

Hong Kong Capital Markets Update

ISSUE 2018-06 | July 2018

CSRC rules on Chinese Depository Receipts (CDR)

The China Securities Regulatory Commission (CSRC) recently published [the "Chinese Depository Receipt \(CDR\) Issuance and Trading Administrative Measures \(Trial\)"](#) and other rules in relation to the issuance of shares and CDRs by pilot innovative enterprises. The rules came into force on 6 June 2018, the date of promulgation.

The introduction of CDRs is expected to lure Chinese "tech unicorns" to float on the mainland exchanges. The move came shortly after HKEX adopted its new listing regime for "new economy" companies. Together, these regulatory changes provide additional strategic financing platforms for innovative Chinese enterprises.

This *Capital Markets Update* provides an overview of the relevant requirements for an unlisted or overseas-listed pilot red chip enterprise¹ to issue CDRs.

Overview of CDRs

CDRs are securities issued by a depository in mainland China, which are backed by and represent an interest in underlying overseas shares. In addition to the issuer of the underlying overseas shares, a typical depository arrangement also involves three other parties: depository, custodian and depository receipt holder.

Depository is a domestic legal person holding the underlying overseas shares. It also issues the corresponding CDRs to represent interest in the underlying overseas shares.

Custodian is a financial institution entrusted by the depository to deposit the underlying overseas shares.

Depository receipt holder is a holder of the CDRs issued by the depository. They can enjoy benefits associated with the underlying overseas shares, such as entitlement to dividends and exercising voting rights. However, since CDR holders are not shareholders recorded in the shareholder register, they are unable to exercise shareholder rights directly. Instead, they have to exercise their rights through the depository.

Eligibility of pilot red chip enterprises

Selection process

As CDRs are still in its pilot phase, the newly formed Technology Innovation Consultation Committee of the CSRC will conduct a preliminary assessment of the eligibility of applicants. The CSRC then selects pilot red chip enterprises using that as a reference.

Industry requirements

Pilot red chip enterprises must be innovative enterprises from high-technology and strategically important emerging industries such as internet, big data, cloud computing, artificial intelligence, software and integrated circuit, high-end equipment manufacturing and biomedical industries.

Company scale

Overseas-listed pilot red-chip enterprises

- Must have a market capitalisation of no less than RMB 200 billion

Unlisted pilot red-chip enterprises

Must meet one of the following criteria:

- The audited revenue from principal business for the latest financial year shall be no less than RMB 3 billion and the valuation of the enterprise shall be no less than RMB 20 billion; or
- Meet CSRC requirements on research and development capabilities, patents and market competitiveness, while at the same time fulfill the following requirements:
 - Achieve a compound annual growth rate (CAGR) of over 30% for its operating income in the latest three financial years;
 - The audited revenue from principal business for the latest financial year is not less than RMB 1 billion; and
 - Research and development expenditure account for more than 10% of the total revenue of its principal business in the latest three financial years.

¹ Red chip enterprise refers to an enterprise incorporated outside mainland China, but whose main business activity is in the country.

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These requirements can be waived if a pilot red chip enterprise is important to the country's innovative development strategy and has strong development potential.

Listing criteria

Pilot red chip enterprises applying for a listing of CDRs are required to comply with the relevant requirements under the *Securities Law of the People's Republic of China* (Securities Law) and the *Chinese Depository Receipt Issuance and Trading Administrative Measures (Trial)*. This includes having a three-year track record, no significant dispute over the ownership of assets, no change in the controlling shareholders for the latest three financial years and no significant non-compliance issues.

The pilot red chip enterprises can maintain its existing shareholding structure, corporate governance structure and other operating practices, which are allowed under the laws and regulations in the jurisdiction of incorporation. However, the standard of the investor protection measures in place must not be inferior to those required by the laws and regulations in mainland China. If the pilot red chip enterprises have special arrangements, such as weighted voting rights and variable interest entity structures, the arrangements and their associated risks should be disclosed in a prominent position in the prospectus. Additional investor protection measures should be implemented, including imposing restrictions over the transfer or increase of weighted voting rights.

Review and approval process

For public offering of CDRs, the pilot red chip enterprise should submit an application to the CSRC. The Public Offering Review Committee will vet the application in accordance with the Securities Law and other regulations issued the CSRC.

Simplified procedures are available if the CDRs are targeting qualified investors. Specific procedures will be determined accordingly by the CSRC.

Financial reporting, internal controls and other financial information

Financial reporting

A pilot red chip enterprise can choose to prepare its financial statements in accordance with the Chinese Accounting Standards for Business Enterprises (CASBE) or other equivalent accounting standards recognised by the Ministry of Finance. If the pilot red chip enterprise is listed overseas, it should disclose by way of a note to the financial statements a reconciliation of the financial information disclosed in its domestic and foreign financial statements.

If a pilot red chip enterprise prepares its financial statements in accordance with International Financial Reporting Standards (IFRS) or the Generally Accepted Accounting

Principles (GAAP) in the United States, it should prepare a statement of adjustments to show how such financial statements can be adjusted to conform to CASBE.

The financial statements and statements of adjustments (if any) should be audited by a mainland China accounting firm with appropriate qualifications in accordance with mainland China auditing standards.

Internal controls

The pilot red chip enterprise should have appropriate internal controls in place to ensure the entity's operating efficiency, compliance with laws and regulations and reliability of financial reporting. In addition, it should engage a mainland China accounting firm with appropriate qualifications to perform attestations over its internal controls in accordance with mainland China auditing standards.

Other financial information

In addition, pilot red chip enterprises are required to submit other relevant financial information to the CSRC such as tax payment information and underlying financial statements for principal operating entities. These requirements are similar to those of a regular initial public offering.

Investor protection measures

The CSRC has imposed a series of additional investor protection measures in response to industry-specific risks and pilot red chip enterprises with variable interest entity and/or weighted voting rights structures. This includes:

- CDR holders shall enjoy the same rights and interests as the shareholders of the underlying overseas shares;
- Pilot red chip enterprises with variable interest entity and/or weighted voting rights structures should fully disclose the relevant risks. They should not abuse such special arrangements to infringe upon the CDR holders' legitimate rights;
- The underlying overseas shares of CDRs are separated from the assets of the depository and custodian in order to ensure the safety of the underlying overseas shares;
- The controlling shareholder should undertake not to give up its status as a controlling shareholder for at least three years following the listing of CDRs.

Conclusion

The launch of the pilot CDR rules is a key reform initiative aimed at attracting pilot red chip enterprises back to the A-share market.

CDRs can increase the presence of innovative enterprises in China's domestic capital markets, optimising the market structure and aligning with global markets. Moreover, it enhances the role of the capital markets as a key financing platform to support the development of technology and innovation and promote industrial reforms.

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