is underestimated. For a listed company, the Procedures represent an opportunity to increase the price per share and further increase the company investment value through purchasing its own shares.

According to the trading rules of stocks, a decrease of a listed company's registered capital should be approved by the CSRC. However, the Procedures clearly state that the buyback only needs to be registered with the CSRC for record. This breakthrough regulation thus signals to the market that the regulatory body will fully respect the independent participation of listed companies in share buybacks. At the same time, the Procedures do not make any mandatory provisions regarding the buyback requirements. The listed companies may use buybacks as a supporting measure in the integration of tradable and non-tradable shares in the secondary market, thereby maintaining investor confidence and share price stability.

The mechanisms of share buyback and controlling shareholder share increase introduced through the Procedures and the Circular are also helpful in regulating the relationship between supply and demand of tradable shares. This will help in turning around the market's dispirited status, attracting more investors and building a better environment for the listed companies to participate in the reforms.

ANALYSIS OF THE RELEVANT ISSUES IN THE IMPLEMENTATION AND OPERATION SHARE BUYBACKS AND CONTROLLING SHAREHOLDER SHARE INCREASE

Comparatively speaking, the implementation of the buyback initiative is more complicated than the majority shareholder share increase initiative. The latter is only a unilateral act of the controlling shareholders and the Circular dictating its processes does not make many provisions for the controlling shareholders. However, since buybacks may cause material changes to the share structure of a listed company, the Procedures provide that the implementation of such buybacks shall go through five main steps: the internal approval procedure of a listed company; co-ordination with the creditors; registration with the CSRC for the record, and finally the conduct of the buyback and the cancellation of shares. These steps are discussed further below.

The Internal Procedures of a Listed Company

According to the Procedures, a share buyback shall at first be a preliminary plan made by the board of directors of the listed company in question and then adopted through a shareholders' meeting. The Procedures specify that a share buyback shall be valid only if approved by the two-thirds of a listed companies' voting shareholders in attendance at an appropriate shareholders' meeting.

Another important point under the Procedures is that there is no mandatory provision for tradable shareholders to sell their shares, even if a share buyback is adopted by shareholders at the appropriate meeting. In such a circumstance, tradable shareholders may choose to either sell the shares to the company or continue to hold them. This flexible system ensures that the options of the tradable shareholders are kept open.

Co-ordination with Creditors

The Procedures provide that the buyback of shares of listed companies shall not damage creditors' interests. Respective listed companies must register buyback documents with the CSRC only after they have informed their creditors. The articles relating to the protection of creditors are mainly derived from the restrict provisions of the PRC Company Law in relation to the buyback of shares. There are no detailed provisions under the Procedures in relation to the specific processes necessary in informing the creditors. According to PRC Company Law, listed companies must notify the creditors within 10 days from the day on which a share buyback decision is adopted by the shareholders' meeting and shall announce such at least three times in the newspaper within 30 days. The creditor is entitled to require the company to repay the debt or provide corresponding security within 30 days from the date on which it receives a share buyback notification; or within 90 days from the date on which the first announcement is made if without notification.

Creditors of a listed company include bearers of convertible bonds. There is no special provision in the Procedures as to whether listed companies shall perform according to the aforementioned obligations in accordance with PRC Company Law during the purchase of shares. In practice, there is always some warrantor whose qualification has been examined carefully by the CSRC to provide sufficient security on the listed company's performance regarding repayment obligations.

Government Regulations

The Procedures state that the CSRC will not make substantial judgment on share buybacks, instead making the requirements for relevant professional advisors very strict.

According to the Procedures, the CSRC records the buyback application without making substantial judgment. A listed company may conduct a share buyback only if the CSRC does not illustrate its dissidence within 10 working days. However, the record system does not mean there is no supervision over buybacks by the regulatory body. Indeed, a market-driven supervision system has been brought in.

The Procedures provide that when conducting a share buyback, an independent financial advisor and law firm should be hired to issue professional opinions in relation to it. The Procedures also make detailed provisions in relation to the content of such professional opinions. A lawyer, for example, should verify relevant issues such as the qualifications necessary of a listed company proposing a buyback; the approval procedures; the procedures to inform the creditors; and the legitimacy of the capital sources for the buyback. In addition, the Procedures further require that professional advisors involved should be honest and diligent, conduct a due diligence investigation on the buyback, check the datum on record and ensure the truth, accuracy and completeness of the documents issued.

Conduct of the Buyback

The Procedures specify two kinds of share buyback: buyback by collective bid and buyback by offer. When a collective bid is adopted, the listed company gains direct access to the tradable share market. When a share buyback by offer is conducted, the listed company may at its discretion decide the quantity of shares bought back, provided that the offer price shall not be lower than the average market price within 30 days before the announcement of the buyback report.

Cancellation of Shares

The Procedures provide that listed companies shall halt buybacks and cancel the relevant shares within 10 days and make corresponding changes to its registration with the Administration of Industry and Commerce (AIC) office upon the expiration of the share buyback, or completion of the implementation of the buyback plan.

One additional point is that China's B-share market has been in a slump for the last few years. There are now arguments as to the necessity of the existence of such a market. If the regulatory body finally decides to close the B-share market, the cancellation of shares through share buybacks, as specified in the Procedures, may be one method by which to close the market.

CONCLUSION

By their very nature, current reforms in China's securities market are designed to be market-driven. Since the Procedures and the Circular are directive in nature, and market factors have been taken into consideration, the mechanisms of share buyback and controlling shareholder share increase created by the regulatory body will help accelerate the Pilot Reform Projects to some extent. Certainly, the situation surrounding China's listed companies is complicated and diversified and no single solution may apply to all listed companies. The same applies for the share buyback and controlling shareholder share increase mechanisms. Their actual effect in the market, however, will only be realized through practice.

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