First direct listing for Chinese company in New York

Mark S Bergman, Richard S Borisoff and Nicholas C Howson of Paul, Weiss, Rifkind, Wharton & Garrison, New York, look at legal aspects of the first direct listing of a PRC company in the US.

The People’s Republic of China (PRC) has begun a systematic process of financing selected state-owned enterprises and is looking offshore for sources of capital. A few state-owned enterprises have listed securities on foreign markets and others have been designated for overseas initial public offerings in the near future. This process can be expected to accelerate in coming years.

On August 4 1994, Shandong Huaneng Power Development Co Ltd (Shandong Huaneng) became the first PRC enterprise to list its securities directly on the New York Stock Exchange (NYSE). Shandong Huaneng listed American Depositary Shares (ADSs), each representing 50 ordinary N Shares.

This transaction added another letter to the alphabet soup of Chinese capital markets options: N Shares, which now join A Shares (Renminbi-denominated shares traded on PRC exchanges and held by domestic investors), B Shares (Renminbi-denominated shares traded on PRC exchanges and held by overseas investors) and H Shares (Hong Kong dollar-denominated shares traded on the Hong Kong Stock Exchange).

Shandong Huaneng’s ADSs were listed in connection with a global initial public offering of ADSs through US, European and Asian syndicates. The Shandong Huaneng offering was unprecedented in a number of respects, and the problems that arose and were resolved in connection with the offering and listing are likely to arise in subsequent offerings by PRC state enterprises.

Shandong Huaneng

Shandong Huaneng owns interests in existing coal-fired electric power plant projects in Shandong Province. It plans to expand these projects and build and operate new projects. The company and its majority-owned subsidiaries have an installed capacity of 1,325 MW and plan to expand capacity to at least 6,050 MW. Shandong Huaneng was formed by Huaneng Power Generation Corporation, Shandong International Trust and Investment Corporation and Shandong Province Electric Power Company.

Interests in the power projects contributed to Shandong Huaneng in connection with its formation were owned in whole or in part by various combinations of the three promoters. The promoters were required to obtain an appraisal of all of the assets to be contributed by them and conduct a feasibility study of the establishment of a new entity. The promoters contributed their respective interests in the various plants in return for legal person A Shares, based on the appraised value of the plants and the proportionate interests contributed. Under present PRC law, such legal person shares are not transferable absent special approvals.

The offering

The Shandong Huaneng offering was unprecedented in a number of respects. It was the first direct NYSE listing by a PRC company and, hence, the first issuance of N Shares. Before this listing, PRC companies had:

- accessed foreign capital markets through indirect or back door listings, involving the issuance and listing of shares by Bermuda holding companies or the transfer of PRC assets to a Hong Kong shell;
- listed B Shares on the Shanghai or Shenzhen stock exchanges; or
- listed H Shares on the Hong Kong stock exchange, including an issuer that followed such a listing with a US offering and listing of ADSs representing H Shares.

Secondly, it was the first listing on any foreign stock exchange by a PRC power company, and it was the first PRC company to access overseas capital markets following the promulgation of the PRC Company Law.

On the basis of the offering, as well as general regulatory developments in the PRC last year, it appears that, at least for the foreseeable future, the significant hurdles to
be overcome by PRC companies listing in the US will be encountered in the PRC, not in the US. From a US regulatory perspective, many of the issues that are encountered are of the type that normally arise when a non-US issuer seeks to list its securities on a US stock exchange and/or offer securities publicly in the US. Other issues are common to offerings by issuers from emerging markets generally. From a PRC regulatory perspective, many of the issues are being addressed for the first time.

**US legal issues**

Like any non-US issuer seeking to raise capital in the US through the use of American Depositary Receipts (ADRs) representing ADSs (which, in turn, represent ordinary shares of the non-US issuer), Shandong Huaneng, by reason of the Securities Act of 1933, had to prepare, file and have declared effective by the US Securities and Exchange Commission (SEC) a registration statement on Form F-1 covering the N Shares and a registration statement on Form F-6 for the ADSs.

Because Shandong Huaneng was listing securities on the NYSE, it also had to register the ADSs under the Securities Exchange Act of 1934 (the Exchange Act), which it did using a Form 8-A, and had to obtain clearance from the NYSE for the listing. By reason of its registration under the Exchange Act, Shandong Huaneng will be subject to the periodic reporting requirements applicable under the Exchange Act to non-US issuers. In the future it will prepare and file with the SEC an Annual Report on Form 20-F.

**Financial statements:** From a US disclosure perspective, one of the costliest and most time-consuming burdens on a PRC company is the need to prepare historical financial information required by the SEC.

Foreign issuers generally are required to provide three years of historical financial information prepared in accordance with US generally accepted accounting principles (GAAP) or on the basis of another accounting system accompanied by reconciliation to US GAAP. Shandong Huaneng was able to obtain, following pre-filing conferences with the accounting staff of the Division of Corporation Finance, a waiver from these arrangements and, instead, was required to provide one year of historical financial information and one year of pro forma financial information.

Shandong Huaneng did not exist as an entity prior to the offering. The power projects that were contributed to Shandong Huaneng operated as separate assets or, in one case, a cost centre of the Shandong Power Grid. Also, a substantial portion of Shandong Huaneng's capacity had come on stream within the past year.

In addition, a new basis for calculating the tariffs charged by the power plants (which will represent substantially all of the revenues of Shandong Huaneng) was entered into, which was significantly different from the tariffs charged by the various plants to the Shandong Power Grid prior to the offering. Whereas previously the plants had acted as cost centres, in effect being made whole for all demonstrated generating costs (including principal and interest repayments on state-mandated debt funding), the new tariffs enshrined the principle of a 15% return on assets (including some assets under construction), after covering fixed and variable generating costs, certain financing costs and taxes.

The SEC concluded that historical financial information would be less useful to investors, and that Shandong Huaneng instead should provide only one year of historical financial information and one year of pro forma information, reflecting, among other things, the new tariffs, the asset revaluations arising from the assets appraisal required under Chinese law and a change in the rates and basis of taxation that would be applicable following the offering.

Issuers must address accounting matters as early as possible. Although PRC companies in general keep extremely good records, there generally has been no need for concepts of cash flow or balance sheet accounting. In addition, PRC GAAP differs from US GAAP and International Accounting Standards in a number of significant respects so that preparing US GAAP financials (or reconciliations) can be a time-consuming process.

**Confidential review:** One accommodation the SEC will make for foreign issuers is to allow their registration statements to be processed on a confidential basis. Shandong Huaneng availed itself of this opportunity. Under this procedure, a substantially complete draft of the registration statement is filed with the Office of International Corporate Finance on a non-public basis (the SEC generally takes the position that no review will be undertaken unless the financial statements are in final form.) The staff reviews the registration statement in the normal 30-day review period. SEC comments can be addressed in amended drafts filed on a non-public basis.

This procedure can be of great help for PRC state enterprises and for the government itself. During the review period the issuer can undertake organizational tasks and obtain its domestic approvals without the glare of publicity that normally accompanies the filing of a registration statement for an offering of this type. If there are delays in obtaining the myriad of governmental approvals, an offering can be postponed without any public relations repercussions for the issuer or the government. Publicly known delays over an extended period of time would discourage potential investors, thereby hampering the government's financing programme.

**Due diligence:** The due diligence effort involved in an offering by a PRC state enterprise is considerable and is costly and time-consuming. Foreigners often are under the impression that the economic system in China operates on a centralized basis and various ministries coordinate in such a way as to require little paper work or few approvals for various actions by PRC state enterprises.

In fact, PRC state enterprises need approvals from as many as half a dozen ministries for almost any activity, including expanding operations, obtaining necessary raw materials at appropriate prices, pricing product or expanding into new lines of business. Therefore, a large volume of documentary due diligence must be under-
taken to ensure that all approvals for operation of the issuer's facilities have been duly obtained, and for this purpose it is essential to have bilingual lawyers who can speak and read Chinese so that they can review such documents (and interview relevant officials).

Counsel undertaking a due diligence review must be unusually proactive in determining which approvals are necessary, and whether or not the approvals may in fact be documented. As the incorporation and listing process is so new, many governmental bureaux are unclear as to the required procedures for even such essential steps as establishment of the issuer. Departments with jurisdiction may only offer oral approvals, or decline to pass on a particular question.

Lawyers and accountants must interview relevant officials to ensure that the descriptions of the company's business and financial performance in the registration statement are accurate. While in the US context this inquiry normally would be limited to officers, directors and consultants to the company and its principal suppliers and customers, in state-run economies the focus must include government officials involved in the regulation of the enterprise.

While bilingual lawyers are vital to the due diligence process, it is also important to understand the PRC system from a cultural viewpoint. For example, PRC managers are accustomed to a system that targets quotas and encourages optimistic forecasts. The issuer must be made aware of the purpose of the due diligence process in order for its representatives to adopt the more conservative approach appropriate to the context in which such questions are being asked.

**Disclosure:**

Like their counterparts all over the world, Chinese issuers addressing the US disclosure system for the first time can find the process daunting. The issuer as well as its regulators will want to understand the basis for disclosures in the registration statement, as well as the provisions in the ADR Deposit Agreement and Underwriting Agreement.

Explanations that disclosures are required by foreign securities laws or market practice do not always suffice. For example, standard US risk factor disclosure at times can be viewed by a Chinese issuer and its regulators as critical of China or overwhelmingly discouraging to investors. As with much of the rest of the process, the role of counsel is to educate, as well as advise, and in doing so, counsel must be sensitive to the cultural differences that must be bridged.

**PRC legal issues**

**Development of legislation:** Only now is the PRC developing the system of legislation necessary for the creation of legal entities appropriate for listings on overseas stock exchanges. Not only is there little experience with the existing legislation, but in many cases the legislation itself is ill-equipped to deal with foreign listings.

For example, on July 1, 1994, a new Company Law came into effect. Many observers expected that the law would address issues relating to Chinese companies wanting to list overseas. It became clear when drafts of the Company Law were circulated, however, that the legislation would not resolve many such questions. The Company Law was then supplemented by special overseas listing rules, which were promulgated on August 4, 1994 (the day of the Shandong Huaneng offering).

Yet these rules also contain a number of omissions. For example, the rules failed to clarify the parameters of indirect or back door listings by PRC companies and the approval process for such listings, did not allow for different classes of ordinary shares and failed to provide exemptions from certain restrictive elements of the Company Law.

Despite the problems arising from incomplete or inappropriate provisions of law, one advantage of the relatively early stage of development of this area is that PRC regulators are practical people who will make exceptions where necessary. For example, the Shandong Huaneng establishment and offering took place prior to adoption of the overseas listing rules. Prior to such adoption, the Shandong Huaneng articles of association were technically not in compliance with certain provisions of the Company Law. The offering was allowed to proceed,
however, when the relevant officials issued a blanket waiver from the restrictive terms of the Company Law for the articles.

The waiver, however, did not help with issues that the Company Law and overseas listing rules fail to address. For example, the shares underlying the ADSs sold in the public offering were designated as N Shares to differentiate them from the A Shares held by the promoters. This separate designation was required since under PRC law A Shares can only be held by PRC citizens or entities. The main purpose of this distinction is to provide the PRC authorities with a mechanism to control the flow of foreign exchange — A Shares are purchased with and receive dividends in Renminbi and N Shares are purchased with and receive dividends in US dollars (N Share dividends are declared in Renminbi but must be converted to US dollars before payment.)

N Shares and A Shares are, for purposes of PRC law, not considered separate classes of shares, but different kinds within the same class. Holders of N Shares and A Shares enjoy equivalent voting power and dividend rights, but, subject to approval, holders of N Shares receive dividends in US dollars. In addition, such holders also have separate ‘class’ votes in certain circumstances.

The approval process: One of the great challenges for a PRC issuer is to obtain all the necessary approvals required for an overseas offering. It must obtain separate approvals to increase capital, to become a company limited by shares, to adopt its articles of association, and to publicly issue stock. Separate approvals also are required to cover foreign exchange issues and, possibly, specific tax issues. At times clearing all these hurdles can seem to be an endless and unpredictable process.

An additional challenge is to coordinate among the various ministries. Different ministries may have different views on the same question, and the issuer or its counsel must facilitate a unified approach. As with all bureaucracies, Chinese ministries can move slowly, which can frustrate time schedules. While the situation will improve as regulators become more familiar with these transactions, for now time schedules should contemplate the potential for delays.

Other issues: Other issues arose that are likely to be relevant in future offerings. One threshold question was whether shareholder suits against the company would be resolved by means of arbitration or through the Chinese court system. The articles of association of PRC state companies previously listed in Hong Kong mandate arbitration for such disputes, thereby circumventing the untested Chinese court system. This was seen as advantageous to foreign investors because of the concern that Chinese courts may not be sufficiently versed in corporate law questions to adequately resolve such issues, or that resolving such matters in PRC courts may give the PRC company a home court advantage. The Hong Kong Stock Exchange required arbitration as a condition for allowing such companies to be listed in Hong Kong.

The NYSE did not impose such a requirement. The Chinese government had made a policy decision that, in the future, offerings on the NYSE would not benefit from mandated foreign arbitration, but that investors in PRC companies would be required to rely on the Chinese court system. From the Chinese perspective, this is understandable. It is not only a question of national pride, but also a concern that if all such matters are handled through arbitration, the Chinese court system will never develop the expertise necessary to resolve these matters. As a practical matter, this concern may be largely irrelevant — even in the event of arbitration in a non-PRC location, the award would have to be enforced through the same court system that some seek to avoid.

Another issue involves the various legal and political relationships among the issuer, its promoters and its principal suppliers and customers. For example, in the Shandong Huaneng transaction, each of the promoters had extensive connections with the Shandong power industry. In fact, one of the promoters is the sole purchaser of power from the company and its principal regulator. Such relationships are to be expected in a state-run economic system. SEC rules require disclosure of such relationships, and care should be given to clearly delineating such interconnections in the registration statement.

It is also important to be aware of the differences between the US and PRC legal systems. For example, there is no domestic requirement imposed on PRC issuers listing only on a non-PRC stock exchange to provide interim financial information. US investors purchasing securities of foreign issuers offered in the US generally must rely on the issuer’s home country requirements for such interim financial reports, since the requirement to file a Form 6-K under the Exchange Act — under which many foreign issuers file semi-annual financial information — is triggered only where the issuer is required by its home jurisdiction to file, publish or circulate such information. As a result, a contractual obligation was added to the ADR Deposit Agreement requiring Shandong Huaneng to provide semi-annual financial information.

Conclusion
The Shandong Huaneng transaction was a precedent-setting event that will provide a significant impetus to further offerings by PRC state enterprises that the government of China wishes to finance. Much was learned by US regulators and PRC authorities regarding the process of bringing PRC state enterprises to the US capital markets. US regulators showed admirable flexibility, as did the PRC oversight agencies and the State Council. PRC regulators became aware of the tremendous amount of work required for successful completion of such a transaction.

Finally, Shandong Huaneng demonstrated that New York can act as the principal market for the trading of a PRC company’s securities, without the need for an intermediate listing in Hong Kong or any other local market. The true China plays may now be accessed directly through Wall Street.
Lee C. Buchheit's series of articles on how to negotiate standard clauses in Eurocurrency loan agreements will be published in book form in the spring of 1995 by IFLRev Books. The articles will be edited and accompanied by an extensive bibliography. Directed principally at lawyers, bankers and corporate borrowers seeking an introduction to Eurocurrency lending agreements, the articles deal with such standard clauses as:

- Defining indebtedness
- Increased costs
- Illegality
- Capital adequacy
- Eurodollar disaster
- Libor definition
- Tax gross-up
- Pari passu representation
- Permissible liens
- Cross default
- Currency indemnity
- Broken funding
- Negative pledge
- Sharing
- Payment default
- Assignment
- Substitution to jurisdiction
- Waiver of immunities
- Material adverse change
- Expense reimbursement

Each topic is covered in a short, easily digestible essay that explains the purpose of the clause in the agreement and sets out the respective negotiating positions of both the borrower and the lender.

For further information, or to place an advance order please fax:

(44 71) 779 8768

Pre-publication offer to IFLRev subscribers only $45 per copy