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The comprehensive implementation of the registration-based system of IPO regulation in China: practice, progress, problems and prospects

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ABSTRACT

In June 2019, the Shanghai Stock Exchange Sci-tech Innovation Board was established with the deployment of the registration-based system as a pilot test, opening the chapter of China's initial public offering regulatory reform. Implemented for nearly four years under gradualism, the registration-based system was expanded to the whole Chinese stock market in February 2023, further catching the spotlight on its functioning and effectiveness in accommodating issuers while safeguarding investors to promote market development. This article conducts a close examination of the registration-based system, exploring its functioning in practice, canvassing its progress and problems in accommodating issuers and looking into the landscape and prospects of investor protection. This article argues that although the registration-based system does not eliminate regulatory uncertainty, it improves regulatory efficiency to attract issuers while relying on the close engagement of public regulators in the transition era and supporting mechanisms in the long run to ensure investor protection.

KEYWORDS

Registration-based system; merit-based system; regulatory efficiency; regulatory certainty; investor protection

I. Introduction

Initial public offerings (IPOs) provide an important route for companies to raise capital. The process by which companies solicit investment in their shares is a key concern of securities regulation.¹ In the main, there are two models of IPO regulation, namely, the disclosure-based system and the merit-based system. The former is adopted by many developed economies, e.g. the US² and Hong Kong,³ in which regulators do not make substantial examinations or value judgment on proposed IPOs but focus on whether

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¹Robin Hui Huang, 'The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis' (2011) 41 Hong Kong Law Journal 261, 261.

²Securities Act of 1933 ss 7 and 10 (US).

³Companies Ordinance (Cap 32) s 38 (HK).

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information is appropriately disclosed on the issuer side to determine market entry. By comparison, China employed the merit-based system in the past two decades before its recent IPO regulatory reform, which conducted substantial examinations and value judgment on proposed IPOs for quality control, apart from the adoption of disclosure-based rules akin to those used in many developed economies.

Since its birth around the Millennium, the merit-based system has served several thousand Chinese IPOs and has promoted China's stock market development. However, this system born regulatory inefficiency and uncertainty, causing a long IPO queue. Given that many Chinese issuers are nowadays backed by private equity funds⁴ which often use their investees' IPOs as an exit route for investment returns,⁵ the regulatory uncertainty and inefficiency under the merit-based system may have thus set considerable barriers for the Chinese stock market to accommodate issuers. This is the background against which moves by Chinese authorities to implement the registration-based system to respond to and shape market development are to be considered.

Under the registration-based system, regulators focus mainly on the quality of information disclosure to decide market entry. Meanwhile, regulators retain the power to conduct occasional substantial examinations but do not make value judgment. Due to its disclosure-centred nature, the registration-based system is regarded as the Chinese version of the disclosure-based system.⁶ Yet, given China's state control over the market, the political economy decides that the registration-based system may be fundamentally different from its global counterpart. Thus, whether the registration-based system can ensure regulatory certainty and efficiency to attract issuers is a source of concern. Moreover, considering that the Chinese stock market still has numerous unsophisticated retail investors – a situation not substantially different from what it was before the reform –, the removal of value judgment in IPO regulation poses a question about how to ensure investor protection under the registration-based system, compared to the merit-based system that has been replaced.

This article examines the merits and problems of the registration-based system in accommodating issuers and explores the landscape of investor protection both in the transition era and in the long run. The remainder of this article proceeds as follows: Section II looks into the global and local context of implementing the registration-based system. Section III discusses the strengths and drawbacks of the merit-based system to provide a basis for comparative legal analysis. Section IV canvasses the progress and problems of the registration-based system in accommodating issuers against the backdrop of China's political economy. Section V explores the landscape and prospects of investor protection under the IPO regulatory reform. The final section concludes.

⁴Lin Lin, 'Private Equity Limited Partnerships in China: A Critical Evaluation of Active Limited Partners' (2013) 13 *Journal of Corporate Law Studies* 185, 192.

⁵Michael Brennan and Julian Franks, 'Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the UK' (1997) 45 *Journal of Financial Economics* 391, 408.

⁶See, e.g. Samuel Shen and others, 'China Expands IPO Reform to Help Companies Raise Capital' (*Reuters*, 1 February 2023) <www.reuters.com/world/china/china-expand-registration-based-ipo-system-2023-02-01/>. Unless otherwise stated, all URLs in this article were last accessed on 11 April 2023.

Table 1. The evolution of the IPO regulatory framework in China.

	Regulatory system	Ancillary mechanism
1990–1999	Quota	–
1999–2004	Merit-based	Channel & Recommendation
2004–2019	Merit-based	Sponsorship
2019–2023	Hybrid: Merit-based / Registration-based	Sponsorship
2023–Now	Registration-based	Sponsorship

Note: The Table is drawn by the authors.

II. The context of implementing the registration-based system

The Chinese stock market has a short history of 30 years but has achieved profound success with both the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) joining the global top ten in terms of market capitalization, annually raised funds and trading volume.⁷ In accordance with the step-by-step market development, the Chinese IPO regulatory framework has evolved over time, initially using the quota system (1990–1999) and then the merit-based system (1999–2023) to determine market entry (see Table 1).⁸ In June 2019, the Shanghai Stock Exchange Sci-tech Innovation Board (SSE STAR Board) was established with the deployment of the registration-based system as a pilot test, opening the chapter of China's new round of IPO regulatory reform.⁹ This was followed by the introduction of the registration-based system on the SZSE ChiNext Board in June 2020¹⁰ and on the Beijing Stock Exchange in September 2021.¹¹ Most recently, in February 2023, the use of the registration-based system was expanded to the SSE and SZSE Main Boards, marking the comprehensive implementation of the registration-based system.¹² This section examines the context of implementing the registration-based system to provide a ground in which the doctrinal and comparative legal analyses of this article can be anchored.

A. A global context: disclosure-based system v merit-based system

A strong stock market must be based on its attractiveness to both issuers and investors.¹³ It means that accommodating issuers and safeguarding investors are crucial goals of IPO regulation. In global stock markets, the IPO regulatory systems, in the main, contain two models, i.e. disclosure-based system and merit-based system. Under the disclosure-based system, regulators focus on whether issuers have duly disclosed information to decide

⁷At the end of 2017, the SSE was ranked the 4th in market capitalization, the 3rd in annually raised funds, and the 4th in annual trading volume; whilst for the SZSE, the corresponding rankings were the 8th, the 2nd, and the 3rd. Source: WFE Stock Market Ranking (2017).

⁸For a discussion of the quota system, see Leyin Zhang, 'The Roles of Corporatization and Stock Market Listing in Reforming China's State Industry' (2004) 32 World Development 2031.

⁹Measures for the Administration of the Registration of Initial Public Offerings on the Sci-tech Innovation Board (for Trial Implementation) 2020 (科创板首次公开发行股票注册管理办法(试行) 2020).

¹⁰Measures for the Administration of the Registration of Initial Public Offerings on the ChiNext Board (for Trial Implementation) 2020 (创业板首次公开发行股票注册管理办法(试行) 2020).

¹¹Measures for the Administration of the Registration of Initial Public Offerings on the Beijing Stock Exchange to Unspecific Qualified Investors (for Trial Implementation) 2021 (北京证券交易所向不特定合格投资者公开发行股票注册管理办法(试行) 2021).

¹²Measures for the Administration of the Registration of Initial Public Offerings 2023 (首次公开发行股票注册管理办法 2023) (Measures for Registration-based IPOs 2023).

¹³Rafael La Porta and others, 'Investor Protection and Corporate Valuation' (2002) 57 The Journal of Finance 1147, 1147.

market entry. By placing the responsibility for appropriate disclosure on the issuer side, this system aims to provide the market with timely and complete information so as to ensure that investors have the opportunity to make informed decisions.¹⁴ Moreover, regulators do not conduct substantial examinations of the authenticity of the disclosed information, and as such, the saved time cost is conducive to regulatory efficiency. Also, regulators do not make value judgment on the proposed IPOs but leave investors to appraise the value. The philosophy behind this arrangement is that in a well-developed market, regulators are unlikely to outperform the market in assessing the value of financial products.¹⁵ From the perspective of issuers, complying with the information disclosure requirements generally means that they can get an IPO clearance, and thus, the disclosure-based system is beneficial to regulatory certainty.

However, the disclosure-based system may not work well when investors do not rationally interpret and use the disclosed information. For one thing, there is a problem of information asymmetry. Investors' understanding of the disclosed documents depends largely on their investment experience and financial expertise.¹⁶ Therefore, notwithstanding due disclosure, certain financial documents may be too complicated for retail investors to understand and then make informed decisions. For another, behavioural economics reveals that people do not always act rationally. In the context of stock markets, it means that investors may not rely on the disclosed information to make rational decisions.¹⁷ As due information disclosure does not necessarily lead to risk awareness for investors, doubts have been cast on the effectiveness of the disclosure-based system in ensuring investor protection.¹⁸

Compared to the disclosure-based system, the merit-based system relies on regulators' substantial examinations to check the authenticity of the disclosed information and value judgment on the proposed IPOs to decide market entry, apart from the use of disclosure-based rules. Such an arrangement is a double-edged sword. On the one hand, compared to retail investors, public regulators are more professional and experienced in identifying and avoiding investment risks,¹⁹ and thus, their close engagement in terms of substantial examinations and value judgment is beneficial to investor protection. On the other hand, substantial examinations are time-consuming while value judgment is subjective to the detriment of regulatory efficiency and certainty respectively, which may thus push certain issuers to seek cross-border listings elsewhere.

From the discussion above, it could be seen that the disclosure-based system and merit-based system both have pros and cons, and thus, there is no one-size-fits-all model. In conducting securities regulation to accommodate issuers and protect investors, jurisdictions differ in their approach, due largely to the lack of homogeneity in market situation, legal infrastructure and regulatory custom.²⁰ The following subsection will

¹⁴Huang (n 1) 274.

¹⁵Marianne M Jennings, 'The Efficacy of Merit Review of Common Stock Offerings: Do Regulators Know More than the Market?' (1992) 7 *BYU Journal of Public Law* 211, 240–42.

¹⁶Huang (n 1) 275.

¹⁷John R Nofsinger, *The Psychology of Investing* (5th edn, Routledge, 2016) Ch 1 and Ch 5.

¹⁸Huang (n 1) 274.

¹⁹*Ibid*, 279.

²⁰Kathryn Carns and Eilis Ferran, 'Non-Enforcement Led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors' (2008) 8 *Journal of Corporate Law Studies* 191, 193.

canvass China's market situation to further decipher the context of implementing the registration-based system.

B. A Chinese context: the special features of Chinese issuers and investors

To interpret China's IPO regulation and assess its strengths and weaknesses in accommodating issuers and safeguarding investors to promote stock market development, a good departure point is to understand the special features of Chinese issuers and investors. Broadly speaking, along with the rapid development of China's private equity industry from the 2000s, many Chinese issuers have raised a large amount of capital from private equity funds before going public,²¹ a crucial feature with multifaceted influence. First, through injecting huge capital into issuers in exchange for equity ownership, private equity funds may have obtained a significant say on choosing the listing venue, which may ask their investees to go public in a stock market where they trust the IPO regulation. Secondly, as is often the case, private equity funds may have used a valuation adjustment agreement to require their investees to float within a given period agreed in the investment agreement.²² As such, for the investees, the listing time cost is a vital determinant in choosing the listing venue.

On the investor side, as opposed to many developed stock markets that are dominated by professional and institutional investors through which retail customers invest in the stock markets indirectly via fund products, the main investor base of the Chinese stock market is retail investors. As of 31 December 2020, the SSE and SZSE had 263.59 and 246.53 million retail investors, compared to 0.80 and 0.63 million institutional investors respectively.²³ The special characteristics of Chinese issuers and the prevalence of retail investors have inevitably shaped Chinese regulatory thinking in ways that are different from their counterparts elsewhere.

Moreover, China's situation is unique in its socialist market economy of global size that does not exist anywhere else, in which the strong state control via various administrative measures considerably shapes stock market development. Thus, China's IPO regulatory reform of implementing the registration-based system in lieu of the merit-based system must be put into broader political economies for consideration. The following section will examine the strengths and drawbacks of the merit-based system in accommodating issuers and safeguarding investors to provide a basis of comparative legal analysis for assessing the progress and problems of the registration-based system.

²¹Lin (n 4) 192.

²²Besides the two facets discussed in the text, for Chinese issuers, pre-IPO equity financing may have largely diluted corporate founders' shareholding, and thus, founders may intend to use a dual-class share structure (DCSS) to maintain control. Moreover, to raise foreign capital, Chinese issuers may have used a variable interest entity (VIE) structure to 'satisfy' China's regulation of foreign investment. The Chinese stock market regulatory and policy changes responding to the market needs for using the DCSS and/or VIE structure are beyond the scope of this article. For a discussion of introducing the DCSS in China, see Fa Chen, 'Does the Dual-Class Share Structure Help Stock Markets Attract Issuers? Empirical Lessons from Global Financial Centres' (2023) 43 *Legal Studies* 159. For a discussion of the Chinese VIE structure, see Fa Chen, 'Variable Interest Entity Structures in China: Are Legal Uncertainties and Risks to Foreign Investors Part of China's Regulatory Policy?' (2021) 29 *Asia Pacific Law Review* 1.

²³See Shanghai Stock Exchange Statistics Annual 2021, 691 <www.sse.com.cn/aboutus/publication/yearly/documents/c/5641852.pdf>; Shenzhen Stock Exchange Fact Book 2020, 679 <<http://docs.static.szse.cn/www/market/periodical/year/W020221226388078413293.pdf>>.

III. The merit-based system as the predecessor: functioning, strengths and drawbacks

The merit-based system of IPO regulation was introduced in China in 1999 upon the promulgation of the then *Securities Law of China (SLC)*.²⁴ Afterwards, Chinese authorities transplanted the sponsorship mechanism from Hong Kong in 2004 to smooth the operation of the merit-based system.²⁵ Under the sponsorship mechanism that remains in force, IPOs cannot be staged without a sponsor, typically an investment bank licensed by the China Securities Regulatory Commission (CSRC). The sponsor is obliged to confirm to the CSRC that key persons of the issuer, e.g. the controlling shareholder(s) and directors, have received satisfactory guidance on compliance obligations and information has been disclosed on an authentic, accurate and complete basis.²⁶ As such, the CSRC has actually distributed some of its gatekeeping functions to sponsors.²⁷ Reliance on market-oriented private gatekeepers is based on an expectation that sponsors will perform gatekeeping duties prudently and be unwilling to collude in fraudulent offerings to jeopardize their 'reputational capital'.²⁸

Apart from the reliance on sponsors' gatekeeping functions, Chinese authorities also used market entry regulation for investor protection. According to the CSRC's ministerial regulation,²⁹ a qualified issuer must be a joint-stock company (equivalent to a public company limited by shares under English law) with an incorporation history of at least three years,³⁰ full payment of registered capital,³¹ stability of core business and management,³² sound financial status and continuous profitability,³³ no major disputes in core assets³⁴ and equity ownership,³⁵ executive qualification³⁶ and compliance records.³⁷ In addition, issuers were bound to many information disclosure rules that were comparable to the counterparts found in developed stock markets.³⁸ For example, the CSRC required issuers to disclose 'all information that may generate substantial influence on investment decisions',³⁹ which corresponded to the materiality test established in the *TSC Industries Inc v Northway Inc* case in the US.⁴⁰ Moreover, issuers were subject to general corporate

²⁴The ministerial regulation issued by the CSRC in 2000, i.e. the Approval Procedure of the China Securities Regulatory Committee on Stock Issuance (中国证监会股票发行核准程序), stipulated detailed rules regarding the implementation of the merit-based system. Thus, although proposed in 1999, the merit-based system was not formally implemented until 2001.

²⁵Jiangyu Wang, 'Regulation of Initial Public Offering of Shares in China' (2009) 1 China Law 56, 60.

²⁶Measures for the Administration of Securities Issuance and Listing Sponsorship 2023 (证券发行上市保荐业务管理办法 2023) Ch 3 (stipulating sponsors' duties).

²⁷Huang (n 1) 280.

²⁸John C Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press, 2006) 4.

²⁹Measures for the Administration of Initial Public Offering and Listing of Stocks 2022 (首次公开发行股票并上市管理办法 2022) (Measures for IPO 2022, expired in 2023) did not apply to issuers seeking to conduct stock offering and listing on the STAR/ChiNext Board under the registration-based system.

³⁰*Ibid*, Arts 8–9.

³¹*Ibid*, Art 10.

³²*Ibid*, Art 12.

³³*Ibid*, Art 26.

³⁴*Ibid*, Art 10.

³⁵*Ibid*, Art 13.

³⁶*Ibid*, Art 16.

³⁷*Ibid*, Art 18.

³⁸Huang (n 1) 267.

³⁹Measures for IPO 2022 (n 29) Art 41.

⁴⁰426 US 438 (1976), 449 (stating '[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote').

governance requirements⁴¹ and the prohibition of market misconduct like illegal guarantees for controlling shareholders.⁴² As such, the market entry requirements could help pick out issuers of relatively good quality as a means of quality control for investor protection.

Satisfying the aforesaid qualification and disclosure requirements was only the starting point; if issuers were actually to achieve stock issuance under the merit-based system, they must pass the CSRC's merit test. Otherwise, involved issuers could not submit listing applications to the stock exchanges to proceed with their listing process, even though the listing review was a formality in reality.

A. The regulator's substantial examinations: for investor protection but with regulatory inefficiency to issuers

The merit test had a twofold meaning: first, the CSRC's departmental arm, i.e. the Securities Issuance Review Committee, conducted substantial examinations to check the authenticity, accuracy and completeness of the disclosed information, and secondly, the CSRC made value judgment on the quality of proposed stocks to decide market entry.⁴³

As for substantial examinations, Chinese authorities did not make detailed stipulations regarding the procedure and content. In the Chinese legal context, it means that the CSRC could adopt measures essential to check the quality of information disclosure. In practice, in playing its gatekeeping role, the CSRC put a lot of effort into examining the issuers' financial materials and often conducted on-site investigations to find and defeat financial fraud.

The adoption of substantial examinations in IPO regulation was decided largely by the local situation of the Chinese stock market. For one thing, the vast majority of public investors were retail investors without adequate investment expertise and risk-bearing capacity. For another, the Chinese stock market lacked sufficient private gatekeepers who could perform the necessary gatekeeping functions with adequate professionalism.⁴⁴ Besides, the long-lasting state control over the market has caused the lack of third-party supervision, e.g. the Muddy Waters Research, as a market force to combat market misconduct. On these grounds, the CSRC had to play a vital role in counteracting disclosure failure while generating deterrence to discipline potential misconduct to ensure market integrity.

Since its birth around the Millennium, the merit-based system has served the state regulation of several thousand Chinese IPOs. However, the substantial examinations were not subject to a time limit, which considerably accounted for the fact that the CSRC's review process bore regulatory inefficiency. Moreover, with the rapid development of China's economy, domestic companies' public fundraising needs have been booming. Yet, the personnel resources of the CSRC have not kept pace to match the ever-expanding workload of reviewing IPO applications.⁴⁵ As a result, Chinese issuers had to wait in a long queue for their IPO applications to be reviewed, making domestic flotation time-

⁴¹Measures for IPO 2022 (n 29) Arts 14 and 17.

⁴²Ibid, Arts 19–20.

⁴³Wang (n 25) 57.

⁴⁴Huang (n 1) 280–81.

⁴⁵Wang (n 25) 65.

consuming. For example, in 2016, 265 Chinese companies obtained an issuance clearance from the CSRC, and the average time cost of achieving flotation on the SSE/SZSE Main Board, SZSE SME Board and SZSE ChiNext Board was 887, 915 and 798 days respectively.⁴⁶ Of these, the fastest case took 224 days, while the slowest was 56 months.⁴⁷ In comparison, the time needed for completing the stock offering and listing process in the US is relatively short. Take the US IPO of Didi, a Chinese issuer in the ride-hailing industry, for example: it took Didi only 20 days from submitting its IPO application to the US Securities and Exchange Commission (SEC) to achieving listing on the NYSE.⁴⁸

Undoubtedly, under the merit-based system, the time cost of going public in the Chinese stock market was unfavourable to issuers, especially in the event of existing a valuation adjustment agreement in pre-IPO equity financing, which often required the involved companies to achieve listing within a prescribed time.⁴⁹ Moreover, owing to the vast research and development expenses, certain companies with thirsty fundraising needs may have been discouraged by the huge time cost from going public domestically. Thus, the regulatory inefficiency arising from the CSRC's substantial examinations called for legal reforms to accommodate issuers' needs.

B. The regulator's value judgment: for investor protection but with regulatory uncertainty to issuers

Even though the CSRC's substantial examinations could help ensure the quality of information disclosure, this does not necessarily mean that the examinations could guarantee the dissemination of relevant information to improve the stock market efficacy. Instead, due to information asymmetry, the risk profiles might be too complicated for unsophisticated retail investors to understand. Moreover, behavioural economics reveals that investors may not rely on the disclosed information to make rational investment decisions.⁵⁰ The economic analysis of the law provides a basis for justifying the fact that under the merit-based system, apart from conducting substantial examinations, the CSRC also made value judgment on the proposed IPOs to determine market entry.

In making value judgment, the CSRC considered issuers' financial performance as well as their business prospects.⁵¹ That is to say, according to the CSRC's judgment, only issuers that were worthy of investment could be admitted to market entry. Such a gate-keeping mechanism could be justified on the ground that compared to retail investors, the CSRC was more professional and experienced in identifying and avoiding investment risks.⁵² In this way, the value judgment could filter out potential issuers without (good) investment value to safeguard retail investors.

⁴⁶See Sohu Finance, 'How Long Does the IPO Queue Take at Present? Big Data Tells You ...' (现在 IPO 排队多久能上市? 大数据告诉你 ...) <www.sohu.com/a/130843842_649910>.

⁴⁷Ibid.

⁴⁸See Didi's F-1 Form filed on 10 June 2021 and Prospectus filed on 30 June 2021 on the SEC, <www.sec.gov/edgar/browse/?CIK=1764757&owner=exclude>.

⁴⁹Pre-IPO investors are often keen to exit on a timely basis, which enables them to raise future rounds of capital, see Andriy Bodnaruk and others, 'Shareholder Diversification and the Decision to Go Public' (2008) 21 The Review of Financial Studies 2779, 2782.

⁵⁰Nofsinger (n 17) Ch 1 and Ch 5.

⁵¹Measures for IPO 2022 (n 29) Art 30.

⁵²Huang (n 1) 279.

Notwithstanding its strengths, the CSRC's value judgment was not free from problems. First, the CSRC's value judgment may make investors mistakenly believe that the approved IPOs had been endorsed by the CSRC to guarantee investment returns.⁵³ This situation further poses a question about whether the CSRC should bear liabilities for failed value judgment and/or substantial examinations.⁵⁴ In practice, it was not rare for listed issuers to be found to have had conducted fraudulent activities in their IPOs, resulting in a sharp drop in share price to the detriment of investors' economic interests. Yet, the CSRC claimed no liabilities, causing inconsistency between its power and duty.

More controversial was the issue of regulatory uncertainty arising from the CSRC's value judgment. Chinese policymakers did not stipulate detailed criteria or processes regarding value judgment. Hence, for issuers meeting the market entry requirements, the CSRC had broad discretionary power to veto their IPO applications. As a result, certain issuers with the capacity to conduct jurisdiction shopping may be discouraged by the regulatory uncertainty from going public domestically.

The issue of lacking regulatory certainty was even worse when considered in the context of the state over the market. The CSRC is the central regulator of China's securities industry, which is also responsible for preventing financial distress and ensuring an orderly inflow of investment as a state planner.⁵⁵ That is to say, under the merit-based system, the CSRC undertook dual roles as both the institutional embodiment of the state plan for approving the scope of issuers and the central regulator. As such, the CSRC's all-encompassing role with competing duties prompted public concerns about its regulatory integrity.

In practice, the CSRC controlled the pace of stock offerings according to the market situation, which was deciphered as 'unwarranted market manipulation of a major nature'.⁵⁶ For example, against the steep drop in the share price of listed companies in July 1994, the CSRC responded by temporarily suspending to approve IPO applications, thereby leveraging the Chinese stock market index by 122 per cent within a week.⁵⁷ Also, it was an open secret that the CSRC prioritized SOE financing.⁵⁸ Occasionally, it was even a political task for the CSRC to prioritize SOE IPOs at the cost of other issuers' interests.⁵⁹ For instance, in 2010, the CSRC suspended all other IPOs for one week to give way to the flotation of the Agricultural Bank of China, one of China's big four state-owned banks.⁶⁰

Based on the discussion above, it could be seen that the use of the merit-based system in the past two decades was decided largely by the local situation of the Chinese stock market, which was a double-edged sword. Although the CSRC's substantial examinations and value judgment could enhance the quality of information

⁵³Ibid, 268.

⁵⁴Ibid.

⁵⁵Rasoul H Tondkar, Songlan Peng and Christopher Hodgdon, 'The Chinese Securities Regulatory Commission and the Regulation of Capital Markets in China' (2003) 16 *Advances in International Accounting* 153, 160.

⁵⁶Sophie Roell, 'Reining in the Free Market' (1996) 327 *Euromoney* 146, 148.

⁵⁷Xianghai Ma, 'Capital Controls, Market Segmentation and Stock Prices: Evidence from the Chinese Stock Market' (1996) 4 *Pacific-Basin Finance Journal* 219, 237.

⁵⁸Huang (n 1) 269.

⁵⁹Ibid, 270.

⁶⁰See Jianzhong Yin, 'One-Week Suspension of IPO Application is Just to Give Way to the IPO of Agriculture Bank of China' (*Shanghai Securities News*, 11 July 2010) <<http://big5.ifeng.com/gate/big5/finance.ifeng.com/ip0/xgpl/20100711/2394996.shtml>> last accessed 27 September 2021.

disclosure and help pick out issuers of relatively good quality to benefit investor protection, the other side of the coin was that the merit-based system bore regulatory uncertainty and inefficiency, which undermined the attractiveness of domestic flotation to Chinese issuers. As the Chinese stock market develops with ever-increasing IPO applications and maturing private gatekeepers, the merit-based system has become anachronistic, thus triggering the implementation of the registration-based system as the substitute.

IV. The registration-based system as the substitute: mechanics, progress and problems in accommodating issuers

As the Chinese stock market has largely unified the rules of implementing the registration-based system, this section mainly examines the functioning of the registration-based system on the SSE to roughly represent the whole picture. Besides, given that the Chinese stock market reforms have been conducted to make the Chinese bourses more capable of competing with their US rivals in accommodating Chinese issuers, some facets of the US disclosure-based system will be examined to enrich comparative analyses.

A. The mechanics of the registration-based system

As the starting point, the registration-based system requires issuers to satisfy various restrictions that are similar to their counterparts under the merit-based system.⁶¹ It means that implementing the registration-based system does not erode the market entry requirements. Moreover, under the registration-based system, issuers seeking to go public need to pass a two-step test, i.e. the stock exchanges' stock offering and listing review, followed by the CSRC's registration process for final decision.⁶²

1. The stock exchanges' offering and listing review

Upon the modification of the *SLC* in 2005, the authority of stock listing review was transferred from the CSRC to the national stock exchanges. The implementation of the registration-based system has rendered the stock exchanges to further take over the regulatory responsibility of stock offering review that had been spun off from the CSRC, thus integrating stock offering review and stock listing review into a single process.⁶³ Such reallocation of regulatory power differs the registration-based system from the US disclosure-based system, in which stock offering regulation is mainly exercised by the SEC while stock exchanges are responsible for listing review (see [Figure 1](#)).⁶⁴

⁶¹Measures for Registration-based IPOs 2023 (n 12) Arts 10–13.

⁶²Ibid, Arts 5, 16 and 20.

⁶³So far, Chinese authorities have not officially announced the integration of these two review processes. Yet, in many governmental documents, the stock exchange review process is termed 'stock offering and listing review'. Also, in practice, stock offering review and listing review are conducted concurrently by the same arm of stock exchanges, see Measures for Registration-based IPOs 2023 (n 12) Art 19.

⁶⁴Under the US framework for securities regulation, securities offerings are sometimes subject to the regulation at the state level as well. However, the exercise of regulatory power by state authorities is not within the research scope of this article.

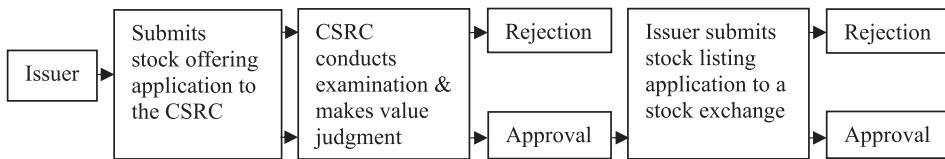
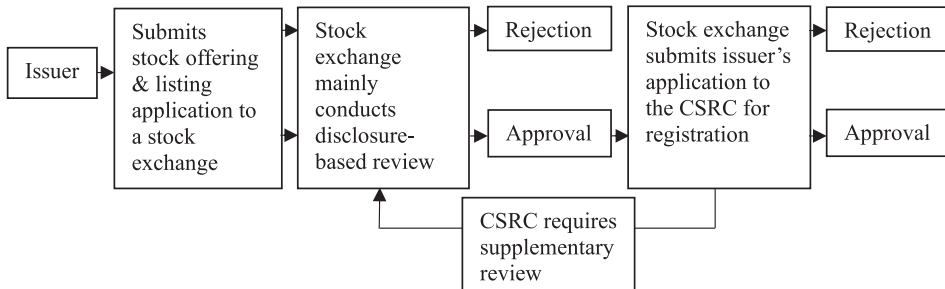
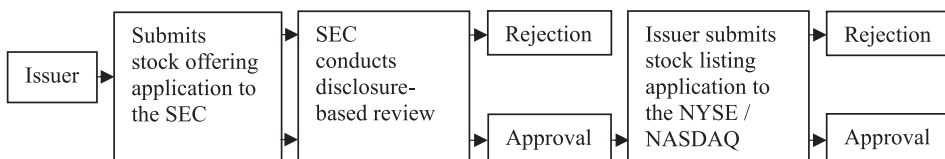
Merit-based system (China)*Registration-based system (China)**Disclosure-based system (US)*

Figure 1. The functioning of the IPO regulatory systems.

In light of the registration-based system, companies seeking to go public need to submit, via a licensed sponsor, an application for stock offering and listing to a Chinese bourse,⁶⁵ jointly with supporting materials, such as Sponsor Letters for Issuance, Audit Report and Legal Opinion.⁶⁶ Upon receiving the application, the involved stock exchange should decide within five working days whether to accept the application for review.⁶⁷ Once the application is launched, both the issuer and involved private gatekeepers will be responsible for the information and documents they have issued.⁶⁸ Meanwhile, the involved stock exchange's Stock Offering and Listing Review Department will review the disclosed information to decide whether the issuer has satisfied the conditions of stock offering and listing and communicate with the issuer via a few rounds of regulatory conversation to ensure that all essential information has been duly disclosed.⁶⁹ Such an approach is not substantially different from its

⁶⁵Measures for Registration-Based IPOs 2023 (n 12) Art 16.

⁶⁶Rules of the Shanghai Stock Exchange on Reviewing Stock Offering and Listing 2023 (上海证券交易所股票发行上市审核规则 2023) (SSE Reviewing Rules 2023) Art 12.

⁶⁷Measures for Registration-Based IPOs 2023 (n 12) Art 16; SSE Reviewing Rules 2023 (n 66) Art 13.

⁶⁸Measures for Registration-Based IPOs 2023 (n 12) Art 17; SSE Reviewing Rules 2023 (n 66) Art 15.

⁶⁹Measures for Registration-Based IPOs 2023 (n 12) Art 19; SSE Reviewing Rules 2023 (n 66) Arts 5–6 and 29–34.

counterpart used by the SEC under the disclosure-based system, which is mainly a 'written conversation' with issuers concerning the content and quality of information disclosure.⁷⁰

Under the registration-based system, the stock offering and listing review process is meant to rely on information disclosure, another aspect similar to the practice of the US disclosure-based system. This is out of the consideration that as investors are absent in the review process, the regulators are responsible for ensuring that investors can access essential information to make informed decisions. However, the registration-based system also contains some merit elements. For one thing, the Chinese stock exchanges will conduct on-site examinations if they find crucial issues for which the issuer and sponsor have given no reasonable explanation.⁷¹ For another, as a routine, the Chinese stock exchanges select some issuers at random to check the authenticity of the disclosed information through on-site examinations.⁷² Implications of this regulatory feature will be considered later.

After completing the review process, the stock exchange will announce either the approval of the application or the termination of the review which is another expression of rejection.⁷³ If the former, the stock exchange will forward the issuer's application materials, together with the exchange's review opinion and the documents produced in the review process, to the CSRC which will conduct the second-step registration process for final decision.⁷⁴

2. The CSRC's registration process

The CSRC's registration process is not a repeat of the stock exchange review. Instead, the CSRC supervises the stock exchange's first-step stock offering and listing review, focusing on whether anything has been missing in the stock exchange's review process, whether the issuer has met the key conditions of stock offering and listing, and whether information disclosure has met the pre-set process.⁷⁵ If the CSRC is concerned about the disclosed information, it can require the stock exchange to resume the exchange-issuer regulatory conversation⁷⁶ or even instruct the stock exchange to conduct a supplementary review.⁷⁷ Also, the CSRC can exercise on-site examinations itself or require the sponsor or other involved private gatekeepers to do so to check the quality of information disclosure.⁷⁸ That is to say, other than the stock exchanges, the CSRC also retains the power to conduct substantial examinations, which is different from the SEC's authority under the disclosure-based system.⁷⁹

⁷⁰Yang Xu, 'The Disclosure-Based System in the US' (美国注册制管窥) (Shanghai Stock Exchange Research Report Series, No 14/2014), 15 <www.sse.com.cn/aboutus/research/research/c/3996085.pdf>.

⁷¹SSE Reviewing Rules 2023 (n 66) Art 42.

⁷²Ibid.

⁷³Measures for Registration-Based IPOs 2023 (n 12) Art 20; SSE Reviewing Rules 2023 (n 66) Art 4.

⁷⁴Measures for Registration-Based IPOs 2023 (n 12) Art 20; SSE Reviewing Rules 2023 (n 66) Arts 4 and 50.

⁷⁵Measures for Registration-Based IPOs 2023 (n 12) Art 24.

⁷⁶Ibid.

⁷⁷Ibid.

⁷⁸Ibid, Art 32.

⁷⁹It is considered that developed economies, such as the US, should conduct a partial return to the merit-based system to counteract market misconduct, see Daniel J Morrissey, 'The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review' (2010) 44 University of Richmond Law Review 647.

Table 2. Comparison of the IPO regulatory systems.

	Merit-based	Registration-based	Disclosure-based
The authority conducting IPO review	CSRC	Stock exchanges & CSRC	SEC
The nature of IPO review	Disclosure & Examination	Mainly, Disclosure	Disclosure
Conducting substantial examination	Yes in all cases	Yes, not in all cases	No
Making value judgment	Yes	No	No

Note: The Table is drawn by the authors.

Afterwards, if the CSRC is satisfied with the quality of the disclosed information, it will admit the applicant to conduct stock offerings. However, it should be noted that granting a registration approval does not mean that the authenticity, accuracy and completeness of the application materials of the proposed IPO have been endorsed by the CSRC and/or the Chinese stock exchanges.⁸⁰ It is also the case with the disclosure-based system, under which the SEC does not guarantee that information is disclosed on an authentic, accurate and complete basis even though it requires so.⁸¹

As discussed above, substantial examinations and value judgment represent the key features of the merit-based system. Under the registration-based system, the CSRC and stock exchanges hold the power to conduct substantial examinations on particular occasions. Nevertheless, they do not conclude the investment value of the proposed IPOs but leave it to the market, a regulatory feature mirroring the practice of the US disclosure-based system.

Having recognized the registration-based system's differentials to the merit-based system as its predecessor and its similarities to the US disclosure-based system as its global counterpart (see Table 2), the following subsections will explore the progress and problems of the registration-based system in accommodating issuers, compared to the merit-based system.

B. The progress in accommodating issuers: the improved regulatory efficiency

As discussed above, due mainly to the absence of a timeline and the CSRC's shortage of human resources, a critical drawback of the merit-based system is its regulatory inefficiency. Thus, in order to retain domestic issuers on the Chinese bourses, it is necessary for the regulatory reform to curtail the IPO time cost.

Upon implementing the registration-based system, the main authority of stock offering review has been handed over to the bourses, thus easing the burden of the CSRC as a single regulator with the effect of improving the overall regulatory efficiency. Besides, compared to the pre-reform securities regulation that stipulated stock listing review as a separate process, the registration-based system has integrated the stock exchanges' offering and listing review into a single process to reduce the time cost of Chinese flotation.

More importantly, under the registration-based system, a strict timeline is stipulated for the review process. In the first step, upon accepting the issuer's stock offering and listing application for review, the involved stock exchange is bound to launch the first round of comments within 20 working days and complete the review within three

⁸⁰Measures for Registration-Based IPOs 2023 (n 12) Art 9; SSE Reviewing Rules 2023 (n 66) Art 11.

⁸¹SEC, 'About the SEC: What We Do' <www.sec.gov/Article/whatwedo.html> last accessed 1 October 2020.

months.⁸² Also, the maximum time that the issuer, sponsor and other involved agencies can collectively spend in replying to the stock exchange's comments is three months.⁸³ In the second step, the CSRC is bound to make the final decision within 20 working days from receiving the issuer's application materials forwarded by the stock exchange.⁸⁴ That is to say, the registration-based system reduces the time cost of Chinese flotation to approximately half a year, which is significantly less than that under the merit-based system. In practice, from 22 July 2019 to 31 November 2020, the average time that issuers spent from submitting their IPO applications to floating on the SSE STAR Board under the registration-based system was 228 days, which was considerably shorter than that of listings on the SSE and SZSE Main Boards under the merit-based system, i.e. 550 days, in the same period.⁸⁵ Thus, the significantly reduced time cost provides a solid ground in which the value of the registration-based system can be anchored.

It is noteworthy that apart from implementing the registration-based system to cut the listing time cost, Chinese authorities have also streamlined the stock offering and listing process to accommodate issuers by creating a so-called IPO Green Channel. The IPO Green Channel was initially employed in 2016 to provide issuers from underdeveloped regions with a fast track of review process, under which involved IPO applications could be reviewed immediately by the CSRC without having to wait in queue.⁸⁶ This mechanism has been created to facilitate certain issuers to achieve public fundraising to boost their business development, thus having the further effect of benefiting local taxation and employment. In 2018, the IPO Green Channel mechanism was borrowed by Chinese authorities to satisfy the listing needs of Chinese issuers from the bioscience, cloud computing, artificial intelligence and advanced manufacturing industries.⁸⁷ In practice, Foxconn, the largest global manufacturer of Apple's smartphones and Amazon's Fire tablets, became the first beneficiary of this legal innovation.⁸⁸ In this case, Foxconn launched its IPO application on 1 February 2018 and used only 36 days to obtain the listing leave from the CSRC, thereby becoming the fastest Chinese IPO in history.⁸⁹

Compared to the IPO Green Channel that is available only to issuers from specific industries, the registration-based system does not adopt a similar industry sector restriction, which is therefore beneficial to a broader range of Chinese issuers. However, the strengths of the registration-based system do not mean that this system fits perfectly into the Chinese regulatory framework. The following subsection explores the problems of the registration-based system.

⁸²SSE Reviewing Rules 2023 (n 66) Arts 36 and 44.

⁸³Ibid, Art 44.

⁸⁴Measures for Registration-Based IPOs 2023 (n 12) Art 24. However, in the event that the stock exchange conducts on-site examinations and/or the CSRC instructs the stock exchange to resume the exchange-issuer written conversation or conduct on-site examinations, relevant time spent will not be counted.

⁸⁵Yuye Zhan, 'The Time Needed to Go Public has been Shortened, and the Fastest IPO Used 53 Days' (上市周期缩短,最快用时 53 天) (Shenzhen Press Group, 3 December 2020) <http://szsb.sznews.com/MB/content/202012/03/content_958174.html>.

⁸⁶Opinions of the China Securities Regulatory Committee on Playing the Role of the Capital Markets in Supporting the Nation's Poverty-Alleviation Strategy (证监会关于发挥资本市场作用服务国家脱贫攻坚战略的意见) Art 2(4).

⁸⁷See Shi Jing, 'Foxconn Unit's Planned Public Float Progressing at Fast Pace' (China Daily, 6 March 2018) <www.chinadaily.com.cn/a/201803/06/WS5a9defb2a3106e7dcc13fc6b.html>.

⁸⁸For an introduction of Foxconn's IPO, see Stella Yifan Xie, 'China Fast-Tracks IPO Approval for Foxconn Unit' (The Wall Street Journal, 9 March 2018) <www.wsj.com/articles/china-fast-tracks-ipo-approval-for-foxconn-unit-1520587810>.

⁸⁹Ibid.

C. The problems in accommodating issuers: the persistence of regulatory uncertainty

Apart from low efficiency, regulatory uncertainty is another critical drawback of the merit-based system. However, the implementation of the registration-based system has not resolved this problem, due essentially to Chinese bourses' lack of regulatory independence derived from China's political economy.

Through a global lens, stock markets are regulated by a variety of bodies that operate on a hierarchy of levels, including (i) stock exchanges that exercise self-regulation functions by employing rules to govern listing and trading activities; (ii) industry self-regulatory organizations, such as the US Financial Industry Regulatory Authority, which adopt rules on a consensual basis and require the compliance with these rules as a prerequisite for market participants to conduct securities-related activities; (iii) specialized regulators like the SEC and CSRC; (iv) the central government, typically through a ministerial arm, retains authority over significant policy issues. The allocation of regulatory power amongst the aforesaid bodies differs between jurisdictions, generating roughly three models of securities regulation, namely the government-led model (e.g. Japan), the flexibility model (e.g. Hong Kong) and the cooperation model (e.g. the US).⁹⁰

China adopts a government-led model of securities regulation with the CSRC playing a central role in regulating the stock market and the stock exchanges carrying limited power of self-regulation as front-line regulators. Upon the modification of the SLC in 2005, the CSRC handed over the power to formulate listing and trading rules, review stock listing applications, and discipline quoted companies to the SSE and SZSE.⁹¹ The implementation of the registration-based system has further conferred the main responsibility of stock offering regulation to the stock exchanges. In this way, the CSRC has superficially separated its supervisory and regulatory responsibilities. In reality, however, the stock exchanges still lack regulatory independence, making the redistribution of regulatory power in some sense in the name only.

Unlike the bourses of many developed economies that are commercial parties, the Chinese stock exchanges are quasi-official institutions without independent power to decide important affairs and appoint key persons. The General Meeting of Members serves as the supreme body of the Chinese stock exchanges, bearing the power to make the exchange constitution.⁹² Nevertheless, the constitution must obtain approval from the CSRC to become valid.⁹³ Besides, both the SSE and SZSE are required to establish a Council⁹⁴ as the decision-making organ mainly in charge of formulating operational rules and budgeting,⁹⁵ of which between one third and a half of the Council members are appointed by the CSRC.⁹⁶ Also, the general managers steering the stock exchanges

⁹⁰John C Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 *University of Pennsylvania Law Review* 229, 255–56. For a discussion of the characteristics of the three models of stock market regulation, see Howell E Jackson and Stavros Gkantinis, 'Markets as Regulators: A Survey' (John M Olin Center for Law, Economics and Business, Faculty Discussion Paper No 2007-579) 22–38 <www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_Gkantinis_579.pdf>.

⁹¹Securities Law of China 2005 (中华人民共和国证券法 2005) Arts 55, 56 and 115.

⁹²Measures for the Administration of Securities Exchanges 2021 (证券交易所管理办法 2021) Art 18.

⁹³Securities Law of China 2019 (中华人民共和国证券法 2019) Art 99.

⁹⁴*Ibid*, Art 167.

⁹⁵Measures for the Administration of Securities Exchanges 2021 (n 92) Art 22.

⁹⁶*Ibid*, Art 23.

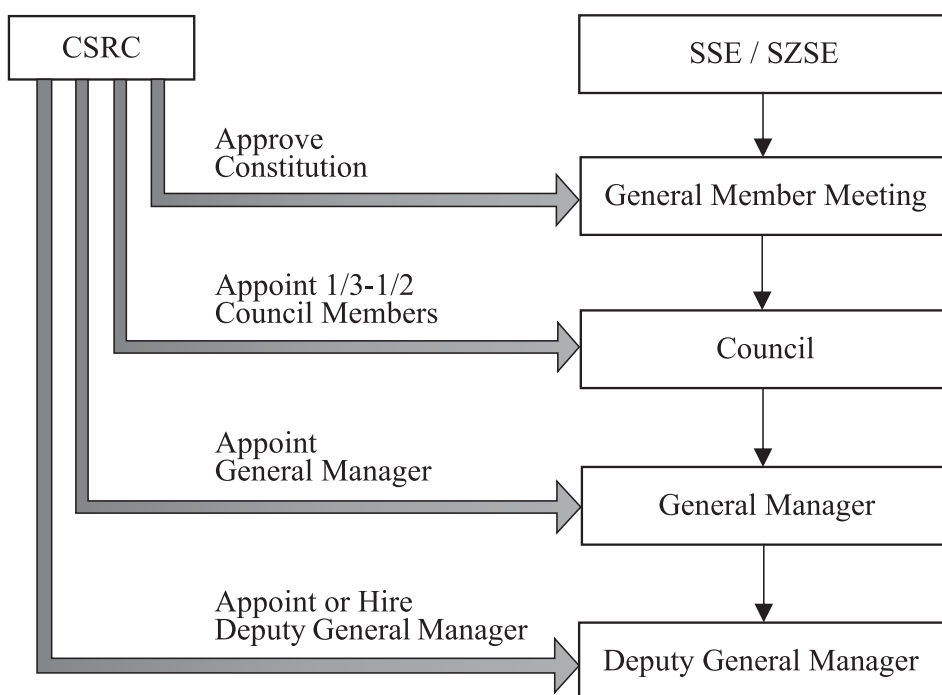


Figure 2. Chinese stock exchanges' lack of institutional independence.

are appointed directly by the CSRC,⁹⁷ while the deputy general managers are appointed or hired by the CSRC (see Figure 2).⁹⁸ The afore-mentioned key persons are normally state officials with a high bureaucratic level, who used to work in the CSRC before taking positions in the stock exchanges and will usually return to the CSRC after their term of office in the stock exchanges terminates.⁹⁹ More importantly, the CSRC reserves the power to dismiss Council members and senior executives who are considered unsuitable to hold their positions.¹⁰⁰ On these grounds, no matter the form by which the regulatory power is distributed between the CSRC and national bourses, the former can always pull the strings with the latter acting *de facto* as marionettes.

Moreover, under the registration-based system, in the first-step review process, the stock exchanges can ask the CSRC for instructions if the existence of significant issues concerning the interpretation and application of the rules issued by the CSRC, major unprecedented issues or like circumstances.¹⁰¹ Besides, the CSRC conducts routine annual checks and random checks to examine whether the stock exchanges have appropriately regulated stock offerings and listings.¹⁰² In these regards, the stock exchanges actually act

⁹⁷Securities Law of China 2019 (n 93) Art 102.

⁹⁸Measures for the Administration of Securities Exchanges 2021 (n 92) Art 27.

⁹⁹Kai Lyu, 'The Institutional Transformation of China's Stock Exchanges: A Comparative Perspective' (2015) 5 Accounting, Economics and Law 43, 76.

¹⁰⁰Measures for the Administration of Securities Exchanges 2021 (n 92) Art 35.

¹⁰¹SSE Reviewing Rules 2023 (n 66) Art 21.

¹⁰²Measures for Registration-Based IPOs 2023 (n 12) Art 53.

as subordinates of the CSRC,¹⁰³ regardless of the implementation of the registration-based system or not. As a result, if the CSRC's broad discretionary power with opaque nature in deciding market access under the merit-based system fails to build certain issuers' trust in China's securities regulation *per se*, it seems unlikely the nominal redistribution of regulatory power upon implementing the registration-based system will change much.

In addition, under the registration-based system, the CSRC holds post-registration regulatory power with unpredictability to issuers. According to the Chinese regime, if a significant matter – which is of potential impact on the proposed offering and listing – occurs, the CSRC can postpone or suspend the IPO or listing.¹⁰⁴ Where necessary, the CSRC can withdraw the registration decision if the post-registration matter is severe enough to make the issuer not satisfy the conditions of stock offering and listing any longer.¹⁰⁵ In an example of practice, on 3 November 2020, the CSRC exercised the post-registration regulatory power to suspend Ant Group's spotlight-catching listing. Before the suspension, Ant Group had passed the CSRC's registration process and had conducted stock issuance with the shares to be listed on the SSE STAR Board for public trading from 5 November 2020. However, the CSRC, jointly with other central regulators of the Chinese financial industry, promulgated a ministerial circular with far-reaching influence on Ant Group's business compliance and market valuation, and used this as a basis to exercise the post-registration regulatory power to impose the suspension.¹⁰⁶

Overall, by removing value judgment, the registration-based system is conducive to the enhancement of regulatory predictability, meaning that issuers satisfying the qualification and disclosure requirements will normally secure regulatory approval on their IPO applications. However, given the CSRC's exercise of post-registration regulation in the Ant Group case, regulatory uncertainty still exists, which may discourage certain issuers from going public in the Chinese stock market.

Such an issue is further related to China's stock market internationalization. As the second-largest economy worldwide with stock exchanges of global size, China has not opened its stock market to foreign issuers thus far.¹⁰⁷ Also, global investors are entitled to invest in the Chinese stock market via limited routes.¹⁰⁸ Nevertheless, internationalization is an important goal that Chinese authorities pursue, although it is not a policy priority in the recent Chinese IPO regulatory reform. If the Chinese stock market is opened to foreign issuers in the future, whether foreign issuers would trust the Chinese IPO regulatory framework or not will be a central concern. However, the persistence of regulatory uncertainty indicates that despite sharing some similarities to the disclosure-based

¹⁰³Yang Cao, 'Approval System to Registration System of Stock Issuance in China's Capital Market: To Perfect the Stock Issue System in China' (我国股票发行从核准制到注册制发展的初步研究 – 兼论我国证券法关于股票发行制度的修改与完善) (2015) 9 *Reformation & Strategy* 68, 71.

¹⁰⁴Measures for Registration-Based IPOs 2023 (n 12) Art 27.

¹⁰⁵*Ibid.*

¹⁰⁶For an introduction of the Ant Group IPO suspension, see Ryan McMorro and Hudson Lockett, 'China Halts \$37 bn Ant Group IPO, Citing "Major Issues"' (*Financial Times*, 4 November 2020) <www.ft.com/content/c1ee03d4-f22e-4514-af46-2f8423a6842e>.

¹⁰⁷Strictly speaking, upon the establishment of the Shanghai-London Stock Connect, London Stock Exchange (LSE)-based global issuers can issue Chinese depositary receipts that represent their shares, thereby achieving flotation on the SSE. Yet, no LSE-based global issuers have issued Chinese depositary receipts by the end of 2022.

¹⁰⁸The available routes for global investors to access China's A-share market are to get licensed under the Qualified Foreign Institutional Investor (QFII) scheme and trade the shares of selected issuers listed in China via the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Shanghai-London Stock Connect.

system, the registration-based system seems unlikely to cultivate the confidence of certain Chinese issuers who may seek jurisdiction shopping to float overseas. As such, building foreign issuers' trust to go public in China would be even more difficult.

It is noteworthy that some scholars suggest Chinese authorities corporatize stock exchanges to enhance their independence.¹⁰⁹ However, given the dominance over stock exchanges as an important 'political and economic project' for Chinese authorities, it seems unlikely that a demutualized institutional transformation of Chinese stock exchanges will occur in the near future.¹¹⁰

Satisfying issuers' preferences to cultivate stock market competitiveness has to go hand-in-hand with effective protection of investors, the suppliers of capital.¹¹¹ After examining the progress and problems of the registration-based system in accommodating issuers, the following section will canvass the Chinese IPO regulatory reform from the perspective of investor protection.

V. Safeguarding investors under the registration-based system: present and prospects

A vital feature distinguishing the registration-based system from its predecessor is the removal of value judgment. Given the fact that the local situation of the Chinese stock market has not experienced material changes, the regulatory shift inevitably poses a question about how the IPO regulatory reform can serve its purpose of accommodating issuers' needs while ensuring investor protection. This section canvasses the approaches adopted by Chinese authorities for investor protection in the transition era and looks into the landscape in the long run.

A. The use of supporting mechanisms

The IPO regulation under the registration-based system is meant to rely mainly on information disclosure, although the regulators hold the power to conduct substantial examinations on certain occasions. In the event of disclosure failure, however, investors will suffer economic loss. Thus, the effective avoidance and rectification of disclosure failure are significant to investor protection.¹¹² To smooth the IPO regulatory reform, Chinese authorities have used a couple of other legal innovations to reinforce investor protection. These include the stipulation of stringent legal liabilities that are binding on private gatekeepers to ensure that gatekeeping duties are duly performed, the reliance on the mandatory delisting mechanism to achieve market cleanness, and the introduction of a US-style securities class action mechanism, i.e. the special securities representative action (SSRA) mechanism, to ensure *ex-post* remedy.

According to Chinese legal regimes, sponsors are required to conduct comprehensive and substantial examinations of the application materials of stock offering and listing and

¹⁰⁹See, e.g. Xuan Tian, 'Promoting the Reform of Corporatizing Stock Exchanges' (推进交易所公司制改革) <<https://finance.eastmoney.com/a/202303062653309992.html>>.

¹¹⁰Kai Lyu, 'The Role of State/Market Division and Political Economy in Understanding Institutional Transformation of China's Stock Exchanges: Response to Dr. Ortiz' (2015) 5 Accounting, Economics and Law 99, 103.

¹¹¹La Porta and others (n 13) 1147.

¹¹²Wang (n 25) 65.

are responsible for the authenticity, accuracy and completeness of the documents they have issued.¹¹³ Likewise, other gatekeepers, such as law firms and accounting firms, are responsible for their professional opinions.¹¹⁴ As private gatekeepers are familiar with issuers' situation and have relevant expertise, they are expected to play a significant role in finding and avoiding fraudulent activities. Global practice has revealed that the inadequacy of legal deterrence is a major reason for gatekeeper failure.¹¹⁵ Thus, against the backdrop of implementing the registration-based system, Chinese policy-makers have stipulated strict legal liabilities. If private gatekeepers are found guilty of wrongdoing, they will bear legal sanctions ranging from correction at one end of the spectrum to the withdrawal of their licence at the other, depending on the severity of their fault.¹¹⁶ Meanwhile, the stock exchange will impose disciplinary sanctions on the sponsors and other intermediaries concerned, typically refusing applications submitted by them for a certain period.¹¹⁷ As an example in practice, on 26 January 2022, China launched a formal investigation into three gatekeepers, i.e. King & Wood Mallesons (a law firm), ShineWing Certified Public Accountants (an accounting firm) and Sino-German Securities (a sponsor), for their potential involvement in the financial fraud of a delisted company, i.e. Letv, and halted the 48 ongoing IPO projects endorsed by them for review.¹¹⁸ As such, by stipulating stringent penalties which can both sanction occurred misbehaviours and generate general deterrence, it is expected that private gatekeepers will play their duties prudently to find and avoid fraudulent activities so as to benefit investor protection.

Moreover, along with the implementation of the registration-based system, Chinese authorities have put high reliance on the mandatory delisting mechanism to maintain market integrity. Owing to the time-consuming IPO process under the merit-based system, many Chinese issuers have resorted to reverse acquisition, also known as backdoor listing, for domestic flotation. Such a situation has resulted in the reluctance of poorly performing quoted companies to undergo a delisting actively because they can sell themselves to potential issuers seeking to conduct a reverse acquisition. This has generated the Chinese stock market some listed companies with low liquidity. However, under the merit-based system, the mandatory delisting mechanism was ineffectively enforced. Compared to the merit-based system, the registration-based system does not require regulators to conduct value judgment, meaning that some companies without good business prospects may enter the stock market. Thus, against the backdrop of implementing the registration-based system, Chinese authorities have intensified the use of the mandatory delisting mechanism to reinforce investor protection. In practice, after the implementation of the registration-based system in 2019, the number of mandatory delisted companies was considerably larger, compared to that before the IPO regulatory reform.¹¹⁹

¹¹³Measures for Registration-Based IPOs 2023 (n 12) Art 7; SSE Reviewing Rules 2023 (n 66) Art 27.

¹¹⁴Measures for Registration-Based IPOs 2023 (n 12) Art 8; SSE Reviewing Rules 2023 (n 66) Art 28.

¹¹⁵Coffee (n 28) Ch 3 (explaining gatekeeper failure).

¹¹⁶Measures for Registration-Based IPOs 2023 (n 12) Arts 61–64.

¹¹⁷SSE Reviewing Rules 2023 (n 66) Art 79.

¹¹⁸See Asia Financial, 'China Bourses Halt IPO Applications in Regulatory Probe' (28 January 2022) <www.asiafinancial.com/china-bourses-halt-ipo-applications-in-regulatory-probe>.

¹¹⁹According to the CSRC, the average number of mandatory delisted companies per year before 2019 was 3, compared to 9 in 2019 and 17 in 2021. Source: CSRC Annual Reports 2015–2021.

Through a global lens, the Chinese supporting mechanisms are modelled on the practice of the US, in which the disclosure-based system is backed by a number of mechanisms, including the gatekeeping function of private gatekeepers, the mandatory delisting mechanism and strict securities enforcement. In fact, the strength of the US regulatory framework is anchored, to a large extent, in the effectiveness of mandatory delisting. According to empirical research, the annual delisting rates of the NYSE and NASDAQ both exceeded five per cent.¹²⁰ In light of US listing rules, many circumstances can trigger the delisting of a quoted company, such as financial underperformance, typically the one-dollar minimum stock price requirement¹²¹ and financial fraud. For instance, Luckin Coffee, the Chinese rival to Starbucks, was delisted from the NASDAQ due to misstating its revenue and expenses to defraud investors.¹²²

Besides, since under the registration-based system, regulators do not conduct substantial examinations in each IPO application regarding the authenticity, accuracy and completeness of the disclosed information, some fraudulent activities may not be found and avoided before IPOs. Thus, to ensure investor protection, China has designed the SSRA mechanism for affected investors to recover their interests through private enforcement on an *ex-post* basis. The first SSRA lawsuit, i.e. *China Securities Investor Services Centre v Kangmei Pharmaceutical Co*, was ruled on 12 November 2021,¹²³ in which the court decision required the wrongdoers and liable accounting firm and accountant to bear joint and several liability to compensate RMB 2.459 billion for the affected investors, an amount even larger than the monetary settlement of the US securities class actions against Alibaba (US\$250 million, equivalent to RMB 1.75 billion).¹²⁴ A sufficiently large penalty, even if associated with a low probability of detection, can create significant deterrence. In this way, the first SSRA lawsuit has recovered the damaged value and generated general deterrence.¹²⁵

B. The interplay between public and private gatekeepers

Under the registration-based system, the CSRC and stock exchanges will conduct a substantial examination when they deem it necessary. Besides, the stock exchanges exercise substantial examinations at random as a routine. Thus, the CSRC and stock exchanges have regulatory flexibility in deciding the frequency of conducting substantial examinations according to the changing market situation. At one end of the spectrum, if the market is not ready for the IPO regulatory reform, it may be necessary for the CSRC or stock exchanges to conduct substantial examinations on all IPO projects, making the registration-based system a nominal substitute for the merit-based system. At the other

¹²⁰The exact figure of the NYSE was 6% in 2014, while the counterpart figure of the NASDAQ was 8%, see Xu (n 70) 11.

¹²¹NYSE Listed Company Manual r 802.01C; NASDAQ Stock Market Rules r 5810(c)(3)(A).

¹²²See Alistair Gray, 'Luckin Coffee to Pay \$180m in Accounting Fraud Settlement' (*Financial Times*, 16 December 2020) <www.ft.com/content/4db3b074-829f-4f1c-a256-11c7e28a31d1>.

¹²³*China Securities Investor Services Centre v Kangmei Pharmaceutical Co*, Intermediate People's Court of Guangzhou City, Guangdong Province [2020] Civil Judgment No 2171 (广东省广州市中级人民法院民事判决书 [2020] 粤 01 民初 2171 号).

¹²⁴See ISS, 'The Top 100 U.S. Class Action Settlements of All Time as of December 2019' <www.issgovernance.com/library/the-top-100-us-class-action-settlements-of-all-time-as-of-december-2019/>.

¹²⁵For a discussion of the Chinese SSRA mechanism and the first SSRA lawsuit, see Fa Chen, 'The Chinese-Style Securities Class Action Mechanism for Investor Protection: Context, Content, Comparison and Consequence' (2022) 30 Asia Pacific Law Review 287.

end, when the Chinese stock market is well developed, the public regulators may get rid of the reliance on substantial examinations, as their counterparts do under the disclosure-based system. In this sense, the registration-based system is a middle way between the merit-based system and disclosure-based system.

Given that the Chinese stock market still has numerous unsophisticated retail investors and lacks third-party regulatory power, in the transition era when private gatekeeper liabilities and securities class actions are yet to spread their effects in the stock market, a certain degree of reliance on the CSRC's engagement is necessary to build market confidence. In the long run, however, effective investor protection under the registration-based system will rely considerably on private gatekeepers in finding and avoiding fraudulent activities and securities enforcement through which to redress investors and sanction misbehaviours. Thus, China's IPO regulatory reform is not just about expanding the coverage of the registration-based system across the stock market under gradualism, but also it is changing the interplay between public and private gatekeepers to make the latter play key gatekeeping functions incrementally instead of a sudden shift to cause a regulatory gap.

VI. Conclusion

China used the merit-based system to regulate IPOs in the past two decades, under which the CSRC conducted substantial examinations and value judgment to decide market access so as to ensure investor protection. However, the merit-based system bore regulatory inefficiency and uncertainty, which undermined the attractiveness of domestic flotation to Chinese issuers and thus triggered the implementation of the registration-based system as the substitute.

Under the registration-based system, the CSRC has transferred some regulatory power to the stock exchanges. Besides, the CSRC does not conduct value judgment but leaves it to the market. However, due to the political economy underlying it, the registration-based system cannot eliminate the regulatory uncertainty arising from the CSRC's all-encompassing role with broad discretionary power and opaque nature. As a result, the persistence of regulatory uncertainty is unlikely to build certain issuers' confidence in going public domestically. Notwithstanding the problems, the registration-based system rests its value on the significantly curtailed time cost of Chinese flotation, compared to the time-consuming process under the merit-based system, thereby delivering market attractiveness to issuers.

To ensure investor protection against the risks brought by the regulatory change, the CSRC retains the authority to conduct substantial examinations. Meanwhile, the registration-based system relies on a couple of supporting mechanisms, such as sponsors' gatekeeping function, to maintain market integrity. In light of China's market situation, the supporting mechanisms may play an important role in the long run. In the transition era, however, the public regulators' close engagement is still needed to avoid a regulatory gap for investor protection.

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