

Investing in Pre-IPO-Stage PRC Companies

By Christophe Han and Leo Wang

Opportunities to invest in Chinese companies that plan to list on a domestic exchange have gradually matured. Since the majority of share reforms were completed in September 2006, the shares previously issued by companies during initial public offerings (**IPOs**) are now freely tradable on domestic exchanges. Moreover, the central government has revised the IPO approval process. As a result, European and US private equity investors view public listing as the best withdrawal mechanism for their investments, and one that has already demonstrated its effectiveness in China. Nonetheless, the requirements of the PRC Company Law and PRC Securities Law for companies to list on an exchange remain quite strict, so it remains difficult for small- and medium-sized private companies to list. Private equity investment has therefore become a popular shortcut for companies intending to list on the domestic exchanges.

Exercise caution before investing

Investors should carefully consider the legal and policy environment they operate in before investing in pre-IPO-stage companies. Private equity investors focus on locking up a company as their investment target and getting the fastest, highest return on their investment through a public offering. Companies focus on attracting private equity investment prior to their offering. In this situation, it is important for both companies and private equity investors to carefully consider, from both commercial and legal perspectives, the opportunity costs and the safety of their investments.

Choose an effective strategy

Private equity investors must carefully select investment opportunities and design effective share-holding strategies. Private equity investments are limited both by the investors' (or fund's) own capital transfer requirements and by the legal restrictions on equity transfers

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before and after IPOs. Under Article 142 of the PRC Company Law, for one year after a company restructures as a share-limited company, the sponsor's stock may not be transferred. Moreover, shares already issued by a company prior to an IPO may not be transferred for one year after the offering. The Stock Exchanges themselves also impose further requirements. Article 5.1.4 of the Shanghai Stock Exchange's Share Listing Regulations and Article 5.1.6 of the Shenzhen Stock Exchange's Share Listing Regulations both require that when a company files an IPO request with either exchange, any person who obtained that company's stock through a share issue designed to increase capital during the 12 months prior to an IPO must promise that they will not transfer those shares for 36 months from the date they obtained such stock. Finally, Article 8 of the *Temporary Regulations on Issues with Establishing Foreign-Invested Share-Limited Companies* issued by the Foreign Trade Cooperative Commission in 1995 requires that a sponsor's stock in foreign-invested share-limited companies may not be transferred for three years from the date the company is registered. Although the Ministry of Commerce (MOFCOM) is currently considering revisions to Article 8, it still remains in effect. Only by fully understanding these various lockup periods and their effect on the investor's own capital transfer requirements can private investors develop reasonable share holding plans.

Make appropriate concessions

During the capital raising process, private equity investors must have the courage and vision to make the right concessions. Private equity investors are accustomed to companies guaranteeing return on their investments, and specially establishing share buy-backs, priority rights to subscriptions and distributions of new shares, or priority rights to participate in sales of shares. Companies also offer private equity investors veto power in the board of directors or other such privileges to help guarantee the safety of and the return on their investment. In China, these types of conditions are frequently seen in the joint venture contracts or Articles of Association of companies planning to attract private equity investment and restructure as a Sino-foreign joint venture. However, before their IPOs, companies must comply with the China Securities Regulatory Commission's (CSRC) requirements for listed companies. CSRC regulations require that these types of special privileges must be removed from the company's articles of association, because of their potential effect on the rights and interests of public investors. Private equity investors must therefore make some concessions.

Guard against uncertainties

When preparing for an IPO, private equity investors must find some way to protect their own rights and interests. Private equity investors face the risk that the company's IPO will fail or be perpetually postponed. Reducing the time between the investors' concessions and the company's public offering will help to reduce the risks arising from the uncertainties associated with the IPO. Investors could consider retaining various profit guarantees, share-buy backs, veto powers, and other special clauses in the pre-IPO company's articles of association, and promising to waive these special guarantees on the date the company's IPO is successfully listed. Such promises would then be reflected in the revisions to the company's articles of association and securities filings. Private equity investors could also consider requesting that when a company reorganizes as a share-limited company, that the sponsor's agreement or shareholder's agreement retain provisions preserving the current shareholders' rights and interests (such as priority rights to subscriptions and distributions of new shares, priority rights to participate in sales of shares, and anti-dilution rights). However, if these types of clauses are retained, it generally must be done on condition that it will not affect a company's ability to successfully make an IPO.

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