A Rule Pushed by the Market: China's New Measures for Offering and Underwriting Securities

Following a year-long hiatus, China recently reopened its market to IPOs. To guide the market, the China Securities Regulatory Commission introduced the Measures for the Administration of the Offering and Underwriting of Securities. The new Measures change the way that underwriters and institutions conduct IPO price inquiries in China. What do these Measures entail and how will they affect China's market in the future?

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When China reopened its market to initial public offerings (IPOs) in May 2006, after a year-long suspension, the China Securities Regulatory Commission (CSRC) issued several regulations to cover various issues affecting IPOs. One of these was the *Measures for the Administration of the Offering and Underwriting of Securities*, which became effective in September 2006.

The Measures set new standards for IPO price inquiries and securities issuance. They consolidate the regulatory framework on new share issuance and set a standard for intermediaries, such as underwriters and institutions participating in IPO price inquiries.

Before the Measures were promulgated, securities were priced and issued according to constant changes in China. The CSRC used various approaches to enforce transparency and fairness for IPO pricing, such as fixed pricing and pricing according to price-earnings ratio. However, since these approaches were criticized for lacking flexibility and depriving underwriters of pricing freedom, the CSRC introduced the Measures to address these problems.

The Measures were formally issued after only six days of their draft release. This prompted speculation that the Measures were introduced to create a framework before the dual IPO of Industrial and Commercial Bank of China in Shanghai and Hong Kong. CSRC officials did not confirm the speculations, but they did state in a press release that the Measures were issued in response to large overseas-listed Chinese companies trying to launch IPOs in China. The press release also stated that the Measures were created to address domestic companies trying to launch IPOs in and outside of China.

Additionally, the CSRC found it necessary to formulate IPO pricing and underwriting rules that were similar to those used in mature markets. The main concern was to enforce clear rules that local and foreign investors could understand.

PRICE INQUIRY AND PRICING

Procedures

The Measures outline a two-stage pricing inquiry process: initial price inquiry and book-building price inquiry. The price range of an IPO must be determined through the initial price inquiry process, while the IPO's specific offering price should be determined according to the book-building inquiry process. Most IPOs launched on the board of small and medium-sized enterprises are priced high on the price range of initial price inquiries. Thus, the Measures give issuers the choice to follow the book-building process after they complete initial price inquiries.

Qualified inquired institutions

According to the Measures, price inquiries must be conducted by qualified institutions including fund management companies, securities companies, trust and investment companies, finance companies, insurance institutional investors and qualified foreign institutional investors (QFIIs). Additional conditions in the Measures apply to the amount of certain institutions' registered capital and investment record (such as, securities companies, trust and investment companies and finance companies).

A qualified inquired institution cannot participate in book-building inquiries and offline placement if it has not participated in the initial price inquiry, or if it participated in the initial price inquiry but did not make a valid quotation. This provision closes a loophole in the old pricing procedure, which allowed institutions to submit arbitrary quotations without intention to subscribe to relevant stocks.

Suspension of issuance

To ensure fairness and control of issuance prices, issuers and their lead underwriters cannot determine the issuing price. They must also suspend issuances when either of the following situations arise after the initial price inquiry:

i. there are less than 400 million publicly-offered shares and less than 20 inquired institutions providing valid quotations; or

ii. there are more than 400 million publicly-offered shares and less than 50 inquired institutions providing valid quotations.

SECURITIES OFFERING

Manner of securities offering

Securities offering can be conducted via online issuances or offline placements. Online issuances refers to issuances made via the electronic systems of securities exchanges; offline placements are organized and completed by underwriters.

Under the previous regulation, online subscriptions were conducted after the completion of offline pricing and placements. This two-stage process was frequently used by institutional investors who used the same fund to subscribe to stocks online and offline.

According to a CSRC statement regarding the two-stage process, the previous IPO rate allotted to public investors was below 1%. The new Measures require institutions to conduct all offline placements and online issuances simultaneously. The CSRC's goal is to generate enthusiasm from public investors.

When an online issuing price has not been determined, investors who participate in the online issuance must subscribe to the upper limit of the price range. When the issuing price is lower than the upper limit of the price range, the price difference must be refunded to investors.

According to the Measures, depending on an IPO's range, issuers and lead underwriters must establish a claw-back mechanism between offline placements and online issuances. They must also adjust proportions according to the status of subscriptions.

Offline placement

The Measures impose different limits on the amount of shares allotted via offline placement. The limits are based on the total amount of publicly issued shares, and a lock-up period of at least three months for shares subscribed via offline placement. Shares should be placed on securities investment products managed by qualified inquired institutions. Placees are confined to the following types of transactions:

i. approved securities investment funds;

ii. national social security funds;

iii. proprietary securities trading accounts of securities companies;

iv. approved consolidated asset management plans developed by securities companies;

v. proprietary securities trading accounts of trust and investment companies;

vi. consolidated trust plans of trust and investment companies that have been reported to competent authorities.;

vii. proprietary securities trading accounts of finance companies;

viii. securities investment accounts of approved insurance companies or insurance asset management companies;

ix. securities investment accounts managed by QFIIs; and

x. enterprise annuity funds filed with competent authorities.

A qualified inquired institution must designate separate capital and securities accounts for each of the above qualified placees. The accounts should be used for book-building inquiries and offline placements. The placees must pay the subscription capital in full, but the subscription amount of a single securities account must not exceed the total amount of shares placed to the inquired institutions in the same offering.

Placements to strategic investors

To attract long-term capital and optimize the structure for investors, the Measures allow placements to strategic investors when there is an IPO of more than 400 million shares. In such cases, issuers must enter placement agreements with strategic investors early and submit a record to the CSRC. Issuers and lead underwriters must disclose the selection criteria to strategic investors, the total amount of shares that would be placed to strategic investors, the proportion they represent in the total amount of shares issued and the lock-up period.

The Measures forbid strategic investors from participating in initial price inquiries and book-building inquiries of IPOs. The Measures also require strategic investors to commit to a lock-up period of at least 12 months.

SECURITIES UNDERWRITING

Manner of securities underwriting

A securities company is required to follow one of the following processes to underwrite securities:

i. firm underwriting, a method of securities underwriting in which underwriters must distribute all securities to be offered and purchase those that they cannot dispose of; or

ii. best-effort underwriting, a method of securities underwriting in which underwriters agree to sell as much of an offering as possible and return unsold shares to issuers.

Listed companies must adopt a best-effort underwriting method when they make private placements or give share allotments to existing shareholders.

Underwriters' obligations

Underwriters must perform underwriting activities in accordance with relevant underwriting agreements. Lead underwriters must establish special departments or organizations to coordinate issuers' information disclosure, promotional campaigns, book-keeping, pricing, placements and funds settlements.

The Measures do not authorize securities companies to provide overdraft, kickbacks or use other improper means to induce investors to subscribe to shares. Once they receive a subscription and payment from an investor, lead underwriters must recruit a qualified accounting firm to examine and verify the subscription capital and produce a capital verification report. In IPO cases, underwriters must recruit a law firm to verify that the price inquiry and placement process comply with the law. Lead underwriters must also submit an underwriting report to the CSRC within 10 days of making a listing.

Greenshoe option

To stabilize stock prices, the Measures allow issuers and lead underwriters to exercise the greenshoe option when more than 400 million shares are issued in an IPO. The *Tentative Opinion for Over-placement Option*, which was promulgated by the Commission on September 3 2001, outlines detailed rules applicable to the greenshoe option.

The greenshoe option is granted by an issuer to lead underwriters who can oversell the issuer's shares for as much as 15% of the total amount. Within 30 days of the listing of shares (and depending on market conditions), lead underwriters can purchase an issuer's shares from the market. At that time, they can also request the issuer to issue more shares to investors who have applied for subscription to the oversold portion of shares.

CONCLUSION

By introducing several mechanisms derived from sophisticated markets, the CSRC's Measures support the development of China's capital market and encourage its integration in the international market.