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COUNTRIES COVERED
China » Chinese Depositary Receipts: what they are, how they work and why this represents a golden opportunity p 529

International Briefings

China

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CHINESE DEPOSITARY RECEIPTS: WHAT THEY ARE, HOW THEY WORK AND WHY THIS REPRESENTS A GOLDEN OPPORTUNITY

Most technology giants in mainland China, such as Alibaba, Tencent, Baidu, JD and NetEase have listed their shares on overseas stock markets such as Hong Kong and New York, in order to avoid China's rigid and onerous listing rules concerning foreign ownership, variable interest entities, weighted voting rights and the strict profitability requirement.

The China Securities Regulatory Commission has recently launched a pilot project to allow certain foreign-listed Chinese companies to issue Chinese Depositary Receipts (CDRs) which can be traded on the Shanghai and Shenzhen stock exchanges. Technically speaking, CDRs are not shares but they represent equity interests in foreign companies through an offshore custodian bank.

The popularisation of CDRs will benefit several parties. Chinese investors will be able to purchase interests in some of the top tech companies in the world. It will also lure international capital to the Chinese market and boost the valuation of issuing companies. The market scale of CDRs is estimated to be over $1trn, which will be a source of income for investment banks and international law firms.

In this article the authors analyse the reform of listing rules in China and the operating mechanism of the new Chinese Depositary Receipts.

INTRODUCTION

After a four-decade period of rapid economic growth, China now hosts some of the largest and most well-known companies in the world. For example, Alibaba, the global e-commerce giant, and Tencent, a leading social networking and online gaming company, have been included in the list of Top 10 most valuable brands in the world along with US companies like Google, Apple, Amazon, Microsoft, Facebook, Visa, McDonald's, and AT&T.[1] In addition, Alibaba and Tencent have been in the world's Top 10 public companies having the highest market capitalisation. As of 15 June 2018, the New York-listed Alibaba is worth $522bn while the Hong Kong-listed Tencent is worth HK$3.9trn ($497bn).

Despite the huge success of Chinese businesses, many of them have chosen to list their shares on overseas stock exchanges. As a result, investors in mainland China are unable to purchase foreign-listed shares so have not been able to enjoy the fast development and economic dividends of their favourite brands. In 2018, China Securities Regulatory Commission (CSRC) launched a pilot scheme to allow certain overseas-listed Chinese companies to issue Chinese Depositary Receipts (CDRs) which can be traded on the Shanghai or Shenzhen stock exchanges. The State Council's guideline indicated that CDRs will apply to companies in specific sectors such as cloud computing, big data, artificial intelligence, semi-conductors, bio-tech and high-end manufacturing.[2] Clearly, this move will attract capital to the Chinese market, give local investors more investment choices, as well as boost the market valuation of issuing companies. CDRs will also be a vital source of income for investment banks and international law firms in the upcoming years.

Against this background, this article considers and analyses the reform of listing rules in China. It seeks to provide answers to why many Chinese tech firms opted for overseas listings in the past, by considering legal issues such as the variable interest entity, the dual-class share structure, and the profitability requirement. It then examines the operating mechanism of CDRs and relevant regulatory rules, as well as discussing the first group of CDR issuers.

WHY DID CHINESE TECH GIANTS LIST SHARES OVERSEAS?

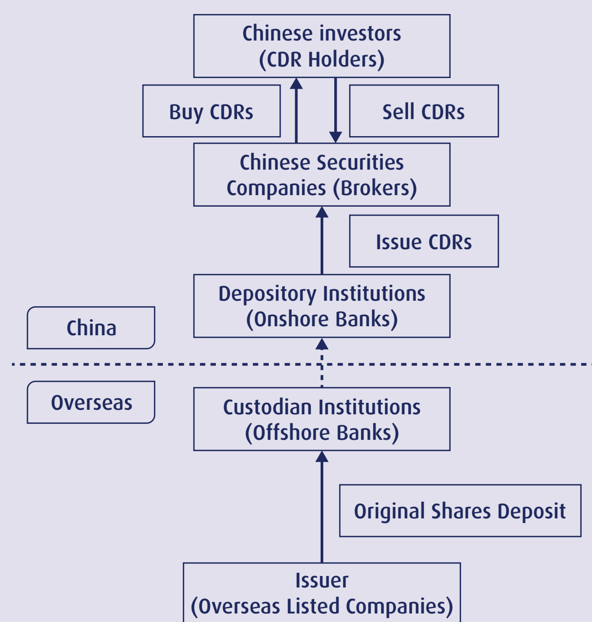
Since the early 1990s, China has established a multi-tier capital markets consisting of national stock exchanges (Shanghai Stock Exchange Main Board, Shenzhen Stock Exchange Main Board, Shenzhen Small and Medium-Sized Cap Board, Shenzhen Growth Enterprises Market), national OTC markets (National Equities Exchange and Quotations, or NEEQ), and regional OTC markets (equity exchange centres in each province). In total, there are over 3,500 public companies listed on the Shanghai and Shenzhen stock exchanges. Shanghai was ranked the 4th largest stock exchange in the world in terms of the market capitalisation of all listed companies ($5.19trn) while Shenzhen was ranked 8th ($3.73trn).[3] Recent years have seen a high level of volatility in China's stock markets. The SSE Composite Index jumped from 2,000 points in

International Briefings

July 2014 to a peak of 5,166.35 points in June 2015, triggering an equity bubble that drew millions of investors to take a bet on the bullish trend.[4] However, it has been followed by a major correction and a slip into bear market territory.

Despite the thriving stock markets, many Chinese technology companies have chosen to list their shares overseas to avoid the legal and technical barriers to IPOs they would encounter on the mainland, as well as to gain access to international capital. The primary concern of listing is centred on the registered place and foreign shareholders. A large number of high-tech companies have adopted a variable interest entity (VIE) as their legal business structure. VIEs enable foreign investors to get around Beijing's restriction of foreign ownership in companies in certain industries such as the Internet, finance and education. Chinese law does not permit foreign capital to own a majority stake in internet companies. However, internet companies often raise considerable funds from foreign venture capital funds and private equity funds. For example, two of the largest shareholders of Alibaba are Softbank (Japan) and Yahoo (US). VIE, therefore, evades the ownership limitation and allows tech firms to acquire capital from international investors. The tech firms' offshore parent companies domiciled in the Cayman Islands and other offshore financial centres enter into a series of contracts replicating the ownership in China's operating companies.[5] However, such contractual control is inferior to proprietary rights in the event of litigation, arbitration or insolvency proceedings. In 2014, Alibaba decided to list its shares in New York partly because its use of VIE had not been accepted by the Chinese regulators. Aside from Alibaba, other tech giants like Baidu, Tencent, Youku and Sohu have all employed the VIE structure, and therefore, can only list shares in overseas markets, predominantly, Hong Kong and New York.

DIAGRAM 1
The operating mechanism of CDRs



Another controversial issue lies in the dual-class share structure, also known as the weighted voting right. Class A shares that are sold to public investors will grant their holders one vote per share, while Class B shares that are held by company executives and private equity investors carry ten votes per share. This practice of using dual-class shares is against the traditional "one share, one vote" principle in company law. The structure benefits the founders of tech firms who will have absolute controlling power over their companies despite not having the majority of shares. Dual-class shares have been widely used by American and Chinese tech companies, such as Google, Facebook and Snap Inc. Richard Qiangdong Liu, the founder and chairman of Nasdaq-listed JD, a leading online B2C shopping portal, owns only 23.7% of shares in JD but has more than 80% of voting rights.[6] Although the dual-share structure is beneficial for the founders of companies, it prejudices the interests of ordinary shareholders and has raised concerns over the abuse of management power. The advocates of such a structure praise it for allowing founders to resist short-termism and to defend hostile takeover bids. At present, the Shanghai and Shenzhen stock exchanges do not permit the dual-class structure and consequently have lost the listing of several tech firms to the New York stock exchange and Nasdaq. Currently, London, Hong Kong and Singapore have been considering introducing dual-class shares as they fear losing their prestigious status as global financial centres, and especially, in terms of attracting IPO business.

Moreover, China's listing rules are particularly strict about the issuer's profitability. PRC Securities Law requires that a company that plans to issue new shares to the public needs to demonstrate sustained profitability and good financial health.[7] The CSRC's IPO regulation further demands that the issuer must make positive profits for the three consecutive accounting years prior to the IPO, and the accumulated profits should exceed CNY30m ($4.61m).[8] In contrast, the listing rules in the US are more lax in relation to a company's profitability. Amazon has made no profits for most quarters over its two-decade trading history.[9] Also, the electric car-marker Tesla made a series of losses after its listing.

HOW DO CDRs WORK?

CDRs are modelled on similar financial instruments such as American Depositary Receipts (ADRs) and European Depositary Receipts (EDRs) which enable US and European investors to purchase the shares of foreign incorporated companies. Depositary receipts originated in the US in the 1920s. Under a depositary receipt arrangement, a portion of the issuing company's shares will be transferred to a custodian bank serving as the broker. The custodian bank will then sell the shares to investors on a stock exchange outside of the country of incorporation. Technically speaking, depositary receipts are not shares. They represent equity interests in foreign companies and allow investors to hold shares through the custodian bank. CDRs are the certificates issued by the custodian bank denoting a pool of foreign equities that will be traded on the Shanghai and

Shenzhen stock exchanges. The objective of issuing CDRs is to lure capital back to the Chinese market to drive economic growth and push forward capital market reform. It will be a convenient method for overseas-listed Chinese companies to dual-list their shares in mainland China with minimal regulatory intervention.

In addition, the issuance of CDRs will give Chinese residents more investment opportunities to purchase shares in some top-tier companies around the world. The potential market scale of CDRs could surpass $1trn. As well as serving listed companies, CDRs will also be utilised by unlisted tech unicorns (a tech start-up with a valuation over $1bn). As of April 2018, there are 234 unicorn companies in the world with a combined valuation of $784bn.[10] The US has 114 unicorns, while China has 65 unicorns including Ant Financial Services Group, Didi Chuxing, Xiaomi and Lufax. All of these unicorns could be potential issuers of CDRs.

REGULATION OF CDR ISSUANCE

On 22 March 2018, the CSRC formally published Opinions for Developing Creative Enterprise Domestic IPO and Pilot Project of Chinese Depositary Receipts, which targets red-chip enterprises and innovative unicorn enterprises in high-tech industries or other emerging industries of strategic importance. It offers such businesses a dual-financing channel to trade on mainland China's stock exchanges. Red-chip enterprises refer to companies that have registered outside the territory of China but their businesses are primarily conducted within China. The pilot CDR projects have to adhere to four principles: serving the national strategy, observing existing laws and regulations, developing orderly and steadily, as well as preventing and controlling risks (protecting the benefits of small and medium investors, strengthening supervision, maintaining financial stability, and curtailing systemic risks).[11]

The Opinions put forward strict thresholds to filter prospective issuers. Issuing companies should conduct businesses in line with the national strategy, master core technologies, receive wide market recognition, and their businesses should fall into the following categories:

- internet;
- big data;
- cloud computing;
- artificial intelligence;
- software and integrated circuits;
- high-end equipment manufacturing;
- biomedical science; and
- other high-tech companies, strategically emerging enterprises, and innovative enterprises that reach certain market scales.[12]

Red-chip enterprises that have already listed in foreign stock exchanges, in light of the Opinions, should have a market value of at least 200bn yuan ($31.23bn) to be qualified as a CDR issuer. For unlisted innovating enterprises including red-chip enterprises and enterprises that have registered domestically, these have to satisfy two conditions. The annual operation revenue of an innovating enterprise should be no less than CNY3bn ($456m) while the valuation of the innovating enterprise should be no less than CNY20bn ($3.1bn). An enterprise which meets the criteria of having a fast-growing amount of revenue, owning self-developed and internationally advanced technology, and having a comparatively dominant position in the industry will be considered by the CSRC which will form an advisory panel to assess its eligibility.

Issuing entities, apart from satisfying the basic listing rules, have to comply with the following requirements:

- The shareholding structure, corporate governance code, and operating specification can comply with the company law and relevant regulations in the jurisdiction where the issuer is incorporated, but the overall level of investor protection rules should be at least the same level of relevant rules under Chinese law; and
- If there exist weighted voting rights, the variable interest entity, and other special arrangements, relevant risks and corporate governance issues should be sufficiently disclosed in the main sections of the prospectus of the company issuing new shares. Relevant methods to protect the interests of investors should also be addressed.[13]

In June 2018, after soliciting public opinion, the CSRC officially released Measures for the Issuance and Trading of Chinese Depositary Receipts.[14] Its promulgation was based on the Opinions, PRC Securities Law and PRC Securities Investment Fund Law. The Measures further explain the policy regarding the issuance and trading of CDRs. The issuance of CDRs is considered a new IPO and the issuer has to satisfy the following requirements:

- Article 13 (1) (2) (3) of PRC Securities Law (the issuer must have a complete and well-operated organisational structure, having the capability of making profits continuously and sound financial health, and not have false records in its financial statements over the past three years and other illegal activities);
- the issuer is a legally incorporated entity that has been operating continuously for over three years. There must be no ownership disputes of the company's major assets;
- the issuer has had the same actual controlling shareholders over the past three years with no significant ownership disputes among the shareholders;
- the issuer, its controlling shareholders, and actual controllers have not conducted illegal activities jeopardising the benefits of investors or the public interest over the past three years;
- the issuer has adopted standardised accounting rules and a sound internal control system;
- directors, auditors and senior managers should have a good reputation, relevant qualifications and good credit records; and
- other regulations of the CSRC.

WHO WILL BE THE FIRST PERSON TO ISSUE CDRs?

Xiaomi is said to be the first company to issue CDRs. Xiaomi is a high-tech company producing smartphones, laptops and other smart electronic devices. On 11 June 2018, the CSRC released Xiaomi's CDR Prospectus which plans to raise $5bn from the sale of depositary

receipts to Chinese investors.[15] According to the Prospectus, Xiaomi will be simultaneously listed on the Hong Kong and Shanghai stock exchanges. The issuance will be based upon Class B common stocks in Shanghai, whereas the number of shares have not yet been disclosed. In 2017, Xiaomi's annual revenue and net profit were CNY114.6bn and CNY3.95bn respectively, which clearly satisfy the issuing standard set by the CSRC.

Apart from Xiaomi, there are a further five potential red-chip businesses which could be among the first cohort of CDR issuers as each of them has a market capitalisation of over CNY200bn: Tencent (Hong Kong-listed, market cap CNY3127.6bn), Alibaba (New York, CNY2926.8bn), Baidu (Nasdaq, CNY489.9bn), JD (Nasdaq, CNY364.1bn) and NetEase (Nasdaq, CNY232bn).

There is no doubt that issuing CDRs will be beneficial for issuers, investors, investment banks and commercial law firms. Issuers can raise further capital from the dual listing in China as well as gain a higher market valuation at home. Investors can purchase shares in high-quality companies. Thus, the overall structure of China's stock markets will be significantly improved. Moreover, it is predicted that CDR issuance will generate CNY2.9-5.7bn income for investment banks in 2018.[16] Clearly, this is a golden opportunity for everyone. ■

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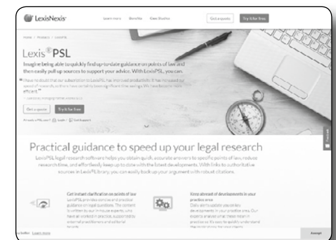

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