

CDR: the coming reform of Chinese securities market

Background

During China's 2018 National People's Congress (NPC) and the National Committee of the Chinese People's Political Consultative Conference (CPPCC) (also known as the "two sessions"), representatives from the financial regulatory authorities mentioned several times that Chinese securities market is ready to create several financial tools or carry out efficient mechanisms aiming at attracting overseas-listed Chinese unicorn¹ companies to return. On 30 March 2018, the *Notice of the General Office of the State Council on Forwarding Several Opinions of the China Securities Regulatory Commission on Conducting the Pilot Program of Innovative Enterprises' Issuance of Stocks or Depository Receipts within the Territory of China*² (the Notice) was issued; and the Chinese Depository Receipt (CDR) soon became an important topic for this year's reform of the Chinese securities market.

¹ A unicorn is a privately held startup company valued at over \$1 billion. The term was coined in 2013 by venture capitalist Aileen Lee, choosing the mythical animal to represent the statistical rarity of such successful ventures.

² Circular of the General Office of the State Council on Forwarding the Several Opinions on Launching the Pilot Program of Domestically Issuing Stocks or Depository Receipts by Innovative Enterprises Guo Ban Fa [2018] No.21.

As defined by the Notice, CDRs are securities on the basis of overseas shares issued in China by a depositary and represent the equity of offshore securities. Actually, CDR is a conception similar to the American Depositary Receipt (ADR), aiming to allow eligible non-Chinese companies to indirectly issue securities in China. Since foreign private issuers could not directly issue shares in the US, the ADR facility was firstly carried out to solve this dilemma in 1927.³ Learning from the Notice, as the pioneer of rules, the ADR is an important reference for CDR. Thus, for the primary understanding of CDR, we may first go through how ADR works.

1. A brief introduction to the ADR

An ADR is a negotiable certificate that evidences ownership of American Depositary Receipt, which, in turn, represent an interest in a specified number (or fraction) of a foreign company's shares.⁴ Through this arrangement, quite a few Chinese companies have been successfully listed in the US (mostly via Variable Interest Entity (VIE) structure).

In general, the key to the operation of the ADR depends on two agreements. One is the underlying deposit agreement among the foreign private issuer, the ADR holders and a deposit bank in the US. The other is the custody agreement between the deposit bank and the custodian bank within the issuer's home jurisdiction. The foreign private issuer deposits the company's shares in a custodian bank, and a depositary bank in the US issues the ADRs representing the deposit of shares in a custodian bank. Pursuant to the terms of the underlying deposit agreement, the depositary bank is responsible for providing the ADR holders services, including registration, transfer ownership and liquidation. ADR holders may exchange the ADRs for the representative number of shares in the foreign company. Conversely, those holders of shares in the underlying foreign company may deposit such shares in exchange for ADRs.

³ J.P. Morgan created the first depositary receipt in 1927 for UK retailer Selfridges, find more information on: <https://www.adr.com/Investors/FindOutAboutDRs>.

⁴ *Accessing the U.S. Capital Markets – A Brief Overview for Foreign Private Issuers*, see more information on: <https://www.sec.gov/divisions/corpfm/international/foreign-private-issuers-overview.shtml#III>.

An ADR facility may not be established unless the foreign private issuer is either subject to the reporting requirements under the *Securities Exchange Act* or is exempt from the reporting requirements pursuant to Rule 12g3-2(b) of the *Securities Exchange Act*. Market participants have generally categorized ADRs into several “kinds” or “levels,” depending on the extent to which the foreign company has accessed the US markets.⁵ Please see the following table for a brief summary.

Table 1: Category of ADRs

Category	Issuance	Way of issuing	Trading market	Investor	Requirement for the U.S. Securities and Exchange Commission (SEC) registration
Un-sponsored ADRs	Existing shares	Private placement	Over the Counter (OTC)	Qualified institutional buyers (QIBs)	No
Sponsored ADRs level 1	Existing shares	Private placement	OTC	US Public	Yes; F-6
Sponsored ADRs level 2	Existing shares	Public offering	National exchanges	US Public	Yes; F-6, F-20
Sponsored ADRs level 3	New shares	Public offering	National exchanges	US Public	Yes; F-1, F-3 or F-4
Private-placed ADRs (SEC Rule 144A)	New shares	Private placement	OTC	QIBs	No
ADRs (SEC Regulation S)	New shares	Private placement	Offshore	Foreign investor	No

⁵ *Accessing the U.S. Capital Markets – A Brief Overview for Foreign Private Issuers*, see more information on: <https://www.sec.gov/divisions/corpfin/international/foreign-private-issuers-overview.shtml#III>.

2. What will be CDR?

Several stock markets have transplanted the “depository receipts” facility for years, such as Hong Kong Depository Receipt (HDR), Japanese Depository Receipt (JDR) and Global Depository Receipt (GDR)⁶, and depository receipts usually run in the “similar” pattern to ADR as described above. According to the Notice, the fundamental institutional arrangement of CDR is also analogous. However, for the specific rule-making, each depository receipts product should be “localized” to the stock market, specifically reflecting on the requirements of domestic regulation on the conditions for issuance and listing, trading mechanism, pricing mechanism, procedure for filing, and disclosure standard. The Notice has drawn a blueprint of the CDR rules, which can be summarized as follows.

Table 2: Summary of the issuance condition of CDR under the Notice

Target enterprises	Qualified enterprises	Red-chip enterprises⁷
	Particular industries	The seven high-tech and strategic emerging industries include internet, big data, cloud computing, artificial intelligence, software and integrated circuit, high-end equipment manufacturing, and biological medicine.
	Certain financial test	1. For large red-chip enterprises that have been listed abroad, the market value is no less than RMB200 billion (approximately US\$30 billion). 2. For innovative enterprises that have not been listed overseas (including red-chip enterprises and enterprises registered in the mainland of

⁶ This is typically in Europe and generally made available to institutional investors both outside and within the US.

⁷ According to the Circular, red-chip enterprises mean those companies registered abroad with main business operation in Mainland China.

		<p>China), either of the following requirements shall be met:</p> <ul style="list-style-type: none"> ▶ The latest year's operating income is not less than RMB3 billion (approximately US\$0.4 billion) and the valuation is not less than RMB20 billion (approximately US\$3 billion). ▶ The operating income grows rapidly, having relatively advantaged position in the same industry competition, with independent research and development, and international leading technologies.
<p>Pilot scheme for the CDR</p>	<p>Conditions for issuing CDRs</p>	<ol style="list-style-type: none"> 1. In accordance with the approval procedures for issuance of shares, the industrial advisory committee under CSRC (as defined below) shall examine and approve the application for the issuance of the red-chip enterprises' CDRs in accordance with the law. 2. In addition to complying with basic conditions of stock issuance specified in the securities law, the following requirements shall be met: <ul style="list-style-type: none"> ▶ The ownership structure, corporate governance, operation specification and other issues may apply to company law, other laws and regulations in overseas registered jurisdiction. However, the protection standard of investors' rights and interests should in no case be lower than the requirements of domestic law. ▶ In case of voting rights differences, VIE structure or similar special arrangements, relevant information, especially risks, corporate governance, and measures to implement provisions protecting investors' legitimate rights in accordance with laws should be disclosed fully in the prospectus and

		other public offering documents.
Investor protection	<p>1. When issuing CDRs, it is necessary to ensure that the holders of CDRs have equal rights with the holders of the overseas stocks, and depositors shall exercise the rights of the overseas stock issuers on behalf of the domestic investors.</p> <p>2. When legal rights and interests of investors are damaged, the experimental enterprises should ensure that the domestic investors are compensated fairly with foreign investors.</p>	

In essence, the Notice can be considered as a policy guide. Specific supporting rules for CDR shall be further made by the Chinese Securities Regulatory Commission (CSRC) in accordance with Securities Law of the People's Republic of China (PRC) and the Notice, such as the legal nature of CDR and the regarding legal relationships, the specific requirements, and methods of conversion between CDRs and basic securities. But at least for the moment, we can learn from the Notice that only enterprises from certain industries may benefit from the implementation of CDR. And for careful consideration, the CSRC will set up an industrial advisory committee on scientific and technological innovation to make preliminary qualification review on the CDR issuing applicants. In short, very strict entry restriction is imposed on CDR applicants.

3. Breakthroughs of the Notice

The Notice has made public the most important breakthrough of CDR rule-making under the Chinese legal system: the harmonization of dual share structure.

Dual share structure is very commonly used for unicorn companies listed in the US, which means the founders of companies can have “super-voting” power in general meetings so that they can keep controlling the management of company matters. Because of the prohibition of the *Securities Law* of 1933, public investors in the US cannot directly hold the ordinary shares of a listed company, but the ADRs

representing the shares issued by the company. An ADR is not issued by the foreign private issuer, but by the depositary bank in the US, and as a result, ADR holders are not recognized as shareholders of the company. But ADR holders can exercise their right to dividend and vote through the depositary bank pursuant to the underlying depositary agreement. Because of the arrangement of dual share structure, “the voting right” of ADR holders is not equal to share proportions their ADRs represent. For most Chinese unicorn companies listed in the US, the dual share structure is an inseparable part for their management system.

However, according to Article 103 of the *Company Law*, each share shall have one vote at a general meeting, which means, “one-share, one-vote” is a very critical foundation for Chinese regulations to protect public investors. But as for CDR, the Notice clearly recognizes the arrangement of dual share class, under the condition that holders of CDR shall have equal rights with the holders of the overseas stocks. On one hand, this reflects the determination at the maximum degree to promote the CDR reform in China securities market; on the other hand, companies that the Notice targeted for shall be cautious because they are subject to the laws of other jurisdictions. Legal differences thereof may lie as the barrier for the sound protection on Chinese investor.

The other issue shall be noted is the Notice also grants the CDR with the capital freedom at large tolerance. The currency of the CDR can be renminbi or US dollar, and the capital can be remitted outbound or used domestically. However, as the Chinese Government still imposes strict foreign exchange control on capital account, the discretion of currency convertibility and free transferability of CDR capital may be doubted.

In other words, breakthroughs also bring challenges for CDR rule makers. In order to make blueprint of CDR under the Notice come true, related laws or regulations, more than just Securities Law, have to be modified accordingly. For example, the *Company Law* may be amended to embrace the dual share class, and foreign exchange regulations may open a special door for CDR.

4. Conclusion

The introduction of CDR will be a big step for the further internationalization of Chinese securities market, which also can be considered as a “shortcut” for Chinese unicorn companies listed overseas to return to the A-share market, without the requirement of delisting and VIE structure removing. This is the reason why CDR is so expectable by Chinese securities market.

As the Notice is only a policy guideline, more detailed implementation rules of CDR need to be further stipulated by CSRC and legal modification shall also be made to keep the sound operation of CDR facility. Undoubtedly, the issuance of specific CDR rules is a challenging project for Chinese rule-makers, but the meaning of CDR to China securities market make it worthy.

For more information, you may contact Mr. Haoxiong Jiang at hxjiang@eylawgc.com or Mr. Arthur Chen at czj@eylawgc.com.

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