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China: Trends & Developments

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Trends and Developments

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Geopolitics and US-China Relations

US-China relations clearly continue to play a critical role in forming China's macro policies and shaping its financial regulatory framework. We believe the Chinese government will continue its reformation and open market policy to ensure a stable environment for the country's development. Even with the notable abatement in private equity/venture capital (PE/VC) investment in the first half of 2022, we believe that the Chinese market will remain a critical place for international and domestic investors, especially those who are interested in the consumer, logistics, clean resource and technology sectors. However, geopolitical factors and different development philosophies continue to influence social governance and financial regulation practices. Communication to reach a common understanding between the regulators and the regulated is more important than ever within the difficult pandemic situation. It appears that market players will need to participate more actively in industry pilot programmes and rule-making processes driven by local government and regulators.

China's Cybersecurity Law, Personal Information Protection Law and Data Security Law

Data compliance is the most common risk and control term in the industry, not only due to the three key data-related legislations effective in recent years, but also because of the heightened trend of regulatory review and enforcement in 2022. According to the Cybersecurity Law, a national security review is required for critical information infrastructure operators (CIIOs) when they purchase network services and products with a possible impact on national security. Similarly, according to the new Cybersecurity Review Regulation effective since 15 February 2022, both CIIOs and network platform operators are required to undergo a cybersecurity review. For network platform operators who want to go public overseas with more than one million users' personal information, a request for a cybersecurity review must be filed with Chinese authorities. In China's Data Security Law, when personal information and important data are shared across borders, data processors or CIIOs are required to conduct a cross-border security assessment and pass the government's security review.

All the data regulations have set a high bar for compliance by market participants. In a lot of practical implementation areas, however, questions on the actual standards of cybersecurity reviews and data security reviews remain open. Regulators across sectors have also been organising pilot projects, for example, in the automobile industry, on the topics of data security assessment and data cross-border transfer, to sort out feasible compliance programmes. All market players are encouraged to actively participate in such activities and take the opportunity to shape data compliance regulation and enforcement regimes.

For companies that want to raise funds through the capital market, it is clear that regulatory reviews of national security, data security and personal information protection are a key requirement. Companies are advised to build a comprehensive data compliance programme and

proactively participate in government reviews. Data compliance has become a critical area for PE/VC funds to perform due diligence on target companies and to follow up on post-investment management.

Compliance and Risk Control

Accounting, tax, environmental, cybersecurity, data security, and financial crime compliance issues have been increasingly scrutinised by Chinese regulators for listed companies. At the same time, Chinese prosecutor's offices have recently implemented a programme to consider not bringing cases to public prosecution in those companies that can enforce effective compliance controls. Both PE/VC market investors and entrepreneurs have become more aware of the importance of regulatory compliance and the potential impact of failure to comply on investment and exit. The standards of pre-investment due diligence have been lifted. Nominee structure, tax violations, foreign currency control, Foreign Corrupt Practices Act (FCPA) matters, and negative media exposure are the most common topics in compliance and risk control. It appears that the market is becoming less and less tolerant of compliance issues. Fund managers and their advisers will therefore need to pay more attention to compliance and risk matters, especially post-investment compliance monitoring and remediation.

China's Attitude towards Blockchain-Based Industry

Blockchain-based projects have attracted huge amounts of money from institutional investors worldwide in recent years. According to business analytics company, CB Insights, for the first quarter of 2022, funds raised in the blockchain industry worldwide amounted to USD92 billion in total and the number of deals closed totalled 461, with an average fundraising amount of USD20 million. In addition, the blockchain industry in China has seen very strong and repaid growth since 2018, and a boost from 2020 to 2021. According to a statistics report released on 8 July 2022 by the China Industrial Blockchain Conference, a review shows that the blockchain market realised sustainable growth in 2021 despite the COVID-19 pandemic – for instance, there are nearly 100,000 blockchain-based or related enterprises throughout the country, and the market size of the whole market in China hit RMB230 billion (approximately USD35.6 billion) at the end of 2021.

Blockchain is a neutral and promising technology that can be used in a wide range of industrial sectors or application scenarios such as finance, supply chain, copyright protection, food safety, logistics, IoT and social governance. However, speculators often induce masses of individual investors lacking in professional investment experience to purchase and trade tokens created in blockchain-based applications, and in many cases, blockchain success stories are fabricated to extract money from individuals by fraud, which has greatly impacted social stability and financial order in China. Against this background, the Chinese government has step by step taken increasingly tough legislative and administrative measures to crack down on fraudulent and criminal acts relating to tokens or virtual currency from 2013 to 2021. Under the latest central-government policies and regulations, the following activities are treated as "illegal financing activities" and thus forbidden:

- the offering of virtual currencies and related derivative transactions;
- trading of virtual currencies as a central dealer;

- exchange between different virtual currencies or between any virtual currency and fiat currencies;
- related information intermediary and pricing services; and
- providing cross-border services to Chinese residents on the internet by overseas exchanges of virtual currencies.

In the worst-case scenarios, violators could be sued for criminal acts if their activities fall squarely under the crimes of "illegal fund-raising from the public", "fund-raising by fraud", "organising and leading pyramid selling activities" and "illegal business operations", etc, and could face criminal charges. In September 2021, "mining" activities for the purpose of creating virtual currencies was added to the category of "not encouraged and restricted for expansion" in the nation's industry catalogue, and relevant financing activities in this area are strictly forbidden.

Nevertheless, China has rolled out an array of policies supporting the development of this industry since 2016, among which a notable one is Guiding Opinions Concerning the Acceleration of the Promotion of the Blockchain Technology Application and Industry Development promulgated by China's Ministry of Industry and Information Technology (MITT) and the Office of Central Cyberspace Affairs Commission in June 2021. Pursuant to this, China aims to take a world-leading role in the blockchain industry by 2025 and the application of blockchain is anticipated to spread in various industrial areas. Meanwhile, China has been active in bringing the blockchain application into the regulatory framework. In February 2019, a regulation was passed by the Cyberspace Administration of China (CAC) to require service providers of blockchain information to perform filing procedures and assume cybersecurity and other relevant responsibilities, thereby providing a monitoring platform to regulate the blockchain industry within China. According to public information available on the official website of CAC, as of 25 July 2022, a total of 2,159 enterprises had successfully completed the required filing procedures with CAC, among which, more than 800 are related to blockchain-based digital collectible projects.

In summary, the blockchain-related industry and its broad derivative applications (eg, metaverse, web 3.0 and NFT) will see great development in China thanks to China's strong information infrastructure, as long as the relevant market players do not step over the policy "red line" – that is, by making blockchain tokens a kind of tradable financial product, security or currency. Some market players operate an initial coin offering (ICO) or other related trading activity overseas but solicit customers and/or obtain technical, marketing and payment support from China, despite the fact that there may be a compliance risk associated with such practice model.

Compliance Concerns in Enterprises Founded by Researchers

Since 2015, laws and regulations have been passed to promote technological enterprises founded by researchers. Scientists and researchers employed by public universities or other state research institutions ("Researchers") are encouraged to take part-time work or start a business without quitting their original position. Start-ups founded by Researchers draw a great deal of attention from PE/VC investors and have received tens of millions through equity finance. However, there are also compliance concerns in the enterprises founded by Researchers, which call for special attention from PE/VC investors.

Generally speaking, Researchers are allowed to establish a company or take the position of director or be part-time employees in a start-up company. However, if such person holds a position that could be defined as leading cadres in the research institutions where they work, such person could be prohibited from taking a part-time job in the start-up company. Researchers also need to comply with the internal regulations of the research institutions where they hold a position. Additionally, for Researchers who are leading cadres in a university under the administration of the Ministry of Education, holding equity interests in a start-up is not allowed.

During the listing process, the China Securities Regulatory Commission (CSRC) and the relevant stock exchanges (together with the CSRC, the "Listing Examining Authorities"), may have additional concerns about applicants in which Researchers are founders or core technicians. The Listing Examining Authorities would review the independence of the business and the stability of its core technician teams. Under the review standards of the Listing Examining Authorities, Researchers who work in the listing applicants have no legal obstruction to providing services to the listing applicants, and a listing applicant needs to build a competent management team to ensure the sustainable running of its business and may not rely on specific Researchers. The Listing Examining Authorities also have concerns regarding the property rights of patents invented by Researchers. According to the patent law of China, an invention-creation by Researchers in the course of executing any task for their research institutions or mainly through taking advantage of the research institution's materials or technical resources will be deemed a service invention-creation, and the right to apply for a patent for this will be vested in research institutions other than the company where the Researcher works as a part-time employee or consultant. For patents that are invented by Researchers and owned by the listing applicants, Researchers need to prove that such patents are not the service invention of the research institutions and that the property rights to such patents are indisputable.

Strengthened Anti-monopoly Supervision of M&A of Internet Giants

The year 2021 was marked by intensive and strict law enforcement on internet platform economy giants in China. Since 2021, the State Administration for Market Regulation (SAMR) has publicised over 100 penalties on merger-related violations involving internet giants, including Tencent, Alibaba and Baidu, which shows a trend of strengthened anti-monopoly scrutiny of internet giants.

According to the Provisions of the State Council on the Threshold for the Reporting of Concentration of Business Operators (the "Reporting Threshold"), the anti-monopoly law enforcement agency may investigate transactions that are below the threshold for antitrust scrutiny but have or may have eliminated or restricted competition. The Guidelines for Anti-monopoly in the Field of Platform Economy (the "Antitrust Guidelines for Platform Economy") further defined the types of transactions to be reviewed, which include:

- one transacting party is a start-up business or an emerging platform;
- the relevant market is highly concentrated;
- there are few competitors; and
- the low turnover results from the free or low-price model of the relevant party.

These are construed to be prevention measures to the "killer acquisitions" of internet giants

which aim to discontinue or take over a target company's innovation projects, leading to undermined competition.

It is expressly stated in the Antitrust Guidelines for Platform Economy that a concentration of business operators involving agreement control (a VIE structure) falls within the scope of concentration declaration. This guideline has cleared the long-existing grey area for the concentration declaration of acquisitions by companies with VIE structures. In the penalty cases publicised by the SAMR after the Antitrust Guidelines for Platform Economy was published, penalties were imposed on transactions conducted by business operators with VIE structures that did not report their transactions to the anti-monopoly law enforcement authority. Cases also show that historical transactions might be investigated and penalised retroactively.

On 24 June 2022, the revised Anti-monopoly Law (the "New Anti-monopoly Law") was passed, with effect from 1 August 2022. Under the New Anti-monopoly Law, the upper limit of penalties for violations of the concentration declaration obligation further rises. The penalties increase to a fine of not more than RMB5 million if the concentration of undertakings does not have the effect of excluding or limiting competition, or a fine of up to 10% of the sales revenue of the violator in the preceding year, if the concentration of undertakings has or may have the effect of excluding or limiting competition.

Investors' Right to Termination and Recovery Clauses in a Financing Agreement

It has been a common practice in China's PE/VC deals that target companies require their investors to pre-agree the automatic termination of their special rights and privileges such as anti-dilution right, redemption right and liquidation preference right before the submission of an IPO filing or even at an earlier date, and to fix this termination mechanism in a financing agreement, typically in the shareholders' agreement. In reaction to said rights termination mechanism, investors normally require a rights recovery clause in the same agreement to achieve balance in this regard, stating that where the IPO application is rejected by the Listing Examining Authorities or withdrawn by the listing applicant, or where it fails to be accepted after a certain period of time, the terminated rights and privileges will automatically become effective again from that date.

Nevertheless, the answers to the following questions regarding rights termination and recovery mechanisms still need to be clarified based on recent practice.

When should investors' rights be terminated?

In most cases, certain special rights and privileges will terminate before the submission of an IPO application by the company. However, the recent trend is for the date of termination to become earlier than before. In some IPO cases, the redemption right or anti-dilution right against the company was terminated on the base date of share reform or the base date of the IPO application, because such rights require the company to perform payment obligations towards investors which could create contingent liabilities on the company and could have a substantial impact on the financial conditions of the company, depending on the situation. As for certain other rights and privileges of an investor that will not impose a cash payment obligation on the company, these can be terminated at a later date.

What kind of investors' rights should be terminated?

According to the official interpretation of the Listing Examining Authorities, regarding the widely-

used valuation adjustment mechanism required by investors and other arrangements of a similar nature, the listing applicants should clean these up before the IPO application, except where all the following tests are met:

- the listing applicant itself is not a party to the valuation adjustment mechanism;
- such arrangements would not lead to a change of control of the listing applicant;
- such arrangements are not linked with the market valuation of the listing applicant; and
- such arrangements would not seriously impact the listing applicant's sustainable operating capacity nor are there situations that would materially affect the (public) investors' rights and interest.

In most cases, it appears that the investors' rights and privileges that make the company (as opposed to the controlling shareholder) an obligator are terminated before the IPO application, including redemption right, liquidation preference right, drag-along right, anti-dilution right, dividend preference right, veto right and pre-emptive right, etc.

Whether the rights recovery clause is allowed to exist

The Listing Examining Authorities used to allow the existence of a rights recovery clause in history, however, many recent cases show that Listing Examining Authorities tend to require the termination or amendment of such rights recovery clause to the extent that the recovered rights and privileges relate to an applicant's obligations of payment or certain other duties or could adversely impact the valuation of the listing applicant. The trend appears to be for the Listing Examining Authorities to take a more rigorous view in this regard, and the chance to set or entirely keep such rights recovery clause after the IPO application is very limited, even if the relevant obligator is the controlling shareholder rather than the listing applicant itself.

Potential Impact on Deal Terms Brought by Uncertainty in Investment Exits

The recent dramatic decrease of share prices of Chinese companies listed on US and Hong Kong stock exchanges has had a significant impact on both Chinese listed companies and those Chinese companies seeking to be listed offshore. With concerns over IPO exits, it is probable that investors will seek to secure more diversified exits in future, and may attach equal importance to alternative exit mechanisms as to IPOs. This may lead to more intense negotiations of deal terms between investors and target companies and their founders in PE/VC transactions.

Redemption right

A redemption right clause is a common deal term in PE/VC investments. Given the uncertainty in IPO exits, it appears that investors may seek to secure more triggering events for their redemption right and enforce such right more strictly so as to achieve pre-IPO exits. This will lead to stricter obligations on the target companies. For example, investors may seek to exercise their redemption right immediately after a target company fails to achieve a qualified IPO.

Trade sale

To achieve pre-IPO exits, investors may attach more attention and importance to a trade sale. A trade sale is the sale of all or substantially all shares of a target company which will lead to a change of control in the company. Investors may seek to specify the failure of the company and its founders to complete a trade sale as a triggering event for investors' redemption rights, although the trade sale is generally not considered as correlated to, and thus not a triggering

event for, investors' redemption rights. Previously, investors generally only required the founders not to sell the company at a price lower than a certain valuation. In recent deals, however, aggressive investors have required the company and its other shareholders to agree to the trade sale if the company valuation reaches a certain amount, essentially securing a pre-emptive right to initiate the trade sale themselves.

Investors' right to transfer shares

Investors are generally allowed to sell their shares freely, subject to very few exceptions (eg, transfer to the company's competitors not permitted). This common practice may be changed by investors out of concern over a successful IPO. Investors may seek more flexibility in selling their shares to third parties. For example, investors may limit the scope of the company's competitors to which they are not permitted to transfer shares, or even secure a right to transfer their shares to the company's competitors. In addition, investors may further require the company and its founders to repurchase their shares on equal terms and conditions if their transfer of shares to third parties cannot be successfully completed within a certain period.

Investors' option to make subsequent investments

It is not uncommon for investors to seek a right to make follow-on investments in the same company. The main underlying rationale is that investors are optimistic about the company's future and are thus interested in increasing their investments in the future. Simply put, investors may seek to make investments in instalments, making their first instalment while opting to make future instalments and locking the company's valuation for a certain period. This is generally not aligned with the company's need for capital. Therefore, both the company and investors may reach a compromise by imposing restrictions on investors' exercise of such option (eg, shortening the period for investors' exercise of the option or setting a higher company valuation for the investors' option).

Economic interest-related clauses

Future investors may also seek to lower the company's valuation to reduce their investment cost and increase their return on investment. For example, investors may seek to secure a higher hurdle rate of return on investment by negotiating such clauses as preferential dividend rights, redemption rights and liquidation preference. In addition, in the case of "down-round" financing (ie, subsequent financing at a lower valuation than previous rounds of financing) where anti-dilution issues will be brought by investors, the "full ratchet" mechanism is expected to be used more frequently in future, as opposed to the "weighted average" mechanism which has commonly been used previously.

Corporate governance

With regulatory and compliance law enforcement being increasingly intensified (eg, antitrust, data privacy and security), investors may seek more involvement in the company's corporate governance in future. To this end, investors may seek to expand their veto rights while restricting the founders' decision power (in particular, over matters involving company spending such as annual budget, expenditures and major transactions, etc). In addition, investors may also secure a more detailed information right and inspection right in order to enhance their post-investment management.

Global Law Office (GLO) dates back to 1979, when it became the first law firm in the People's Republic of China (PRC) to have an international perspective, fully embracing the outside world. With more than 500 lawyers practising in its Beijing, Shanghai, Shenzhen and Chengdu offices, GLO is today known as a leading Chinese law firm and continues to set the pace as one of the PRC's most innovative and progressive legal practitioners, including in the private equity and venture capital sector. Not only does it have vast experience in representing investors, but it has also extensively represented financing enterprises and founders. With a deep understanding of the best legal practices and development trends of each investment term, the team at GLO knows how to find the most effective balance of interests in terms of negotiation so as to realise all-win results. Vast practical experience and industrial background knowledge enable GLO to enhance value in every process of the client investment cycle.

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