China Law Update

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The New Chinese Growth Enterprise Market Is Launched -- Stock Transfer Duties On "State-Owned" VC Firms and PE Funds?

On March 31, 2009, the China Securities Regulatory Commission ("CSRC"), the nation's securities watchdog, issued the *Measures on Administration of Initial Public Offering and Listing on the Growth Enterprise Market* (the "Measures"). The long-awaited Growth Enterprise Market (GEM) was finally launched when the Measures came into effect on May 1, 2009. GEM is a NASDAQ-style stock market designed to nurture cash-hungry, innovation-driven startup firms in China. The Measures require applicants to have a minimum 10 million yuan, or nearly 1.5 million U.S. dollars in accumulated net profit in the two years prior to a listing. In Comparison, an application to list on the main boards requires a minimum 30 million yuan in accumulated net profit in the three previous three years.

According to a CSRC official, CSRC will start reviewing initial public offering (IPO) applications for GEM before October 1. The CSRC has handled applications from 149 companies seeking to list on the GEM market since it started receiving applications on July 26.

However, a later regulation issued in June (*The Implementation Measures for the Transfer of Certain State-owned Shares from the Domestic Securities Market to the National Social Security Fund, hereinafter referred to as the "Implementation Measure"*) has arisen worries from private equity funds (PE) and venture capital firms (VC) who invest in companies that plan to list on the GEM.

The Implementation Measure requires companies that have made initial public offerings (IPO) on the domestic stock exchanges to transfer its state-owned shares amounting to 10 percent of the total in IPO to the National Social Security Funds (NSSF), under a State Council decision. If the amount of state-owned shares is not sufficient to meet the 10-percent requirement, the company must transfer all state-owned shares that it holds. The requirement is part of the government's effort to finance the country's social security system and the retirement of the aging population. It can also help to secure stability in the domestic stock market before the re-ignition of IPOs.

The focus of the Implementation Measures is the definition of "state-owned shareholders". Since many VC firms have been financially supported by local governments since first started, a large number of VC firms in China can be defined as "state-owned shareholders". On the other hand, PE funds that obtained financing from institutions such as the NSSF or China Development Bank may also be defined as "state-owned". Once tagged as "state-owned", PE funds and VC firms will be severely hindered from making new investments and from further development by the transfer requirement.

Responding to the above mentioned problem, Liu Jianjun, director of the Department of Finance of the National Development and Reform Commission , said in a forum on September 19 that the policy to exempt state-owned VC from stock transfer will soon be unveiled. This speech didn't give PE funds relief. Those who mainly invest in pre-IPO projects in startup companies are trying to define them as VC firms and some others have considered transferring their shares to private companies before the IPO. In addition, PE funds in the form of Limited Partnership argue that there is no clear law to classify them as "state-owned shareholders" of listed companies.

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