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*Only Chinese Companies That Created Offshore Structures Before The New M&A Rules Can List Abroad, For Now*

→ By partners **Matthias von Oppen** and **Joseph Marx** of Dewey & LeBoeuf

One of the highlights of 2007 in the German capital markets was the successful IPOs (IPOs) of ZhongDe Waste Technology and Asian Bamboo on the Prime Standard segment of the Frankfurt Stock Exchange. These were the first two IPOs of Chinese companies through a German holding company (referred to as indirect listings), on the Prime Standard segment of the Frankfurt Stock Exchange. Both of the IPOs experienced strong demand and were oversubscribed more than 13 times at the upper end of the price range. In the coming year, capital market specialists at Sal Oppenheim expect up to six IPOs of Chinese companies on the Prime Standard segment. The hard work of Deutsche Börse and several German investment banks appears to be bearing fruit.

***Stumbling Blocks***

There are a number of different reasons for Chinese companies to list on a foreign market. In addition to the internationalisation of business and the domestic prestige associated with foreign listings, Chinese law itself motivates many smaller and high-growth companies to obtain them. The preparations for an IPO in China are cumbersome and time-consuming. Before issuers can apply for a market listing, they must show a minimum profitability (Ebit) equal to about €3 million (\$4.7 million) per financial year over a period of three years. The company must then undergo a so-called 12-month apprenticeship period, in which it fulfills all corporate governance rules that apply to publicly-traded Chinese companies.

When selecting potential Chinese candidates for a foreign listing, however, banks should at an early point consider not only the usual qualitative selection parameters but also the unique structural aspects of Chinese law. This is because not every promising Chinese company meets these requirements. And there are other stumbling blocks that could delay the transaction.

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The Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, known as the New M&A Regulations, are a particular source of concern. They have been in effect in China since September 8 2006. As the scope of these regulations applies in particular to corporate restructuring through the creation of holding companies outside China — essential for a foreign listing — the New M&A Regulations have severely restricted the potential number of Chinese companies listing on a foreign market. Because Chinese law prohibits the shares of Chinese companies from being traded outside China, Chinese companies are forced to use a foreign holding company as a listing vehicle. The New M&A Regulations stipulate that the contribution of shares to a foreign holding company or the acquisition of such a company requires the approval of the Chinese Ministry of Commerce (Mofcom) and the China Securities Regulatory Commission (CSRC). But no such approvals have been issued since the New M&A Regulations came in to effect. The most likely reason is that this is to prevent foreign investors from influencing Chinese companies and/or to prevent the flow of funds out of China.

The New M&A Regulations do not apply to Chinese companies traded on the Prime Standard segment, as these companies have obtained the status of so-called foreign invested enterprises by creating offshore structures before the New M&A Regulations came into effect. According to estimates by Deutsche Börse, about 300 private Chinese companies implemented such offshore structures in time. The pipeline of Chinese candidates for foreign listings will be primarily restricted to these companies, unless there is a fundamental change in government practice in China.

### ***Forbidden Territory***

With regard to foreign listings of Chinese companies, it must also be remembered that holdings in Chinese companies in certain industries are prohibited or restricted for foreign shareholders. These so-called protected industries are listed in the Investment Catalogue (Catalogue for the Guidance of Foreign Investment Industries) published by Mofcom and the National Development and Reform Commission. The Investment Catalogue lists specific industries in which foreign investments are desired, limited, or completely prohibited. The latest version of the Catalogue was published on October 31 2007. Industries listed as restricted or prohibited include insurance, publishing and telecommunications. These restrictions also apply in cases where the shares of the Chinese operating company/companies are transferred to a foreign single-purpose company, which is in turn

held by the original Chinese shareholders. As a result, the Investment Catalogue has a direct effect on the restructuring necessary for a foreign listing.

Despite these restrictions, Chinese companies from protected industries have been able to conduct foreign listings in the past by entering into special contractual arrangement. Examples include the Nasdaq-listed companies Sohu.com (foreign listing in 2000), Ctrip (2003), and Baidu (2005). This was accomplished by creating a foreign single-purpose company (a so-called Various Interests Entity, or VIE), which exercises control not through its shareholdings, but rather through separate contractual agreements with the Chinese operating company. These contractual arrangements typically involve profit appropriation arrangements, loan agreements, exclusive operating agreements regarding the performance of the business activity, share pledges, and, in the event of a loosening of the investment restrictions, a unilateral purchase option for shares in the controlled Chinese operating company. As a rule, this economic and operating control also permits the preparation of consolidated financial statements at the level of the holding company (VIE). Chinese lawyers are discussing the question of whether a corresponding contractual form is also possible to circumvent the approval requirements of the New M&A Regulations, but no one has tested it in practice.

The structuring of foreign listings for Chinese companies in protected industries requires significant additional effort, and the structuring of foreign listings for companies subject to the New M&A Regulations may even be precluded. Experienced legal advisers should analyse these special structural aspects carefully before starting the complex process for listing a Chinese company on a foreign market.