
China's Second Board

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I. Significance of and events leading to the establishment of a Second Board

On 31 March 2009 the China Securities Regulatory Commission (CSRC) issued *Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on the ChiNext* [i.e., the Second Board, also called the Growth Enterprise Market] ("*Interim Measures*"), which came into force on 1 May 2009. This marked the creation by the Shenzhen Stock Exchange of the long-awaited market for venture businesses. As the original plan to establish such a market in 2001 had come to nothing when the dotcom bubble burst, the market's final opening came after a delay of nearly 10 years.

Ever since the 1980s, when the Chinese government began to foster the development of science and technology, venture capital has been seen in China as a means of supporting the development of high-tech companies financially¹. The aim, as can be seen from the name of the 1996 *Law of the People's Republic of China on Promoting the Conversion of Scientific and Technological Findings into Productivity*, was to support the commercialization of scientific and technological developments. Venture capital funds developed gradually in the late 1990s, and between then and 2000 it looked increasingly likely that a Second Board would be established. When the CSRC published a draft plan for this in September 2000, the stage was set. However, when the dotcom bubble (and especially the NASDAQ bubble) burst, this plan was shelved. Also, Chinese investors and venture capitalists were probably not quite ready for such a move.

As a result, Chinese venture businesses sought to list on overseas markets (a so-called "red chip listing") from the late 1990s. However, as these listings increased, so did the criticism that valuable Chinese assets were being siphoned overseas².

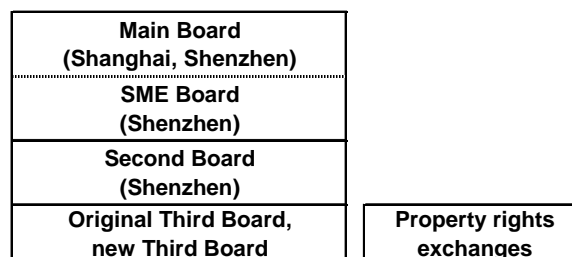
On the policy front, in 2004 the State Council published *Some Opinions on Reform, Opening and Steady Growth of Capital Markets* ("*the Nine Opinions*"), in which the concept of a "multi-tier capital market" was presented for the first time. A first step in this direction was made in the same year, when an SME Board was established as part

¹ See Jingu and Kamiyama (2008).

² For more on red-chip listings, see Jingu and Kamiyama (2008).

of the Main Board. Although there appear to have been plans to eventually relax the SME Board's listing requirements, which were the same as those for companies listed on the Main Board, and to make it a market especially for venture businesses, it was decided to establish a separate market (the Second Board) for this purpose and to learn from the experience of the SME Board. With the establishment of a Second Board, China's capital market now has the multi-tier structure in Figure 1. With companies transferring from both the new and the original Third Board to the SME Board and, as we will see, companies looking to transfer from the new Third Board to the Second Board, we expect to see more such transfers³.

Figure 1: Schematic diagram of China's multi-tier stock market



Note: The SME Board is part of the Main Board. Some property rights exchanges also trade unlisted, non-public stocks (see Jingu (Spring 2009)).

Source: NICMR.

As well as being part of the process of creating a multi-tier capital market, the establishment of the Second Board was one of the measures included in the policy document *Several Opinions of the General Office of the State Council on Providing Financing Support for Economic Development ("the 30 Financial Measures")*, published in December 2008 in response to the global financial crisis and intended as a way of making it easier for SMEs to raise capital.

It goes without saying that the creation of the Second Board was also an important development in that it gives private equity funds the opportunity to exit their investments. The absence of such an exit had been a disincentive to such investment, with most funds looking for a red chip listing (see above) as a way of exiting their investments. However, with surplus savings at home, the Chinese authorities began to encourage companies to raise capital on the domestic market rather than overseas. This led, in September 2006, to a rule making it more difficult for Chinese venture businesses to list their shares on overseas markets. The corollary of this was that it increased the need for a means whereby Chinese private equity funds could exit their investments at an early opportunity and on their own market. The creation of the Second Board was therefore a belated response to this need⁴.

³ For more on the original and new Third Boards, see Jingu (Autumn 2009).

⁴ Partnerships have hitherto not been able to open securities trading accounts. However, in October 2009, the CSRC published a draft amendment to the *Measures for the Administration of Securities Registration and Settlement*, proposing that partnerships should be allowed to open such accounts. If this becomes law, private equity partnerships will be able to exit their investments via the Second Board.

II. Rules and regulations governing the establishment of the Second Board

1. The *Interim Measures*

We now take a closer look at some of the rules and regulations governing the establishment of the Second Board.

First, the *Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on the ChiNext*, issued by the CSRC on 31 March 2009 with effect from 1 May 2009. The *Interim Measures* consist of six chapters and 58 articles, stipulating issue terms and procedures, disclosure requirements, regulatory procedures, and legal responsibilities.

First, the General Provisions chapter. The first thing this says (Article 1) is: "These Measures are formulated for the purposes of promoting the development of innovative enterprises and other growing start-ups" This shows that one of the main listing criteria is a company's technological innovativeness and growth potential. The Chinese authorities have actually made it clear that, although the Second Board and the SME Board are both intended for SMEs of similar sizes, the Second Board is specifically intended for SMEs at the initial (rather than the growth or mature) stage of their development with a high degree of technological innovativeness and an innovative business model while the SME Board is specifically intended for companies with relatively stable earnings at the mature stage of their development. They have also made it clear that the Second Board is not simply a "small SME Board." This suggests to us that the authorities want to see technologically innovative companies listing on the Second Board and SMEs in traditional sectors listing on the SME Board.

Next, Article 7 says: "A market access system that is commensurate with the risk tolerance of investors shall be established for investors on the ChiNext and investment risk shall be fully disclosed to investors." One noteworthy feature is the adoption of the concept of the "qualified investor" in an attempt to improve risk control (see below for the rules governing access).

Furthermore, Article 8 says: "China Securities Regulatory Commission (hereinafter, CSRC) shall, in accordance with law, examine and approve the issuer's IPO application and supervise the issuer's IPO activities. The stock exchange shall formulate rules in accordance with law, provide an open, fair and equitable market environment and ensure the normal operation of the ChiNext." Until the Second Board was established, it was thought by some that the stock exchange had the right to approve new issues. Under the *Interim Measures*, however, it is the CSRC that examines and approves applications.

Second, offering conditions. Article 10 stipulates four numerical conditions for companies applying for IPOs.

- (1) The issuer must be a duly incorporated company limited by shares and must have been in operation for more than three consecutive years. For any company limited

by shares which has been transformed as a whole from a limited liability company by converting its original book value of net assets into shares, the required operation period may be counted from the date of establishment of the limited liability company.

- (2) The issuer must have been profitable in the two most recent consecutive years, with accumulated profits no less than RMB10mn and in steady growth; or the issuer must have been profitable in the most recent year with net profits of no less than RMB5mn and revenues of no less than RMB50mn, and its revenue growth rate for either of the two most recent years must have been no less than 30%. Net profits shall be calculated based on the amount before or after deducting non-recurring profits and losses, whichever is smaller.
- (3) The issuer must have net assets of no less than RMB20mn at the end of the most recent accounting period with no uncovered losses.
- (4) The issuer must have a total share capital of no less than RMB30mn after the IPO.

The numerical conditions are less demanding than those for the Main Board, including the SME Board (Figure 2). However, the authorities have sought to safeguard investors' interests and ensure risk control by introducing the aforementioned concept of the qualified investor and various other measures (see below).

In qualitative terms, the issuer must mainly operate one line of business (Article 12); its assets must not be dispersed; and its earnings must be sustainable. More specifically with regard to the latter, the *Interim Measures* stipulate that the issuer's business model or its mix of products or services must not have undergone or undergo any material change which has or will have a significant adverse impact on its sustainable profitability (Article 14).

There are also rules on corporate governance. They further stipulate that, in the most recent two years, there must have been no significant changes in the principal business, directors and senior management of the issuer, nor any change of its de facto controller (Article 13); there must be no intra-industry competition, nor any related-party transaction that severely affects the company's independence or is obviously unfair, between the issuer and its controlling shareholder, de facto controller or any other enterprise under the control thereby (Article 18); the issuer shall have a sound corporate governance structure, and have established such systems in accordance with law as the shareholders' general meeting, board of directors, board of supervisors as well as independent directors, board secretaries and audit committee (Article 19); and the issuer and its controlling shareholder and de facto controller shall not have committed any major illegal acts in the three most recent years that impair investors' legitimate rights and interests or public interests (Article 26).

Third, offering procedures. The *Interim Measures* seek to make sponsoring securities companies more responsible by requiring them to conduct due diligence investigations and make prudential judgment on the issuer's growth and render special opinions thereon. They also require them to explain the issuer's innovative capability

Figure 2: Comparison of listing rules

Main Board (Measures for the Administration of Initial Public Offering and Listing of Stocks)	Second Board (Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on the ChiNext)
<p>Qualifications for issuers:</p> <ul style="list-style-type: none"> •The issuer must be a duly incorporated company limited by shares and must have been in operation for more than three consecutive years. For any company limited by shares which has been transformed as a whole from a limited liability company by converting its original book value of net assets into shares, the required operation period may be counted from the date of establishment of the limited liability company (Article 9). •In the most recent two years, there must have been no significant changes in the principal business, directors and senior management of the issuer, nor any change of its de facto controller (Article 13). <p>Financial and accounting requirements:</p> <ul style="list-style-type: none"> •The issuer must have been profitable in the most recent three consecutive years, with accumulated profits more than RMB30mn and in steady growth. Net profits shall be calculated based on the amount before or after deducting non-recurring profits and losses, whichever is smaller (Article 33). •The issuer must have a net cash flow of more than RMB50mn accumulatively, or have a business income of more than RMB300mn accumulatively for the latest 3 accounting years (Article 33). • The issuer must have a total amount of stock capital of no less than RMB30mn before the IPO (Article 33). •The proportion of its intangible assets (upon deduction of its land use right, right to aquatic breeding and right to mining) in its net assets not being higher than 20% at the end of the most recent accounting period (Article 33). •The issuer must have no uncovered losses in the latest period (Article 33). 	<p>Qualifications for issuers:</p> <ul style="list-style-type: none"> •The issuer must be a duly incorporated company limited by shares and must have been in operation for more than three consecutive years. For any company limited by shares which has been transformed as a whole from a limited liability company by converting its original book value of net assets into shares, the required operation period may be counted from the date of establishment of the limited liability company (Article 10 (1)). •In the most recent two years, there must have been no significant changes in the principal business, directors and senior management of the issuer, nor any change of its de facto controller (Article 13). <p>Financial and accounting requirements:</p> <ul style="list-style-type: none"> •The issuer must have been profitable in the most recent two consecutive years, with accumulated profits no less than RMB10mn and in steady growth. <p>Or the issuer must have been profitable in the most recent year with net profits of no less than RMB5mn and revenues of no less than RMB50mn, and its revenue growth rate for either of the most recent two years must have been no less than 30%. Net profits shall be calculated based on the amount before or after deducting non-recurring profits and losses, whichever is smaller (Article 10 (2)).</p> <ul style="list-style-type: none"> •The issuer must have net assets of no less than RMB20mn at the end of the most recent accounting period with no uncovered losses (Article 10 (3)). •The issuer must have a total share capital of no less than RMB30mn after the IPO (Article 10 (4)).

Source: NICMR, from *Measures for the Administration of Initial Public Offering and Listing of Stocks* (2006) and *Interim Measures on the Administration of Initial Public Offerings and Listings of Shares on the ChiNext* (2009).

in its special opinions if the issuer is an innovative enterprise (Article 32). Furthermore, they require listing applications to be reviewed by the CSRC's ChiNext Public Offering Review Committee (Article 34).

Fourth, information disclosure. Article 39 of the *Interim Measures* stipulates that the issuer shall make a statement in its prospectus pointing out the risks of investing in Second Board companies: namely, inconsistent performance, high operational risk, and the risk of delisting. Similarly, Article 41 stipulates that (1) the issuer and all of its directors, supervisors, senior management, (2) the sponsoring securities company, (3) the controlling shareholder and the de facto controller shall sign and seal the prospectus to ensure the truth, accuracy and completeness of its contents. This is to emphasize the responsibility of all those involved (i.e., the controlling shareholder, the de facto controller, the directors, supervisors, senior management and sponsor) and to

make investors fully aware of the risks. These are also the aims of the rules and regulations we will look at below.

Fifth, supervision. Articles 51 and 52 stipulate that the stock exchange (namely, the Shenzhen Stock Exchange) shall establish systems for listing, trading and delisting Second Board stocks, urge sponsors to fulfill their ongoing supervisory obligations, and establish a market risk warning system and an investor education system. Articles 53, 54 and 55 specify penalties for issuers, sponsors and securities service providers (e.g., accountants) that issue documents containing misrepresentations, misleading statements or material omissions.

Since the publication of the *Interim Measures*, a whole series of rules and regulations have been published: *Interim Measures on Securities Issuance and Listing Sponsor System*, *Provisional Measures of the Public Offering Review Committee of the China Securities Regulatory Commission*, *Rules Governing the Listing of Shares on the ChiNext of Shenzhen Stock Exchange*, various rules on checking the eligibility criteria for qualified investors, *Application Documents for Initial Public Offerings and Listings of Shares on the ChiNext*, and *Prospectuses of ChiNext Companies*. We now take a closer look at each of these in turn.

2. Amendments to the *Interim Measures on Securities Issuance and Listing Sponsor System* and the *Provisional Measures of the Public Offering Review Committee of the China Securities Regulatory Commission*

The *Interim Measures on Securities Issuance and Listing Sponsor System* and the *Provisional Measures of the Public Offering Review Committee of the China Securities Regulatory Commission* were amended (on 13 May and came into force on 14 June) by way of complementing the *Interim Measures*.

The main aim of the amendments was to adapt the existing rules and regulations to the Second Board's characteristics: namely, the small size of the companies listed on it, the large number of candidates for listing, their high earnings volatility and risk, and their degree of scientific and technological specialization.

The amendments to the *Interim Measures on Securities Issuance and Listing Sponsor System* consist of measures to improve the sponsorship system ((1) and (2) below) and amendments intended to reflect the Second Board's characteristics in the wording of the legislation ((3))⁵.

In particular, (1) the period for which sponsors have to monitor and advise companies listed on the Second Board has been extended. Under Article 36, the period has been extended by one year: to three fiscal years (compared with two in the case of the Main Board) plus the rest of the year in which a company's shares are listed, and to two fiscal years (compared with one in the case of the Main Board) plus the rest of the year in which a company has a rights issue or issues a convertible bond.

⁵ The following is based on the press releases by the CSRC when it published its revised drafts of the two measures in April 2009.

Also, (2) a sponsor of a company that has had an IPO, or listed, on the Second Board is required to publish a follow-up report on a website designated by the CSRC not later than 15 trading days after the company publishes its annual or interim report. The follow-up report consists of an analysis and independent opinion (Article 36) in which the sponsor has to analyze how it will monitor and advise the company according to its particular circumstances, ensure that it operates in accordance with the regulatory requirements and complies with any terms of acceptance and disclosure requirements, and check its disclosure documents. Also, the sponsor has to (i) monitor the company's activities and advise it in order to ensure that it has a system to prevent the controlling shareholder, the de facto controller or any other party from embezzling the company's funds; (ii) monitor the company's activities and advise it in order to ensure that its internal controls prevent any directors, supervisors or senior managers from abusing their positions; (iii) monitor the company's activities and advise it in order to ensure that any related-party transactions are fair and in accordance with the law, and to express any opinions about such transactions; (iv) ensure that any funds the company raises are deposited in a dedicated account and that investment projects are carried out properly; and (v) check whether the company has pledged any of its collateral to a third party (Article 35).

If a listed company issues an ad hoc report on an important matter such as any funds it has raised, any related-party transactions it has engaged in, how it has invested any funds, or any collateral it has pledged, its sponsor has to issue an analysis and neutral opinion within 10 business days (Article 36).

These are the amendments made to make sponsors more accountable. As far as the amendments made to reflect the Second Board's characteristics in the wording of the legislation are concerned, the condition "if the operating profit of a listed company declines 50% or more year on year in the year of its listing" has been removed from the list of conditions that oblige the CSRC to penalize the company's sponsor. (In certain circumstances, the CSRC will refuse to consider listing recommendations from the sponsor's representative for 3–12 months; and, in particularly serious circumstances, it will even strip its representative of his status.) However, the condition continues to apply to sponsors of companies listed on the Main Board. The reason it was removed is that Second Board companies tend to have volatile earnings (Article 72).

According to the *Provisional Measures of the Public Offering Review Committee of the China Securities Regulatory Commission*, companies considering a listing on the Second Board should be "innovative enterprises and other growing start-ups," and separate review committees have been set up for listings on the Second Board as well as the Main Board and for mergers and acquisitions by listed companies to reflect the fact that the Second Board is different from the Main Board in terms of offering conditions, information disclosure, and ongoing supervision (Article 2). (In the past there was only one public offering review committee.) Furthermore, members of each review committee are not permitted to be members of any of the other review committees (Article 7). This is to ensure the independence and specialized nature of the Second Board's own public offering review committee.

Also, the membership of the committee was increased to 35 (Article 6), 10 more than that of the Main Board's Public Offering Review Committee, to reflect the fact that Second Board companies tend to be small and are large in number. Also, the proportion of management and technology specialists on the committee was increased (see below).

3. Rules Governing the Listing of Shares on the ChiNext of Shenzhen Stock Exchange

Next, the Shenzhen Stock Exchange published *Rules Governing the Listing of Shares on the ChiNext of Shenzhen Stock Exchange* on 6 June (with effect from 1 July).

These consist of 19 chapters, with the emphasis being on improving investor protection by making those involved (the controlling shareholder, the de facto controller, and the sponsor) more accountable and on increasing market efficiency and improving the market mechanism by means of information disclosure. We have identified the following 10 main points⁶:

- (1) Lock-up period for shares owned by an issuer's controlling shareholder and de facto controller

While there is a risk that the controlling shareholder and the de facto controller may sell their shares as soon as a company is listed and that the company's stability may be threatened if the lock-up period is too short, there is a risk that private equity funds may be deterred if it is too long because they may not be able to recover their investment for a long time. For these reasons, (i) the controlling shareholder and the de facto controller may sell their shares once at least three years have passed since the shares were listed (i.e., on the same conditions as the Main Board); (ii) other shareholders may not sell any shares acquired as a result of a capital increase during the six months immediately preceding the listing application for 12 months after listing, no more than 50% of such shares 12–24 months after listing, and the remainder only at least 24 months after listing; (iii) while any other shares may be sold 12 months after listing in accordance with the *Company Law*.

- (2) Extending the period of supervision and guidance

This is basically the same as the provisions of the *Interim Measures on Securities Issuance and Listing Sponsor System*.

- (3) Asserting the principle of the survival of the fittest by strictly applying delisting rules

To reflect the fact that investing in companies listed on the Second Board is risky, the delisting criteria, like those for SME Board stocks, are more rigorous than those for Main Board stocks. More specifically,

⁶ The following is based on the press releases by the Shenzhen Stock Exchange when it published its draft of the rules in May 2009.

- (i) when shares are delisted, they are "delisted directly." In other words, unlike Main Board shares that have been delisted, they are not automatically traded on the original Third Board (OTC market). However, if a delisted company satisfies the conditions of the original Third Board, it can apply to have its shares traded on that market.
 - (ii) Two new delisting conditions have been added: where a company's net assets in the last fiscal year are shown as negative in the auditor's report and where a certified public accountant has issued an adverse opinion or a disclaimer of opinion in a company's annual report for the last fiscal year and this is deemed serious by the exchange. (In the case of Main Board stocks, the condition is that a company has reported a loss for the past three fiscal years, which also applies to the ChiNext.) The shares of such a company are initially treated as being at risk of being delisted (and are subject to a 5% price limit). If the situation does not improve (e.g., if the company's net assets are still negative the following fiscal year), trading in its shares is suspended; and, if the situation still fails to improve (e.g., if the company's net assets are still negative in its interim report for the following fiscal year), the shares are delisted.
 - (iii) Also, companies that fail to publish an annual or interim report by the prescribed deadline will have their shares delisted—at the earliest, after three months (compared with six months in the case of the Main Board).
 - (iv) Furthermore, in order to ensure that market efficiency is not affected by a lack of liquidity, a company's shares will also be delisted if their cumulative trading volume over 120 trading days is less than 1mn shares. More specifically, the shares are delisted if their cumulative trading volume over 120 trading days after a delisting risk warning has been issued is less than 1mn shares.
- (4) Stricter disclosure requirements on first day of listing
- Stricter disclosure requirements are applied to prevent abnormal share price movements on the first day of listing.
- (5) Controlling shareholder and de facto controller subject to stricter disclosure requirements
- More specifically, prior to the listing of a company's shares, the controlling shareholder and de facto controller are required to sign a *Declaration and Undertaking with regard to the Controlling Shareholder and De Facto Controller*.
- (6) Timely disclosure of earnings information in period reports
- If a company is unable to publish its annual report within two months of the end of its fiscal year, it is required to publish a preliminary report. This is intended to ensure that companies comply with disclosure requirements in good time. (They are still required to publish an annual report within four months of the end of their fiscal year.)

(7) Real-time disclosure by means of ad hoc reports

Companies may publish ad hoc reports during the lunchtime trading break or after trading ends at 15.30. Also, if any information that could have, or has had, a major impact on a company's share price is reported in the media, the company may apply to have trading in its shares suspended or publish an ad hoc report on the designated website—either before the start of the morning trading session or during trading hours.

(8) Criteria for disclosure by means of ad hoc reports

Criteria on the kind of transactions (including related-party transactions) that require a company to disclose information by means of an ad hoc report are determined according to the characteristics of Second Board companies. Such transactions include how a company's funds are invested and whether it pledges collateral to a third party. Also, a company is required to announce important events such as important contracts and the resignation of employees with important technological know-how.

(9) Tighter controls on any funds raised

Companies are required to manage centrally in a special account any funds they have raised and to have an external auditor report on those funds.

(10) Rules governing share sales by controlling shareholders and de facto controllers

The controlling shareholder and de facto controller of a company are subject to a "1% rule" if they sell any of their shares in that company. What this means is that, if a shareholder or the de facto controller of a company with at least a 5% stake in the company buys or sells 1% of the outstanding shares in the company, the company must disclose this within two trading days.

4. Checking investor eligibility

As the companies listed on the Second Board are more risky than those listed on the Main Board and are subject to more rigorous delisting rules (see above), investor protection requires that checks be made on whether Second Board shares are suitable for all those wishing to invest in them. The rules on checking investor eligibility consist of (1) the CSRC's *Provisional Rules for Checking the Eligibility of Prospective Investors in Second Board Stocks* (issued on 30 June and in force since 15 July), (2) the Shenzhen Stock Exchange's *Implementation Rules for Checking the Eligibility of Prospective Investors in Stocks Listed on the Shenzhen Stock Exchange's Second Board* (issued on 1 July and in force since 15 July), and (3) the Securities Association of China's *Letter of Disclosure of Risks of Investing in Second Board Stocks (Mandatory Provisions)* (issued on 1 July and in force since 15 July).

The CSRC's *Provisional Rules* lay down the following general rules: (1) investors in Second Board stocks are required to understand and be able to tolerate the risks involved (Article 2); (2) the Shenzhen Stock Exchange will lay down specific implementation rules (Article 3); securities companies are required (3) to devise a

mechanism and procedure for checking investor eligibility (Article 4) and (4) to sign a letter of disclosure of risks of investing in Second Board stocks jointly with an investor before he trades on the Second Board for the first time to confirm that they have fully appraised him of the risks involved (Article 5). Each securities company is required to draw up a letter of disclosure of the risks of investing in Second Board stocks based on the Securities Association of China's *Letter of Disclosure of Risks of Investing in Second Board Stocks (Mandatory Provisions)*.

The Shenzhen Stock Exchange's *Implementation Rules* require securities companies to assess a client (investor)'s eligibility in terms of his economic circumstances, assets/income, and investment experience (Article 2). Also, according to the Exchange's rules, "investors that are natural persons and with at least two years' experience of trading on the stock market" may apply to trade on the Second Board⁷. Investment experience is measured from the first time an investor has bought or sold shares traded on either the Shenzhen or Shanghai stock exchanges in his own name (Article 5). In addition, securities companies and their clients (i.e., investors) are required to sign a letter of disclosure of the risks of investing in Second Board stocks at the securities companies' offices. Clients may begin to trade two trading days later (Article 6).

The letter contains such things as a check on whether the client has a basic knowledge of the Second Board (e.g., regulatory differences between it and the Main Board, the risk of delisting, business risk, share price volatility risk, and the risk of technological failure by high-tech companies) and a declaration of risk acceptance. The CSRC has pointed out that one of the reasons for requiring natural persons to have at least two years' equity investment experience is that this will ensure that anyone who began investing in or before 2007 will have experienced both the sharp rise that occurred in that year and the sharp fall that has occurred since⁸.

However, this does not mean that anyone with less than two years' experience of investing in the stock market is not allowed to invest in Second Board stocks—only that, in addition to the aforementioned procedures, they are required to make a written declaration that they are prepared to accept all the risks involved. In that case, they have to wait five trading days before they are allowed to trade.

5. Rules governing (1) application documents for listings on the ChiNext and (2) prospectuses of ChiNext companies

On 20 July the CSRC published rules governing *Application Documents for Initial Public Offerings and Listings of Shares on the ChiNext* and *Prospectuses of ChiNext Companies*, and announced that it would begin processing listing applications on 26 July. This completed the publication of Second Board administrative rules and marked the Board's final launch.

⁷ Regarding institutional investors, in September 2009 the CSRC allowed qualifying securities investment funds to invest in Second Board shares.

⁸ The CSRC announced this when it published its draft of the *Implementation Rules* in June 2009.

First, we look at the rules governing application documents. As with the other Second Board rules, the requirements are stricter than with the Main Board rules. This reflects the characteristics of the companies hoping to list on the Second Board. More specifically, (1) the controlling shareholder and the de facto controller are required to confirm the contents of the prospectus. This is to make them more accountable for disclosure. Also, (2) the sponsor is required to express an opinion about the company's growth prospects. This is to check whether the sponsor has done its due diligence on the company's technological innovativeness. In addition, (3) companies are required to give details of their capital structure and shareholding structure since their establishment, and this has to be confirmed by its directors, supervisors and senior management; (4) a lawyer has to confirm the authenticity of the seals used by the controlling shareholder, the de facto controller, the directors, the supervisors, and senior management; and (5) the directors, supervisors and senior management are required to confirm that the listing application documents are true, accurate and complete. This is to make all those involved more accountable.

Although the rules governing the prospectuses of Second Board companies are intended to ensure that their contents are as similar to those of Main Board companies as possible, the CSRC has added some rules to reflect the characteristics of Second Board companies by raising the standard of, and making all those involved (namely, issuers, controlling shareholders, and sponsors) more accountable for, disclosure. Also, companies are required to post their prospectuses on a website designated by the CSRC.

Figure 3: Gist of rules governing *Prospectuses of ChiNext Companies*

(1) Disclosure of information about an issuer's core competitiveness, growth potential and innovativeness
(2) More risk disclosure <ul style="list-style-type: none"> • Issuers are required to report on risk factors that could have a negative impact on their operations and finances as well as their ability to continue to make a profit and grow. If they are unable to provide a quantitative analysis of these risks, they should provide a qualitative analysis. • In the case of Second Board prospectuses, issuers are also required to report on the following risk factors: risks of product and service markets; business model risks; asset quality and composition risks; debt risks; technological risks; investment project risks; internal control risks; control right risks; industry risks; regulatory and policy risks; and the risks associated with natural disasters, safe production and foreign trade.
(3) More disclosure of information about how any capital that has been raised is used <ul style="list-style-type: none"> • In view of their distinctive characteristics, Second Board issuers are also required to disclose information about non-fixed assets (specifically, anything related to how they make themselves more competitive in their main businesses: e.g., how they improve their services, develop markets, and improve their human resources).
(4) Disclosure of information about future development and plans <ul style="list-style-type: none"> • Issuers are required to disclose information about their plans and goals for the next three years and how they intend to become more competitive as well as how they intend to use any capital they have raised.
(5) Disclosure of information about corporate governance <ul style="list-style-type: none"> • Issuers are required to disclose information about whether they have established an audit committee, whether they have any overseas investments, whether they have pledged any of their assets as collateral, who decides what, whether this is governed by any company rules, and what steps they have taken to safeguard investor interests.
(6) More financial disclosure (with the following requirements being added to those for Main Board companies) <ul style="list-style-type: none"> • Issuers are required to analyze, and explain the causes and impact of any change in inventories, accrued revenue, intangible assets, principal debts, overseas investments, shareholders' equity, cash flow items, etc. • They are required to give details of and analyze tax items, deferred tax assets and liabilities, net profit attributable to shareholders, and NAV/share.

Source: NICMR, from draft explanation of CSRC's rules governing *Prospectuses of ChiNext Companies*

The rules governing prospectuses consist of 123 articles, with the main disclosure requirements as follows: (1) disclosure of an issuer's core competitiveness, growth potential, and innovativeness; (2) more risk disclosure; (3) more disclosure of how any capital that has been raised is used; (4) disclosure of plans; (5) disclosure of corporate governance; and (6) more financial disclosure (Figure 3).

III. Future developments

As its *raison d'être* is to "promote the development of innovative enterprises and other growing start-ups," the Second Board enables such companies to raise capital by issuing shares. That is why its listing requirements are less demanding than those of the Main Board but also why it has various provisions to mitigate risk. For one thing, the Second Board has its own public offering review committee to check how technologically specialized applicant companies are, reflecting the importance attached to this. For another, issuers and their controlling shareholders, *de facto* controllers, and sponsoring securities companies are subject to more demanding accountability requirements. The key factor here is, not surprisingly, disclosure. Also, the qualified investor system is designed to mitigate the risks to retail investors.

Once the rules and regulations governing the Second Board were published, the CSRC began to process listing applications from 26 July 2009. It has been reported that 108 companies initially applied. As of mid-October, 28 of these had been approved and on 30 October they were listed on the Second Board⁹.

As of 15 December, there are 46 companies whose listing application has been approved by CSRC (including the above-mentioned 28 companies). They come from a wide range of sectors, especially information technology, services, and bi-pharmacy. Thus far, few companies in which foreign private equity funds have a stake have applied. This is because these funds have tended to go for red-chip listings¹⁰.

Another point is movement between the various tiers of China's multi-tier capital market. As of early September, four companies that are traded on the new Third Board had successfully applied to list on the Second Board. As 22 new Third Board companies meet the listing requirements of the Second Board on the basis of their interim reports for the first half of fiscal 2009, a growing number of companies may transfer their listing from the new Third Board to the Second Board. We think this is likely to make the new Third Board a more attractive market for private equity investors¹¹.

⁹ This chapter is based on reports in the media and interviews with those involved.

¹⁰ A company with the ownership structure required for a red-chip listing would have to modify that structure if it wanted a domestic listing.

¹¹ We also think that, once the Second Board becomes more established and if a growing number of companies choose to transfer their listing from the new Third Board to the Second Board, the new Third Board will become more attractive and China's multi-tier capital market as a whole will benefit.

The applicants include companies that were in the process of applying for a listing on the SME Board. The CSRC has also made it clear that it does not see the Second Board simply as a "small SME Board" and attaches great importance to the companies' innovativeness and growth potential.

Meanwhile, the Second Board's Public Offering Review Committee was officially established on 14 August. It has 35 members. A breakdown reveals that the number of representatives of the CSRC and the Shenzhen Stock Exchange has been limited to three and two, respectively, to ensure that the committee has the necessary number of technology specialists. Of the remainder, 14 are accountants, six lawyers, three from the Ministry of Science and Technology, three from the China Academy of Sciences, two from investment trust companies, one from an asset evaluation agency, and one from the National Development and Reform Commission (NDRC). It has been reported that the members include specialists in the six industry fields the CSRC considers particularly important for Second Board companies (namely, new energy, new materials, biotechnology and pharmaceuticals, energy conservation and environmental protection, services and IT).

The authorities clearly want to avoid a situation where the Second Board attracts a large number of second-rate companies and becomes a vehicle for market abuse as it would then run the risk of becoming an illiquid market shunned by investors who have lost trust in it. Indeed, such has been the number of companies applying to list on the Second Board that some observers have expressed concern about their quality. There has also been some concern about investor protection. For example, supplementary agreements between private equity funds and issuers¹² pose a risk to retail investors in that they may suddenly be faced with a change in the controlling shareholder. This is because such agreements can result in a transfer of shares from the founder or controlling shareholder to a private equity fund if the company fails to meet certain agreed targets or in a shareholding structure that is different from the apparent one, for example. The problem of low liquidity, which has long faced the new Third Board market, where small-cap high-tech stocks are also traded, also needs to be addressed¹³.

Ultimately, whether or not such risks can be mitigated will depend on whether the quality of the companies that list on the Second Board improves and disclosure requirements are strictly complied with. For example, according to the rules governing *Prospectuses of ChiNext Companies*, companies are required to disclose the above-mentioned supplementary agreements as a control right risk. The point is whether such requirements will be complied with.

Since there is a potentially large number of high-tech companies in China in the long term, whether or not the Second Board becomes one of the world's few successful venture capital markets will depend on whether all these rules and regulations succeed in shaping its development and the way in which it is run.

¹² This is based on interviews with those involved.

¹³ See Jingu (Autumn 2009).

【References】

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