The Return and Domestic Listing of Red Chip Structure

---- Co-authors: Li Xiang; Sharon Zhang

Part 1 Background

It is understood that some domestic enterprises, which originally propose to list overseas and have established red chip structures, are increasingly intending to return as a result of the depression of overseas security markets and the boom of Chinese stock markets, moreover, there are few successful cases so far.

The author will, respectively in connection with typical red chip structure and agreement-control mode, discuss the feasibility of the return of red chip structure, the reorganization plan and notable matters in the process of reorganization.

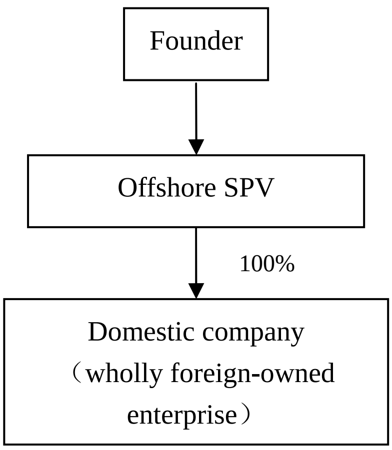
Part 2 Typical Return of Red Chip Mode

1. **Successful cases**

➢ Shandong Delisi Food Co. Ltd (ticker symbol: 002330), which has listed in Growth Enterprise Market of Shenzhen Stock Exchange

➢ Harbin Gloria Pharmaceuticals Co. Ltd, which will list in Growth Enterprise Market of Shenzhen Stock Exchange, subject to the approval of China Security Regulatory Commission

2. Typical red chip structure



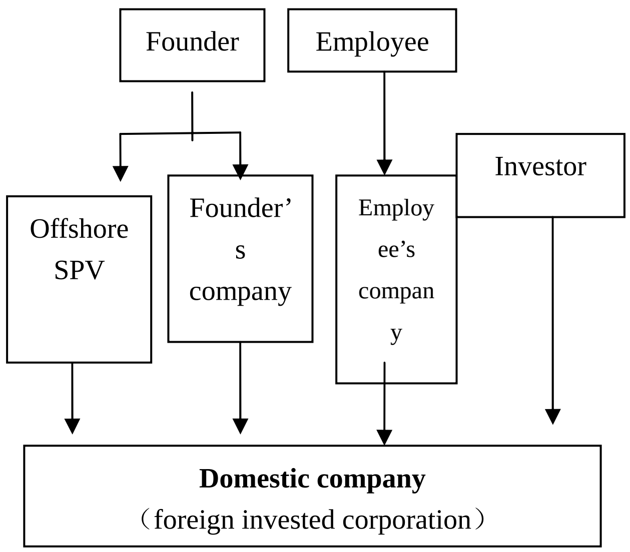
＊generally, there is a holding company combining the offshore SPV and the domestic company(e.g. a Hong Kong legal entity)

In a typical red chip structure, as illustrated above, the original natural person shareholder (the “founder”) established a special purpose vehicle (“SPV”) within an offshore jurisdiction (usually, the Cayman Islands), the SPV merged with the domestic company, as a result, the domestic company thus became a sole subsidiary of the SPV.

3. Reorganization plan

(1) Reorganization plan 1

1) The company's shareholding structure after reorganization



2) Operating steps

a) **The offshore SPV enters into a "share repurchase agreement" with its foreign investor, which provides that the offshore SPV may repurchase its shares held by the foreign investor in whole under special circumstances.**

b) **The domestic company introduces a investor**

The investor and the domestic company enter into an "investment agreement", proposing to increase the domestic company's capital. The principal applications of the increased capital shall be :(i) purchase the equity interests of a foreign party(or parties) in the domestic company; (ii) supplement the domestic company's working capital

c) **The founder establishes a founder's company, the employee wishing to hold the domestic company's shares establishes an employee's company**

In the light of the restriction of existing Chinese laws and regulations on a Chinese natural person acting as the domestic investor of a foreign-invested enterprise and a company limited by shares with foreign investment, the founder shall establish a founder's company within the territory of China, and hold the domestic company's equity interests via such founder's company, in addition, the employee intending to hold the domestic company's equity interests shall establish an employee's company within the territory of China, and hold the domestic company's equity interests via such employee's company

d) **The founder's company and the employee's company acquire equity interests of a foreign party (or parties) in the domestic company, the offshore SPV implements its obligations under the "share repurchase agreement"**

The founder's company and the employee's company acquire portion of the equity interests held by the offshore SPV in the domestic company, the equity transfer price shall be determined with reference to the assessed value, the form of the domestic company shall be altered from a wholly foreign invested company into a Sino-foreign joint venture enterprise. For the purpose of the domestic company's remaining entitlement to preferences as a foreign-invested enterprise, the ratio of the shares held by the offshore SPV in the domestic company shall not be less than 25%; meanwhile, the equity transfer shall not cause the major change of the domestic company's directors and officers and the change of the actual controller.

The offshore SPV shall implement its obligations under the "share repurchase agreement" after the receipt of payment for the said equity transfer, and repurchase all shares held by its foreign investors. No longer shall the foreign investor(s) of the offshore SPV hold the shares of the offshore SPV after the completion of such repurchase.

e) **The form of the domestic company in entirety alters into a company limited by shares with foreign investment if appropriate and in a manner of share conversion on basis of net asset book value, and a listing in Chinese stock exchanges shall be applied.**

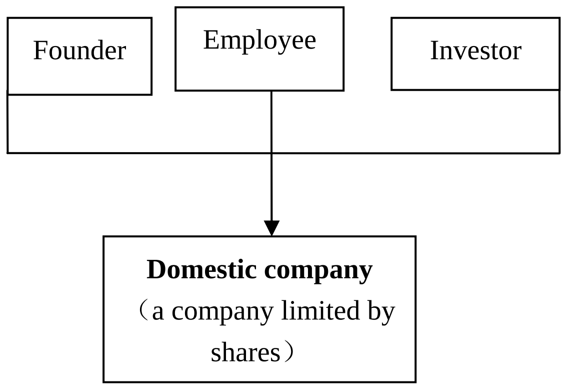
3) General assessment of the plan

In the event of a reorganization in accordance with this plan, there is no major change of the domestic company's primary business and the directors and officers, and there is no any change of the actual controller, and the duration of business may be calculated from the date on which the domestic company was established. As a result, this plan may accelerate the process of the domestic company's listing; moreover, if the domestic company proposes to list overseas in the future, the original red chip structure may be recovered through equity reorganization.

However, pursuant to the latest policies issued by China Security Regulatory Commission, in the event that the actual controller is a Chinese nationality or legal person, the intermediate structure is required to be cancelled; in the event that the actual controller is a foreign nationality or legal person, a adequate disclosure after due diligence investigation is required. In addition, such Chinese nationality or legal person must hold the equity interests of the domestic company directly, a controlling type of indirect shareholding shall be cancelled, and a clear definition of the equity and an express disclosure are required, a shareholding through a foreign company shall be denied. As a result, the feasibility of this plan is in doubt.

(2) Reorganization plan 2

1) The company's shareholding structure after reorganization



2) Operating steps

a) The offshore SPV enters into a "share repurchase agreement" with its foreign investor, which provides that the offshore SPV may repurchase its shares held by the foreign investor in whole under special circumstances.

b) The domestic company introduces a investor

The investor and the domestic company enter into an "investment agreement", proposing to increase the domestic company's capital. The principal applications of the increased capital shall be :(i) purchase the equity interests of a foreign party(or parties) in the domestic company; (ii) supplement the domestic company's working capital

c) **The founder and the employee intending to hold the domestic company's shares acquire equity interests of a foreign party (or parties) in the domestic company, the offshore SPV implements its obligations under the "share repurchase agreement"**

The founder and the employee intending to hold the domestic company's shares acquire all of the equity interests held by the offshore SPV in the domestic company, the equity transfer price shall be determined with reference to the assessed value,

The offshore SPV shall implement its obligations under the "share repurchase agreement" after the receipt of payment for the said equity transfer, and repurchase all shares held by its foreign investors. No longer shall the foreign investor(s) of the offshore SPV hold the shares of the offshore

SPV after the completion of such repurchase.

d) **The form of the domestic company in entirety alters into a company limited by shares with foreign investment if appropriate and in a manner of share conversion on basis of net asset book value, and a listing in Chinese stock exchanges shall be applied.**

e) **cancel the offshore SPV**

Part 3 the return of listing in the mode of agreement control

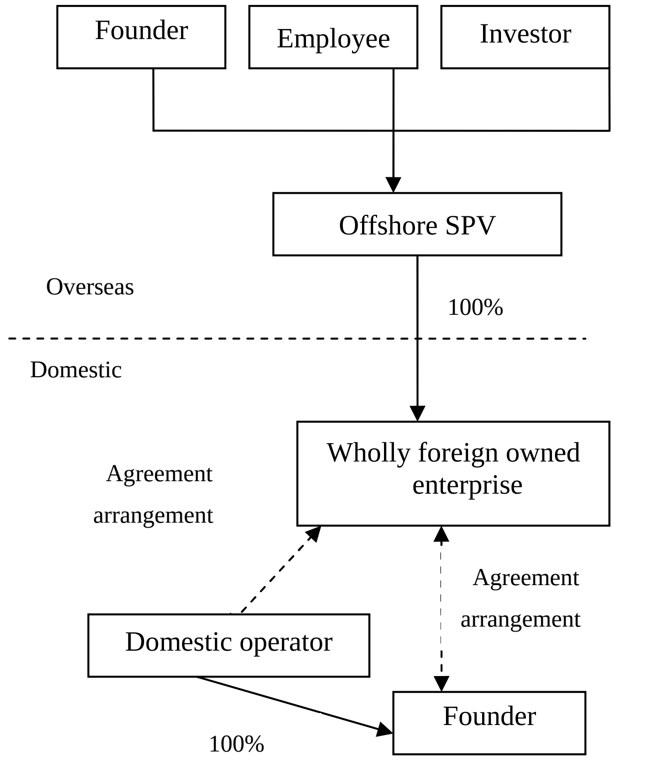
1. Successful cases

- Beijing Venustech Inc. (ticker symbol: 002439), which has listed in Growth Enterprise Market of Shenzhen Stock Exchange

- 263 Network Communication Inc. which will list in Growth Enterprise Market of Shenzhen Stock Exchange, subject to the approval of China Security Regulatory Commission

2. Agreement control mode

The agreement control mode is usually applied by a Chinese company engaging in industries in which a direct foreign investment is restricted or prohibited, such as the telecommunication, media, internet, education etc. when listing overseas. Furthermore, due to the restrictions on offshore financing and round tripping investment by Chinese regulatory provisions in recent years, overseas listings in connection with companies falling with the category of permitted or even encouraged increasingly apply agreement control mode.



＊generally, there is a holding company combining the offshore SPV and the domestic company（e.g. a Hong Kong legal entity）

In a typical agreement control mode, as illustrated above, the natural person shareholder (hereinafter, the “founder”) with Chinese nationality of the domestic operating company (“operator”) establishes a special purpose vehicle (“SPV”) within an offshore jurisdiction (usually, the Cayman Islands), such SPV establishes a sole subsidiary within the territory of China (“wholly foreign owned enterprise”, “WFOE”). The wholly foreign-owned enterprise and the operator and the founder afterward enter into a series of contracts, generally including the following agreement:

- Advisory agreement, the WFOE provides technical supports and advices to the operator, charging for services

- Intellectual property rights license agreement, the WFOE license its copyrights, trademarks, domain names, patents and know-how to the operator, charging royalties.

- Equity pledge agreement, each founder pledges his/her equity interests in the operator to the WFOE, guaranteeing the operator’s implementation of its obligations under each agreement. In addition, the founders undertake that no assignment, sale, pledge, disposal of their equity interests in the operator or encumbrance on such equity interests shall be made without the WFOE’s prior written consent.

- Voting agreement, each founder entrusts the WFOE to exercise their rights as the shareholders of the operator.

- Option subscription agreement, the founders are obliged to sell, and the WFOE may purchase from the founders at the lowest price to the extent permitted by Chinese laws and regulations, all or part of the equity interests held by the founders in the operator.

The WFOE may, through the said agreement arrangements:

- Control the operator effectively
- Obtain substantially all of the operator's profit on operation

3. Main legal barriers of listing within China

Due to Mainland China's prohibition on the listing of foreign companies, the offshore SPV may not list in China.

With regards to the WFOE, notwithstanding its effective control the operator and the realization of consolidated calculation of financial statements, which are carried out through affiliate transactions.. in addition, the operator has no ability of a direct market-oriented independent management. As a result, the WFOE is not suitable for a subject of listing.

With regard to the operator, by the reason of its necessary transfer of substantially all of its profit on operation to the WFOE, as a result, its profit conditions may scarcely satisfy the requirements for listing. Furthermore, the operator may has transferred part of or most business assets to the WFOE, thus there is a lack of the asset integrity

4. Reorganization prior to the listing within China

In view of the said legal barriers with respect to listing inside China, and by the reason that only a company limited by shares may offer shares publicly within China, the operator requires further reorganization and restructuring, principal steps for reorganization includes:

1）The adjustment of the shareholding structure of the offshore SPV

The offshore SPV redeems all of its shares held by a foreign investor(or investors)

2)The termination of transaction arrangements within China

A discontinuing of implementation is agreed, the operator no longer pay any expense to the WFOE, and independently be entitled to the ownerships or use rights of all equipments necessary for the normal production and operation, the intangible assets and other assets.

3）The adjustment of the shareholding structure of the operator

The operator’s shareholding structure shall be in conformity to the offshore SPV’s shareholding structure then.

Key points for operation: no major change of the operator’s directors and officers and no change of its actual controller shall be assured.

4) The form of the domestic company in entirety alters into a company limited by shares in a manner of share conversion on basis of net asset book value

5) The foreign investor(s) invests in the operator

Precedent to the compliance with the industrial policies concerning the foreign investment, the foreign investor may invest in the operator:

Key point for operation: if the foreign investor invests in the operator prior to its change into a company limited by shares, causing the operator into a foreign invested enterprise, a profit record in last 3 years shall be required when such foreign invested enterprise applying for a change into a company limited by shares with foreign nationality; nevertheless, there is no such requirement when a company limited by shares applying for the change into a company limited by shares with foreign investment, as a result, the foreign investor(s) shall invest in the operator after the operator’s change into a company limited by shares.

6) Cancel the WFOE and the offshore SPV

Part 5 Conclusion

We may conclude than on basis of the said analyses: a company who has established a red chip structure may list with China successfully after a series of reorganizations.

In addition, along with the continual and rapid development of China’s stock market, it is estimated that more companies proposing to list overseas may return.