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Link to publication record in King's Research Portal

Citation for published version (APA):
Ye, N., & Lu, L. (2019). How to Harness a Unicorn? Demystifying China's Reform of Share Listing Rules and Chinese Depositary Receipts (CDRs). *International Company and Commercial Law Review*, *30*(8), 454-470.

Citing this paper
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Download date: 18. Apr. 2025

How to Harness a Unicorn? Demystifying China's Reform of Share Listing Rules and Chinese Depositary Receipts

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Citation: Ningyao Ye and Lerong Lu, "How to harness a unicorn? Demystifying China's reform of share listing rules and Chinese depositary receipts" (2019) 30 *International Company and Commercial Law Review* 454-470. Available at SSRN: https://ssrn.com/abstract=3384138

Abstract

This article introduces and analyses China's latest reform of securities laws to attract domestic unicorn companies (with a valuation over $1 billion) and tech giants to list or dual-list their shares on mainland China's Shanghai and Shenzhen Stock Exchanges. In the past, most Chinese tech businesses tried to obtain a listing in either Hong Kong or New York to raise funds, owing to China's onerous listing rules and various legal restrictions on critical issues such as the variable interest entity, dual-share structure and the issuers' profitability. However, the recently introduced initial public offering (IPO) green channel and Chinese depositary receipts (CDRs) aim to entice Chinese businesses to list their shares at home. The Chinese smartphone-maker Xiaomi, as well as the British bank HSBC, are said to be the first group of global companies planning to issue CDRs and float their shares in mainland China.

Introduction

Unicorns refer to unlisted tech companies with a valuation of over $1 billion.[1] In 2013, the term was invented by Aileen Lee, a US-based venture capitalist, to describe the statistical scarcity of such successful business ventures. Since 2003, only 0.07% of venture capital (VC)-backed tech start-ups have joined the unicorn club.[2] As of July 2018, there were 248 unicorn companies globally, with a combined valuation of $826 billion.[3] Nonetheless, unicorns have been concentrated in a few countries, in particular, the US (117 unicorns) and China (73 unicorns). The emergence and popularity of unicorn businesses have revealed certain economic implications. First, tech unicorns represent the fast growth and mass application

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[1] "Technology Companies: The Rise and Fall of the Unicorns", *The Economist*, 28 November 2015, p.57.

[2] Aileen Lee, "Welcome to the Unicorn Club: Learning from Billion-Dollar Start-Ups" (2 November 2013), *TechCrunch* available at: *http://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/* [Accessed 7 June 2019].

[3] "The Complete List of Unicorn Companies", *CB Insights* available at: *http://www.cbinsights.com/research-unicorn-companies* [Accessed 7 June 2019].

of internet technologies such as big data, cloud computing, blockchain and artificial intelligence. Secondly, the existence of tech unicorns showcases the power of capital, which is able to multiply the business scale in a short time if entrepreneurs' brilliant ideas and business plans are endorsed by venture capitalists. So far, the first generation of unicorn companies, such as Facebook, LinkedIn, Tencent and Alibaba, have already listed their shares on stock markets from New York to Hong Kong. This has delivered enormous investment profits to their financiers, as the IPO of unicorns is the most desirable exit strategy for VC funds.

The year 2018 witnessed an increasing number of companies across the world joining the elite billion-dollar club. While the US unicorns such as Uber, Airbnb and SpaceX have been widely reported by the media, less attention has been paid to their Chinese counterparts. After the 40-year market-orientated economic reform, China has become the second-largest economy in the world in 2010. The country has fostered a burgeoning high-tech industry as well as holding a large number of VC funds, which are two prerequisites for producing unicorn businesses. Chinese VC funds have been actively investing money in countries including China, the US and Israel. From January to May 2018, they invested $2.4 billion in Silicon Valley start-ups with a focus on communications technology and biotech firms.[4]

According to China's Ministry of Science and Technology, a unicorn company has to satisfy the following criteria: (1) it should be an enterprise incorporated in China with an independent legal entity; (2) it should be established within 10 years from now, and after 2007; (3) it should have received venture capital investments but has not gone public; (4) it should have a valuation of at least $1 billion; and (5) those with a valuation over $10 billion are called super-unicorns or decacorns.[5] At present, the largest unicorn company in China is the Ant Financial Services Group, which has obtained a valuation of $150 billion.[6] Ant Financial was launched in 2003 by the e-commerce giant Alibaba and it has developed into a fully fledged fintech group operating businesses in four areas: mobile payments, online wealth management, online-based banking and big data credit rating.[7] Other well-known Chinese unicorns include Didi Chuxing ($56 billion: car-hailing), Alibaba Cloud ($39 billion: cloud computing), ByteDance ($20 billion: new media) and Lufax ($18.5 billion: fintech).[8]

Despite the success of Chinese tech companies, most of them (e.g. Alibaba, Tencent, Baidu, JD.com and NetEase) have chosen to list their shares on overseas stock markets such as New York and Hong Kong. Alibaba and Tencent have been ranked among the top 10 most valuable brands in the world, along with other US-based multinational companies such as Google, Apple, Amazon, Microsoft and Facebook.[9] As of 15 June 2018, the New York-listed Alibaba was worth $522

[4] Don Weinland, "Chinese VC funds pour $2.4bn into Silicon Valley start-ups" (18 July 2018), *Financial Times* available at: *http://www.ft.com/content/463b162a-8a3d-11e8-b18d-0181731a0340* [Accessed 1 December 2018].

[5] "Ministry of Science and Technology released 2017 unicorn ranking list: who are the winners?" (24 March 2018), *People.cn* available at: *http://it.people.com.cn/n1/2018/0324/c1009-29886916.html* [Accessed 2 July 2019].

[6] Don Weinland, Sherry Fei Ju and Xinning Liu, "Alibaba spin-off eyes $150bn valuation", *Financial Times*, 12 April 2018, p.14.

[7] Lerong Lu, "How a Little Ant Challenges Giant Banks? The Rise of Ant Financial (Alipay)'s Fintech Empire and Relevant Regulatory Concerns" [2018] I.C.C.L.R. 12, 14.

[8] "Ministry of Science and Technology released 2017 unicorn ranking list: who are the winners?" (2018).

[9] David Meyer, "China Now Has 2 of the Top 10 Most Valuable Brands in the World for the First Time" (29 May 2018), *Fortune* available at: *http://fortune.com/2018/05/29/chinese-brands-alibaba-tencent-brandz/* [Accessed 7 June 2019].

billion, while the Hong Kong-listed Tencent was worth HKD 3.9 trillion ($497 billion).[10] The overseas listing of Chinese tech giants is partly due to the rigid and onerous listing rules in mainland China which deter tech entrepreneurs from floating their shares domestically. As a result, most Chinese investors are unable to purchase the shares of tech companies listed abroad, so they have not been able to cash in the fast growth of their favourite brands. For instance, the share price of Tencent has increased 389 times since its listing on the Hong Kong Stock Exchange in 2004, but the largest proportion of investment returns have gone to international investors, including the South African media company Naspers.

In response to this dilemma, the Chinese financial authorities have launched several pilot listing programmes to encourage Chinese tech companies to list or dual-list their shares on the Shanghai or Shenzhen Stock Exchanges. Against this backdrop, this article aims to discuss and analyse the latest reform of share-listing rules in China. The second part explains why tech giants in China have opted for overseas listing by evaluating China's securities regulations. The third part assesses the pilot reform of listing rules which has introduced a fast-track listing procedure for high-tech companies in China (IPO green channel) and the recent case of Foxconn's IPO will be examined. The fourth part considers China's latest policies and regulations to attract foreign-listed Chinese companies to dual-list their shares in mainland China through the issuance of CDRs, while the fifth part analyses the first group of companies that are enrolled in the initial CDR project. Finally, the sixth part will draw a tentative conclusion.

What accounts for the overseas listing of Chinese tech giants?

China holds a multi-tier stock market which is composed of three elements: (1) national stock exchanges: the Shanghai Stock Exchange main board, Shenzhen Stock Exchange main board, Shenzhen small and medium-sized cap board, and Shenzhen growth enterprises market; (2) national over-the-counter (OTC) markets: national equities exchange and quotations (NEEQ); and (3) regional OTC markets: equity exchange centres in each Chinese province. In total, there are over 3,500 companies listed on the Shanghai and Shenzhen Stock Exchanges. Shanghai was ranked the fourth-largest stock exchange in the world in terms of the combined market capitalisation of all companies listed ($5.19 trillion), while Shenzhen was ranked eighth ($3.73 trillion).[11] Despite the gigantic scale of Chinese stock markets, they have been in the early stage of development and have witnessed a high level of volatility over the past decade. For instance, the SSE Composite Index rose from 2,000 points in July 2014 to a peak of 5,166.35 points in June 2015, triggering an equity bubble which drew millions of investors to take a bet on the bullish trend.[12] It was followed by a major correction and a slip into bear market territory, wiping out wealth worth trillions of yuan.

[10] Jacky Wong, "'How Alibaba Built Its Way to Record Sales" (1 February 2018), *The Wall Street Journal* available at: *http://www.wsj.com/articles/how-alibaba-built-its-way-to-record-sales-1517494566* [Accessed 2 July 2019].

[11] Hong Kong Securities and Futures Commission, "Market Capitalisation of the World's Top Stock Exchanges" (March 2018) available at: *http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/a01.pdf* [Accessed 7 June 2019].

[12] Lerong Lu and Longjie Lu, "Unveiling China's Stock Market Bubble: Margin Financing, the Leveraged Bull and Governmental Responses" (2017) 32 J.I.B.L.R. 146, 147.

For a long time, the price-earnings ratio (PE ratio) in China's stock market has been standing at 28–73, much higher than the average figure for mature markets such as the US, the UK and Japan, which is normally between 10 and 15.[13] This means that the same company listed in mainland China can easily obtain a valuation three to four times of a similar listing in overseas markets like Hong Kong, New York and London. Therefore, obtaining a listing in China has been the primary choice for most entrepreneurs. However, the China Securities Regulatory Commission (CSRC), the stock market regulator, possesses the direct power to approve or refuse any IPO applications, depending on whether the IPO is in line with the country's general economic and financial policies. This is different from other developed markets where privately owned stock exchanges can determine the result of IPO applications if issuing companies meet minimum standards.[14] In 2017, the CSRC rejected or deferred 105 IPO applications, 40% of the total applications that the regulator had reviewed.[15]

Although domestic share listing is very attractive to Chinese businesses, the difficulties of getting administrative approval and overcoming other regulatory hurdles have deterred the attempts of many Chinese entrepreneurs. As a result, most Chinese tech giants have chosen to land overseas stock exchanges to dodge strict de jure examination and technical obstacles they would face in domestic IPOs. Apart from that, listing overseas expands the breadth and depth of financing availability as they can gain access to international investors. It is noteworthy that the Chinese financial regulators impose severe restrictions on the adoption of variable interest entities (VIEs) and weighted voting rights, which prevent tech giants that have used such legal structures from listing in mainland China. Additionally, a large percentage of tech enterprises have registered their parent companies in tax havens such as the Cayman Islands and British Virgin Islands, which have lax regulatory standards and lower tax rates. This also conflicts with China's domestic listing rules. We will discuss three main legal and regulatory obstacles faced by tech companies when applying for an IPO in China.

[13] Securities China, "A Share Valuation Near Historical Low" (6 July 2018) available at: *http://stock.jrj.com.cn /2018/07/06063424776808.shtml* [Accessed 7 June 2019].

[14] Gabriel Wildau and Yizhen Jia, "China keeps IPOs on tight leash to protect policy goals", *Financial Times* (17 December 2017) available at: *http://www.ft.com/content/7e4d0e3a-e176-11e7-a8a4-0a1e63a52f9c* [Accessed 20 October 2018].

[15] Wildau and Jia, "China keeps IPOs on tight leash to protect policy goals" (17 December 2017), *Financial Times* available at: *http://www.ft.com/content/7e4d0e3a-e176-11e7-a8a4-0a1e63a52f9c* [Accessed 20 October 2018].

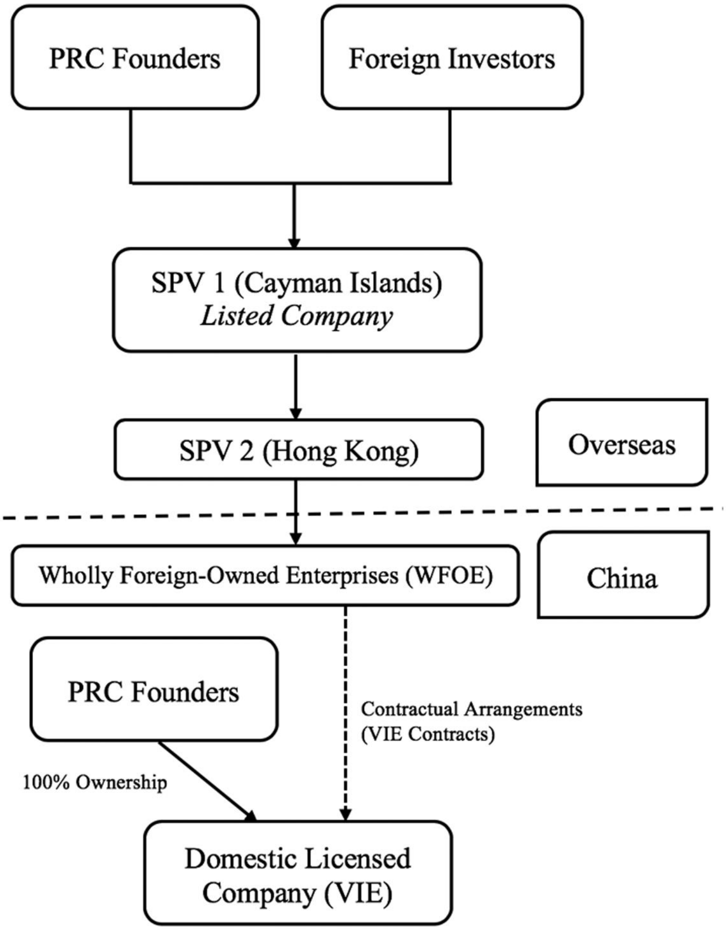
PRC Founders
Foreign Investors
SPV 1 (Cayman Islands)
Listed Company
SPV 2 (Hong Kong)
Overseas
Wholly Foreign-Owned Enterprises (WFOE)
China
PRC Founders
Contractual Arrangements
(VIE Contracts)
100% Ownership
Domestic Licensed
Company (VIE)

Figure 1: A typical VIE structure in China[16]

First, we will discuss the registered place and foreign shareholders. A large proportion of Chinese high-tech companies have adopted a VIE as their legal business structure. VIEs enable foreign investors to evade Beijing's restriction of foreign ownership in companies in certain industries such as the internet, finance, and education. The law in China does not permit foreign capital to own a majority stake in internet companies. However, internet companies often raise considerable funds from foreign VC funds and private equity (PE) funds. For instance, two of the largest shareholders of Alibaba are Softbank (Japan) and Yahoo (US), which own 28.8% and 14.8% of stakes in Alibaba respectively.[17] VIEs allow tech companies to get around the ownership limitation so they can acquire sufficient capital from a large pool of international investors. In practice, the tech firms' offshore parent companies domiciled in the Cayman Islands and other offshore

[16] This chart was compiled by the authors.

[17] Alibaba Group, "FY2018 Annual Report", p.187 available at: *http://otp.investis.com/clients/us/alibaba/SEC/sec - show.aspx?FilingId=12879202&Cik=0001577552&Type=PDF&hasPdf=1* [Accessed 7 June 2019].

financial centres will enter into a series of contracts replicating the ownership in China's operating companies.[18] However, the legal effects of such contractual rights are inferior to those of proprietary rights in the event of litigation, arbitration or insolvency proceedings. In 2014, Alibaba decided to list its shares in New York because its use of VIE had not been accepted by the Chinese securities regulator. Aside from Alibaba, other tech giants such as Baidu, Tencent, Youku and Sohu have also employed the VIE structure, and therefore can only list their shares in overseas markets, predominantly Hong Kong and New York.

Secondly, we discuss the dual-class share structure and weighted voting rights. A company using the dual-class share structure will have two categories of shareholders having different rights: Class A shares sold to public investors will grant their holders one vote per share; Class B shares held by company executives and PE investors carry 10 votes per share. Obviously, the use of dual-class shares is against the conventional "one share, one vote" principle in modern company law. This structure hugely benefits the founders of tech firms who have absolute controlling power over their businesses, 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 Liu, the founder and chairman of the Nasdaq-listed JD.com, an online business-to-consumer (B2C) shopping portal, owns 15.4% of shares in JD.com but he is able to exert 79% of voting rights.[19] Though the dual-share structure is advantageous for the founders of companies, it jeopardises the interests of ordinary shareholders and has raised concerns over the abuse of management power. In contrast, the advocates of such a structure praise it for allowing founders to resist short-termism and to defend hostile takeover bids. Shanghai and Shenzhen stock exchanges do not permit the use of the dual-class structure for public companies and consequently they have lost the listing of several tech firms to the New York Stock Exchange and Nasdaq, which allow the use of such a structure. So far, financial authorities in London, Hong Kong, and Singapore have been considering introducing dual-class shares as they fear losing their prestigious status as international financial centres in terms of attracting lucrative IPO businesses.[20]

Thirdly, we discuss the profitability requirements for prospective share issuers. The share listing rules in China are extremely strict about the issuer's profitability. The Securities Law of the People's Republic of China (PRC) (revised in 2014) (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.[21] The CSRC's IPO regulations further demand that the issuer must make positive profits for three consecutive accounting years prior to the IPO and the accumulated profits should exceed CNY 30 million ($4.61 million).[22] In practice, the stringent profitability requirements are very difficult for tech companies to satisfy since their business models require a long period of time to realise real profits. For

[18] Charles Clover, "Alibaba IPO shows foreign investors able to skirt restrictions" (7 May 2014), *Financial Times* available at: *http://www.ft.com/content/7a8c4816-d5df-11e3-a017-00144feabdc0* [Accessed 1 December 2018].

[19] "The latest shareholding structure of JD.com revealed" (10 May 2019), *Eastmoney* available at: *http://stock.eastmoney.com/a/201905091118284644.html* [Accessed 2 July 2019].

[20] Jennifer Hughes, "Dual class shares make progress in Hong Kong" (26 September 2017), *Financial Times* available at: *http://www.ft.com/content/25348bd8-9dd9-11e7-9a86-4d5a475ba4c5* [Accessed 1 December 2018].

[21] PRC Securities Law 2014 art.13(2).

[22] CSRC, Measures for the Administration of Initial Public Offering and Listing of Stocks (2006) art.33(1).

example, JD.com has spent billions of dollars in the building of its own logistic system and warehouses across China, resulting in constant losses for several financial years.[23] In contrast, the listing rules in the US are laxer regarding a company's profitability. Amazon has made no profits for most quarters over its two-decade trading history.[24] Also, the electric car-marker Tesla made a series of losses after its listing.

Initial public offering green channel—creating a fast track for the listing of unicorn companies

In 2018, the Chinese financial authorities including the CSRC launched several reform measures aiming to attract unicorn companies and foreign-listed Chinese tech firms to list (or relist) their shares in Shanghai and Shenzhen Stock Exchanges. The reform aims to solicit more international capital to China's stock markets and provide more investment opportunities for Chinese residents, as well as improve the market valuation of issuing companies if they are listed at home. On 22 March 2018, the CSRC published *Opinions for Developing Creative Enterprise Domestic IPO and Pilot Project of Chinese Depositary Receipts* (the Opinions)[25] which targets red-chip enterprises and innovating unicorn enterprises that have significant influence on high-tech industries and emerging industries of strategic importance, providing them a dual financing channel to land China's A-shares.[26] According to the Opinions, there will be two principal options for qualified Chinese tech companies to secure a listing in China: (1) issuing CDRs; and (2) launching a new IPO.[27] Red-chip enterprises that have already listed overseas can go through the issuance of CDRs to return China's A-shares. Unlisted red-chip enterprises and innovating unicorn enterprises have the option to be listed in China's A-shares by going for an IPO. Moreover, the Opinions state that the shares and CDRs of pilot enterprises will be traded in Shanghai and Shenzhen stock exchanges with China Securities Depository and Clearing Corporation Limited (CSDC) providing centralised registration, depository and clearance services.[28] The capital raised by pilot enterprises will be denominated in Chinese yuan and the enterprises are allowed to use the raised funds to purchase foreign exchanges or deposits domestically in compliance with Chinese regulations on foreign exchange and foreign capital.

In order to lure unicorn companies to list shares in mainland China's stock exchanges, the Chinese authorities have spent great efforts on streamlining the IPO procedure for high-tech businesses in innovative industries. Traditionally, it costs Chinese companies one to two years to complete relevant procedures to

[23] Cate Cadell, "China's JD.com looks to warehousing assets to help revive profits", (16 August 2018), *Reuters* available at: *http://uk.reuters.com/article/us-jd-com-results/chinas-jd-com-looks-to-warehousing-assets-to-help-revive -profits-idUKKBN1L113H* [Accessed 7 June 2019].

[24] Jon Markman, "The Amazon Era: No Profits, No Problem" (23 May 2017), *Forbes* available at: *http://www .forbes.com/sites/jonmarkman/2017/05/23/the-amazon-era-no-profits-no-problem/* [Accessed 7 June 2019].

[25] CSRC, *Opinions for Developing Creative Domestic IPO and Pilot Project of Chinese Depositary Receipts* (March 2018).

[26] "Red-chip enterprises" refers to companies that have registered outside the territory of China but their businesses are primarily conducted within China.

[27] Opinions (2018), Pt 4.

[28] Opinions (2018), Pt 4.

obtain a public listing in Shanghai or Shenzhen.[29] However, the CSRC has been planning a new "IPO green channel" for unicorn companies from industries such as biosciences, cloud computing, artificial intelligence and advanced manufacturing to have an accelerated IPO procedure which can take only one month to secure the regulatory approval.[30] It is clear that helping these unicorn tech companies to list shares in mainland China has become a top priority for officials from the CSRC, which will form ad hoc panels to consider their IPO applications. Mr Yang Weiming, a member of the Chinese People's Political Consultative Conference and the deputy director of the Central Leading Group on Financial and Economic Affairs, said that

> "establishing the 'IPO green channel' aims to optimise resource allocation, which helps unicorn innovating enterprises gain access to the Chinese capital market and accomplishes the ultimate target of 'Made in China 2025'".[31]

Take the IPO of Foxconn Technology Group (Foxconn) as an example. Foxconn is the largest contract manufacturer in the world, and one of the Fortune Global 500 companies. The company was founded in Taiwan in 1974, and it has been manufacturing industrial robots, cloud computing equipment and other advanced electronics products in mainland China since 1988. Foxconn is known for being the largest manufacturer for Apple's iPhones and Amazon Fire tablets. Foxconn has employed 1.2 million staff globally, including 800,000 workers in mainland China.[32] In 2017, the operation revenue of Foxconn reached CNY 345.5 billion and its net profit amounted to CNY 16.2 billion.[33] Foxconn decided to apply for an ordinary domestic IPO on the Shanghai Stock Exchange, rather than the CDR, simply because the company satisfied all legal requirements of an IPO and did not adopt the VIE structure and weighted voting rights as other most Chinese tech giants have done. Foxconn filed the IPO application on 1 February 2018, and received a final approval from the CSRC on 8 March 2018. Although the IPO application encountered the national holidays of Spring Festival (Chinese New Year) during February 2018, it only took 36 days for Foxconn to obtain the listing approval from the CSRC, which has been the fastest IPO in the history of China's capital market. This has shown the CSRC's determination to attract innovative unicorn companies to be listed in A-share markets.

On 8 June 2018, Foxconn was renamed Foxconn Industrial Internet (stock code: FII) when it officially floated its shares in the Shanghai Stock Exchange. Its public debut turned out to be a great success, for Foxconn began by being traded at 13.77 yuan per share and finally the share price surged 44% to CNY 19.83, the upper

[29] Shi Jing, "Foxconn unit's planned public float progressing at fast pace" (6 March 2018), *China Daily* available at: *http://www.chinadaily.com.cn/a/201803/06/WS5a9defb2a3106e7dcc13fc6b.html* [Accessed 7 June 2019].

[30] Shi Jing, "Foxconn unit's planned public float progressing at fast pace" (6 March 2018), *China Daily* available at: *http://www.chinadaily.com.cn/a/201803/06/WS5a9defb2a3106e7dcc13fc6b.html* [Accessed 7 June 2019].

[31] Keyu Li and Jian Hu, "Unicorn Innovating Enterprises Landing A-shares Provides More Choices for Public" (8 March 2018), *National Business Daily* available at: *http://www.nbd.com.cn/articles/2018-03-08/1197515.html* [Accessed 8 June 2019].

[32] "Where does the 400bn valuation of Foxconn come from?" (11 June 2018), *PE Daily* available at: *http://m.pedaily.cn/news/432289* [Accessed 8 June 2019].

[33] Foxconn, "IPO Prospectus" (February 2018) available at: *http://www.csrc.gov.cn/pub/zjhpublic/G00306202/201802/P020180209563461103749.pdf* [Accessed 8 June 2019].

limit price of first-day trading.[34] It made Foxconn the most valuable tech company in China, with a market capitalisation of CNY 390.6 billion, surpassing Hangzhou Hikvision Digital Technology. Through the public offering of shares, Foxconn raised a capital of CNY 27.1 billion, which was the largest IPO in China since 2015.[35] Obviously, the successful IPO of Foxconn has displayed China's steady financial reforms to reduce regulatory red tape in the area of share issuance, which hopefully will encourage more tech companies to list shares in the domestic share markets.

Chinese depositary receipts—the gateway to dual-list shares in mainland China

In contrast to the IPO green channel which is designed for the unlisted unicorn companies, the mechanism of CDR is made for overseas-listed Chinese companies who wish to dual-list their shares in mainland China. The journey for foreign-listed Chinese companies to travel back to China's capital markets was extremely complicated, time-consuming and costly, prior to the introduction of CDR. In the past, the only feasible method for such companies was to go through the privatisation process (delisting) in the foreign market and then to re-apply for a brand-new IPO in mainland China. After the privatisation, some companies would also consider acquiring or merging with existing public companies that are listed in China to obtain an immediate listing in Shanghai or Shenzhen. The later route is called the borrowing-shell IPO or back-door listing. For example, Qihoo 360 Technology, a Chinese internet security services firm, was originally listed in Nasdaq and announced its $9 billion privatisation plan in 2015, intending to relist at home.[36] After the privatisation process, Qihoo 360 entered into a deal with the Shanghai-listed elevator maker SJEC Corp in late 2017, involving an asset swap plan. It allowed Qihoo 360 to use the shell of SJEC to be traded on the Shanghai Stock Exchange through back-door listing.[37] On 28 February 2018, Qihoo 360 was successfully relisted in Shanghai with a valuation of CNY 385 billion, making it the largest internet company in China.[38]

In contrast to the lengthy and expensive privatisation and relisting procedure, now foreign-listed Chinese companies can go for the latest CDR route. CDR, as a depositary receipt issued by a custodian bank denoting the equity of overseas-listed red-chip enterprises, can be directly traded on the Shanghai and Shenzhen Stock Exchanges. The CDR pilot reform has recently caught media attention. In 2018, the CSRC launched the CDR scheme, hoping to lure capital back to mainland China and lift the Chinese economy, which is currently facing a slowdown. CDR will enable both state and private investors in China to purchase

[34] Xinrong He and Qing Pan, "Foxconn Industrial Internet Surges 44 Percent in Shanghai Trading Debut" (8 June 2018), *Xinhua News* available at: *http://www.xinhuanet.com/fortune/2018-06/08/c_129890780.htm* [Accessed 8 June 2019].

[35] Debby Wu, "Foxconn Industrial Internet Soars in Shanghai Debut" (8 June 2018), *Bloomberg* available at: *https://www.bloomberg.com/news/articles/2018-06-08/terry-gou-s-fii-soars-in-chinese-debut-after-a-4-3-billion-ipo* [Accessed 8 June 2019].

[36] Carlos Tejada, "Qihoo Gets $9 Billion Buyout Offer From CEO" (17 June 2015), *Wall Street Journal* available at: *http://www.wsj.com/articles/qihoo-receives-buyout-offer-from-ceo-1434542416* [Accessed 8 June 2019].

[37] "Qihoo to return to Shanghai via backdoor listing deal with China's SJEC" (3 December 2017), *Reuters* available at: *https://www.reuters.com/article/us-china-qihoo-360/qihoo-to-return-to-shanghai-via-backdoor-listing-deal-with -chinas-sjec-idUSKBN1D304W* [Accessed 8 June 2019].

[38] "Qihoo to return to Shanghai via backdoor listing deal with China's SJEC" (2017).

stocks issued by domestic tech giants. In 2001, CDR was originally proposed by the Hong Kong Special Administrative Region (SAR) Government as many red-chip enterprises expressed their interest in raising funds in mainland China but the plan was shelved owing to various regulatory barriers.[39] In 2016, the People's Bank of China highlighted in its annual report that China was reconsidering the CDR project when a growing number of Chinese businesses went public in the US through issuing American Depositary Receipts (ADRs).[40] According to CITIC Securities, as of the end of 2016, the market scale of global depositary receipt market climbed to $2.9 trillion, and Chinese companies alone accounted for $825.6 billion of total issuance.[41]

CDRs are modelled on similar financial instruments such as ADRs and European depositary receipts (EDRs). Depositary receipts originated in the US in the 1920s, which facilitated US investors to purchase the shares of foreign incorporated companies.[42] 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, but they represent equity interests in foreign companies and allow investors to hold shares through the custodian bank. Thus, 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 main objective of launching CDRs is to attract funds to the Chinese market to boost economic growth and push forward capital markets reform. CDRs will be a convenient tool for overseas-listed Chinese companies to dual-list their shares in mainland China with minimal regulatory interventions. Mr Yan Qingming, the vice-chairman of the CSRC, commented that

> "China has been orderly establishing the CDR system to offer an option for Chinese tech giants listed overseas and unicorn innovating enterprises to come back to mainland China".[43]

[39] Yu Du, "Revealing Unicorn Innovating Enterprises" (13 March 2018), *National Business Daily* available at: *http://www.nbd.com.cn/articles/2018-03-13/1198546.html* [Accessed 8 June 2019].

[40] "Central bank (of China) plans to launch CDR, A-share market could include foreign companies" (21 June 2016), *Yicai* available at: *https://www.yicai.com/news/5031190.html* [Accessed 2 July 2019].

[41] Ziqin Shao and Liang Tian, "CDR is Foundation for International A-shares" (8 March 2018), *Sina Finance* available at: *http://finance.sina.com.cn/stock/marketresearch/2018-03-08/doc-ifxpwyhv9413509.shtml* [Accessed 8 June 2019].

[42] Guy P. Lander, "American Depositary Receipts" (1995) 29 *International Lawyer* 897, 899.

[43] Chunxiang Ouyang, "China Will Establish Chinese Depositary Receipt" (15 March 2018), *China Securities Journal* available at: *http://www.cs.com.cn/zt/2018lh/04/201803/t20180315_5745837.html* [Accessed 8 June 2019].

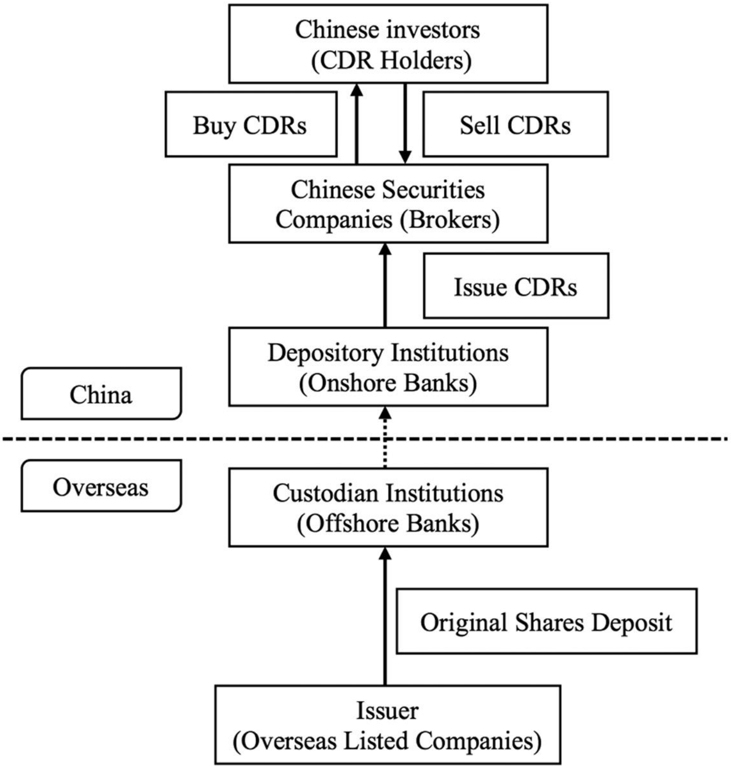
Chinese investors
(CDR Holders)
Buy CDRs
Sell CDRs
Chinese Securities
Companies (Brokers)
Issue CDRs
Depository Institutions
(Onshore Banks)
China
Overseas
Custodian Institutions
(Offshore Banks)
Original Shares Deposit
Issuer
(Overseas Listed Companies)

Figure 2: The operating mechanism of CDRs[44]

The issuance of CDRs will give Chinese residents more investment opportunities to purchase shares in certain top-tier companies around the world. Although China has some of the fastest-growing technology firms, the Chinese people have not yet enjoyed the profits brought by those tech giants. CDRs will also bolster the Chinese stock markets by bringing the trading of the shares of high-quality enterprises to the marketplace. The potential market scale of CDRs could surpass $1 trillion.[45] Aside from serving listed companies, CDRs can be utilised by unlisted tech unicorns such as Ant Financial Services Group, Didi Chuxing and Lufax, which are potential issuers of CDRs. As stated, the CSRC's Opinions in March 2018 promulgated a dual-financing channel for red-chip enterprises and innovative unicorn enterprises in high-tech industries or other emerging industries of strategic importance to be traded on mainland China's stock exchanges. According to the Opinions, the pilot CDR projects have to adhere to the following principles: serving the national strategy, observing existing laws and regulations, developing in an orderly and steady fashion, as well as preventing and controlling financial risks

[44] This chart was compiled by the authors.

[45] Xuelian Zhu, "Five Guess about CDR" (17 March 2018), *China Securities Times* available at: *http://www.nbd.com.cn/articles/2018-03-17/1200015.html* [Accessed 8 June 2019].

(e.g. protecting the benefits of small and medium investors, strengthening supervision, maintaining financial stability and curtailing systemic risks). [46]

The Opinions put forward strict thresholds to filter prospective issuers. Issuing companies should conduct businesses in line with the national strategies, 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.[47]

It should be noted that there have been very strict requirements over the market value of CDR issuers proposed by the CSRC, enabling only a few enterprises to qualify for the pilot scheme. Red-chip enterprises that have already been listed on foreign stock exchanges, in light of the Opinions, should have a market value of at least 200 billion yuan ($31.23 billion) to qualify as a CDR issuer.[48] For unlisted innovating enterprises including red-chip enterprises and companies that have registered domestically, they have to satisfy two conditions: (1) the annual operation revenue of an innovating enterprise should be no less than CNY 3 billion ($456 million); (2) the valuation of the innovating enterprise should be no less than CNY 20 billion ($3.1 billion).[49] 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 a special advisory panel to assess its eligibility case by case.[50] 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 should 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.[51]

[46] Opinions (2018), Pt 2.
[47] Opinions (2018), Pt 3.
[48] Opinions (2018), Pt 3.
[49] Opinions (2018), Pt 3.
[50] Opinions (2018), Pt 3.
[51] Opinions (2018), Pt 5.

On 6 June 2018, after soliciting public opinions, the CSRC officially released *Measures for the Issuance and Trading of Chinese Depositary Receipts* (the Measures).[52] Its promulgation was based on the Opinions, PRC Securities Law (revised 2014) and PRC Securities Investment Fund Law (revised 2015). The Measures further explain the policies 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:

- the issuer must comply with art.13(1), (2), (3) of the 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.

Most significantly, the Measures are trying to address the conflict of laws in different jurisdictions for enterprises that have registered abroad. Article 17 of the Measures completely acknowledges the use of VIE and weighted voting rights, and it highlights that red-chip enterprises should disclose the major differences between the company law of incorporation and the Chinese company law and how this will influence the CDRs and consumer protection in its prospectus document. In particular, enterprises that have been employing VIE and weighted voting rights should fully elaborate on the relevant risks and corporate governance issues and put them in a visible position in the prospectus. A section that specifically explains the consumer protection methods should be included in the prospectus. Article 19 asks the enterprises that have adopted VIE and weighted voting rights to disclose potential risks that Chinese investors will encounter in their periodical reports. Moreover, unlike the issuance of ADRs via business banks in the US, the Measures expand the range of potential custodians which include the CSDC with its subsidiaries, commercial banks approved by the CBRC, and securities companies.

Most recently, the CSRC has released the Decision on Amending the Measures for Issuing and Underwriting Securities (the Decision) to answer the market doubts

[52] Shenliang Liu, "The CSRC Promulgated Rules on CDRs at 6 June 2018" (6 June 2018), *Xinhua* available at: *http://www.xinhuanet.com/fortune/2018-06/08/c_1122954412.htm* [Accessed 8 June 2019].

with respect to the newly launched CDRs.[53] The Decision has made several changes to the original Measures, as it applies to stocks, convertible bonds and CDRs issued in mainland China.[54] A new clause has been added that issuers of CDRs should observe the obligations similar to that followed by issuers of securities and listed companies, and underwriters of CDRs should follow the same rules for underwriters of securities.[55] Besides, the inquiry and pricing relating to CDR issuance has been the most important matter in the latest Decision. Two approaches can be used to determine the issuing price of CDRs: (1) by inquiring offline investors; (2) by direct negotiation between the issuer and the leading underwriter. Offline investors for CDRs refer to individual investors, securities investment fund management companies, securities companies, trust and investment companies, insurance companies, and qualified foreign investors. They have to register at the Securities Association of China (SAC) and comply with following requirements:

- no violation of laws or regulations over the past 12 months;
- individual investors should have over five years' work experience in relation to securities markets;
- investing in CDRs according to existing law;
- having a good credit record, independent professional institutions and personnel;
- having a sound internal risk control that complies with relevant regulations; and
- other requirements.[56]

In addition, institutional investors have to follow the extra requirements to qualify as offline investors for CDRs:

- building up a specialised internal control system to contain moral hazard;
- having in-depth understanding on the prospectus and establishing necessary valuation and pricing models based on scientific, independent, objective, and prudential principles;
- implementing a sound and complete investment decision-making mechanism;
- ensuring that adequate subscriptions have been deposited in banking accounts;
- conducting business in compliance with relevant regulations;
- having good and complete staff training; and
- having a compilation of relevant rules and a backup of data.[57]

If the issuing price of a CDR is to be determined by the issuer and its leading underwriter, only online investors can buy shares.[58] While, through offline inquiries, offline investors have the space to discuss the issuing price with the issuer and the managing underwriter, the number of offline active investors should be more than

[53] CSRC, Decision on Amending the Measures for Issuing and Underwriting Securities (15 June 2018).

[54] Decision, art.1(1).

[55] Decision, art.1(2).

[56] SAC, Administration Rules for Off-line Investors in Initial Public Offerings (15 June 2018), art.4.

[57] SAC, Administration Rules for Off-line Investors in Initial Public Offerings, art.13.

[58] CSRC, Measures for Issuing and Underwriting Securities (13 December 2013), art.9.

10, when a CDR issuance contains no more than 400 million shares; otherwise at least 20 offline investors are needed for a CDR issuance with over 400 million shares.[59] The most noticeable arrangement of the amended Measures is that the Decision not only focuses on the issuers of CDRs but also enables pilot enterprises qualified in the Opinions to provide the allotting of shares to strategic investors, if necessary.[60] It is also noteworthy that underwriters of pilot enterprises are entitled to use the Greenshoe Option to issue stocks or CDRs, in which underwriters will be allowed to sell up to 15% more shares than initial number of shares designed by the issuers in order to offset price fluctuations.[61] The prospectus, filed with the CSRC prior to the IPO, should disclose the number of actual shares and circumstances in connection with the Option. Regarding underwriting, the issuance of either CDRs or securities should follow the same set of rules laid down by the CSRC. Therefore, it can be said that, under the current legal framework, CDRs is considered a similar financial product as traditional securities.

Who will be the first Chinese depositary receipt issuers? Challenges and opportunities

Xiaomi is said to be the first company to issue CDRs to Chinese investors. 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 $5 billion from the sale of depositary receipts to investors in mainland China.[62] 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 but the number of shares has not yet been disclosed. In 2017, Xiaomi's annual revenue and net profit were CNY114.6 billion and CNY 3.95 billion respectively, which clearly satisfy the issuing standard set by the CSRC.[63] Aside from Xiaomi, there are further five potential red-chip businesses that could be among the first cohort of CDR issuers, as each of them has a market capitalisation of over CNY 200 billion: Tencent (Hong Kong-listed, market cap CNY 3127.6 billion), Alibaba (New York, CNY 2926.8 billion), Baidu (Nasdaq, CNY 489.9 billion), JD (Nasdaq, CNY 364.1 billion) and NetEase (Nasdaq, CNY 232 billion).

Most of these potential issuers have claimed that they will be designing and issuing CDRs in mainland China as soon as possible.[64] There is no doubt that the issuance of CDRs will be beneficial for most market participants and relevant parties, including issuers, investors, investment banks and commercial law firms. Despite the fast growth of Baidu, Alibaba, Tencent and JD over the past decade, domestic investors have missed the precious opportunity to invest in their equities. If the pilot scheme succeeds, Chinese investors will soon be able to purchase shares in these high-quality companies. Meanwhile, issuers can raise further capital from

[59] CSRC, Measures for Issuing and Underwriting Securities, art.7.

[60] Decision, art.6.

[61] Decision, art.7.

[62] Xiaomi, "The Prospectus" (11 June 2018) available at: *http://www.csrc.gov.cn/pub/zjhpublic/G00306202/201806/P020180611106685793601.pdf* [Accessed 8 June 2019].

[63] Xiaomi, "The Prospectus".

[64] For example, see JingDong.com and Alibaba: China Business Network, "Alibaba, JingDong.com, Baidu and Xiaomi Are Pursuing the First CDR" (7 June 2018) available at: *https://www.yicai.com/news/5429743.html* [Accessed 8 June 2019].

the dual listing in the Chinese market, which provides great liquidity, as well as gain a higher market valuation at home. In February 2018, after Qihoo 360 was relisted on the Shanghai Stock Exchange, its market capitalisation reached CNY 380 billion ($61.3 billion), which was seven times of its previous valuation (CNY 59 billion, or $9.3 billion) in Nasdaq.[65] It is because domestic investors are more familiar with the business models, services and products of the issuing companies that they are willing to grant them a higher valuation. What is more, China has undergone a bear market for a few years, so bringing well-performing enterprises back to the Chinese market could activate the investment atmosphere and enhance public confidence. Obviously, the overall structure of China's stock market will be significantly improved by the listing of high-tech businesses with strong growth prospects. Finally, leading commercial law firms and investment banks will also be the winners of the pilot CDR scheme, as issuers will pay considerable fees to lawyers, accountants and other financial professionals during the issuance process. It is predicted that CDR issuance will generate CNY 2.9 to 5.7 billion annual income for investment banks.[66]

The CDR scheme also comes with multiple economic and legal challenges. First, it is common that innovating enterprises have unique characteristics regarding their business models and advanced technologies. Therefore, traditional valuation methods will no longer be effective in pricing an innovating enterprise. Since there are no specific provisions under the Opinions or the Measures describing the pricing mechanism for innovating enterprises, it will be difficult for financial regulators, investment bankers and professional institutional investors to decide the market value during public offering. It is recommended that the CSRC and relevant authorities, after accumulating sufficient experience during the trial phase of CDRs, should incorporate the CDR pricing inquiry rules into the *Measures for Issuing and Underwriting Securities*.[67] Another concern is that the pilot enterprises enrolled in the pilot CDR scheme might squeeze the financing recourses and opportunities of other Chinese businesses, especially those in traditional industries. Most pilot CDR issuers have dominant positions in their respective sectors. Once they are traded in Shanghai and Shenzhen, it is highly likely that investors will rush to purchase the stocks of these pilot enterprises. Therefore, the CSRC is recommended to adopt a highly selective approach to filter potential CDR issuers, controlling the quantity and financing scale of issuers. When the CDR market becomes more mature in the future, the CSRC can then extend the scope of pilot enterprises. The last challenge lies in the implementation of CDR-related regulations for the securities regulator. According to the Opinions and the Measures, the CSRC considers the issuance of CDRs as an IPO, which means that the regulator will apply similar rules when they deal with traditional IPOs. However, in practice, there exist substantial differences between IPOs and CDRs, especially the VIE structure and weighted voting rights. As the pilot CDR project is coming soon, it is high time the CSRC drew up detailed rules in terms of how to process the CDR issuance.

[65] "360 Seven Times Market Valuation and Wealth Surge for Zhou Hongyi" (1 March 2018), *Eastmoney* available at: *http://finance.eastmoney.com/news/1344,20180228837820175.html* [Accessed 8 June 2019].

[66] "CDR might generate CNY 50 billion revenue for securities industry" (9 May 2018), *China Securities Journal* available at: *http://cs.com.cn/xwzx/201805/t20180509_5797116.html* [Accessed 2 July 2019].

[67] Decision, Pt 1.

Conclusion

This article has analysed the recent changes of securities laws and public offering rules in China. It focused on the IPO green channel and the CDR regime which aim to attract more Chinese tech companies and innovative businesses in strategically important industries to list their shares on the Shanghai and Shenzhen Stock Exchanges as opposed to overseas share markets. The economic rationale behind China's financial law reforms is fairly simple since they can benefit Chinese investors by offering them better investment opportunities as they can now invest in high-quality tech and innovative companies which are of critical importance to the economy of tomorrow. Moreover, domestic listing will also alleviate the market capitalisation of issuing entities as home investors tend to be better acquainted with the companies' business models and products, which results in a more optimistic valuation. Overall, the reforms will assist Chinese stock markets in capturing more unicorns and strengthen the capital structure and increase the capital allocation efficiency. However, despite the grand policy objectives, the real implementation effects remain to be seen. Currently, the market reaction to the pilot CDR scheme has been mixed. In July 2018, Xiaomi was successfully listed on the Hong Kong Stock Exchange but it announced that it would indefinitely delay its plan to issue CDRs in mainland China without disclosing detailed reasons.[68] In October 2018, the British bank HSBC revealed that it would issue CDRs soon and it will probably become the first foreign company to be listed on China's Stock Exchange via the proposed London–Shanghai Stock Exchange link.[69] At this juncture, China is experiencing many of economic challenges, such as the excessive debt-to-GDP level and the potential trade war with the US.[70] The financial reforms, especially the reform of listing rules and securities regulations, are considered important and necessary for the long-term economic growth in the country.

[68] Julie Zhu and Sijia Jiang, "Xiaomi puts indefinite delay on CDRs in blow to China's plans for tech listings" (23 June 2018), *Reuters* available at: *http://uk.reuters.com/article/uk-xiaomi-ipo/xiaomi-puts-indefinite-delay-on-cdrs-in -blow-to-chinas-plans-for-tech-listings-idUKKBN1JJ03W* [Accessed 8 June 2019].

[69] Don Weinland and Emma Dunkley, "HSBC set to become first foreign company to list in China" (18 October 2018), *Financial Times* available at: *http://www.ft.com/content/e9b519b8-d28b-11e8-a9f2-7574db66bcd5* [Accessed 1 December 2018].

[70] Kelly Olsen, "Trump's trade war is forcing Beijing to retreat from its own anti-debt battle" (19 October 2018), *CNBC* available at: *http://www.cnbc.com/2018/10/19/trade-war-forces-china-to-retreat-in-battle-against-debt -deleveraging.html* [Accessed 8 June 2019].