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# Introducing Chinese depositary receipts to accommodate red-chips: context, functioning, barriers and implications

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## ABSTRACT

Having developed into a market of global size over the past three decades, the Chinese securities market has nonetheless missed many red-chips due to its long-standing taboo on such issuers. Against the backdrop of global regulatory competition and its economic downturn, however, China has recently turned to enfranchise red-chips to float domestically with the introduction of Chinese depositary receipts to serve as the listing and trading instrument, thus catching the spotlight on the functioning and effectiveness of this regulatory shift in promoting market development. This article examines China's regulatory reform of introducing Chinese depositary receipts to accommodate red-chips, canvassing the functioning of this regulatory shift, exploring the post-reform market landscape based on hand-collected data, looking into the regulatory barriers and seeking policy implications in the context of regulatory competition. This article finds red-chips' sparse domestic flotation with the use of Chinese depositary receipts in the post-reform era and suggests policymakers relax the market entry regulation and construct a Sino-Hong Kong common securities market based on stock connects to accommodate red-chips.

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## I. Introduction

In the era of financial globalization, issuers have more freedom to choose listing venues that can best suit their needs.<sup>1</sup> Correspondingly, financial centres worldwide are conducting regulatory competition by means of changing their listing rules to attract issuers.<sup>2</sup> Chinese issuers have long been the targets of global financial centres.<sup>3</sup> Over the past few decades, a multitude of Chinese issuers have pursued jurisdictional shopping by

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<sup>1</sup>Fa Chen, 'Does the Dual-Class Share Structure Help Stock Markets Attract Issuers? Empirical Lessons from Global Financial Centres' (2023) 43 *Legal Studies* 159, 159.

<sup>2</sup>Lars Hornuf and Julia Lindner, 'The End of Regulatory Competition in European Company Law' (2014) *Andrássy Working Paper Series* No 33, 3; see also Eva-Maria Kieninger, 'The Legal Framework of Regulatory Competition Based on Corporate Mobility: EU and US Compared' (2004) 6 *German Law Journal* 741, 741.

<sup>3</sup>Jiangyu Wang, 'Regulatory Competition and Cooperation between Securities Markets in Hong Kong and Mainland China' (2009) 4 *Capital Markets Law Journal* 383, 403.

floating in overseas stock exchanges, in particular, in Hong Kong and New York, despite the fact that the Chinese securities market has developed into a market of global size with both the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) joining the global top 10 in terms of the market capitalization, annually-raised funds and trading volume.<sup>4</sup> At the end of 2021, the Hong Kong Stock Exchange (HKEX) had 2,572 listed issuers with 1,368 of them coming from China.<sup>5</sup> Of these, 174 were companies that were incorporated outside of China and controlled by Chinese governments, and 898 were companies that were incorporated outside of China and controlled by Chinese individuals, which respectively contributed to 11.62 per cent and 51.89 per cent of the total market capitalization of the HKEX.<sup>6</sup> Also, from 2000 to 2019, 244 Chinese companies (excluding SOEs) were listed on the NYSE or NASDAQ, which were all incorporated overseas but had their main business operation in China.<sup>7</sup>

In the Chinese securities market parlance, Chinese companies that are incorporated overseas with their main business operation in China, regardless of whether they are listed or not, are defined as red-chips.<sup>8</sup> Red-chips include Chinese SOEs, but this article focuses on those that are not state-owned. The reason for concentrating on privately-controlled red-chips is that China can determine the listing venue of state-owned red-chips, and thus, accommodating state-owned red-chips is not a policy priority of China's recent securities regulation reforms. For terminological brevity, red-chips referred to in this article mean the privately-controlled sub-set unless otherwise specified.

Red-chips usually have a big business scale and large market share with the potential and ability to develop a large market capitalization. Thus, for China, reshaping the market to accommodate red-chips so as to underpin economic development is a crucial goal of conducting regulatory competition. However, since red-chips are incorporated overseas, they are not allowed to issue shares in the Chinese securities market.<sup>9</sup> This is the background against which moves by Chinese authorities to introduce Chinese depositary receipts (CDRs) as a trading instrument fungible with shares to enable red-chips to float domestically are to be considered.<sup>10</sup>

Six years or so have elapsed since China introduced CDRs to accommodate red-chips in 2018. Notwithstanding not very long experience, it is nevertheless possible to draw some conclusions and seek early implications. Has the supply-front reform of introducing CDRs

<sup>4</sup>At the end of 2017, the SSE was ranked the 4th in market capitalization, the 3rd in annually-raised funds, and the 4th in annual trading volume; whilst for the SZSE, the corresponding rankings were the 8th, the 2nd, and the 3rd respectively. Source: WFE Stock Market Ranking (2017). For the purpose of this article, China means the Mainland. Accordingly, Chinese issuers mean the issuers from the Mainland.

<sup>5</sup>HKEX, 'Fact Book 2021', 1 <[https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/HKEX-Fact-Book/HKEX-Fact-Book-2021/FB\\_2021.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/HKEX-Fact-Book/HKEX-Fact-Book-2021/FB_2021.pdf)>. Unless otherwise stated, all URLs in this article were last accessed on 15 September 2024.

<sup>6</sup>Ibid. The ratios of market capitalization are calculated by the authors.

<sup>7</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

<sup>8</sup>Notice of the General Office of the State Council on Forwarding the Several Opinions of the China Securities Regulatory Commission on Launching the Pilot Programme of Issuing Shares or Depositary Receipts Onshore by Innovative Enterprises 2018 (国务院办公厅转发证监会关于开展创新企业境内发行股票或存托凭证试点若干意见的通知 2018) (Notice of Issuing CDRs 2018), Art 3. It is worth noting that red-chips are used in the HKEX from the 1990s in a narrower sense to denote 'enterprises that are incorporated outside of the Mainland and are controlled by Mainland Government entities', see HKEX, 'Market Statistics 2022', 9 <[https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/e\\_2022-Market-Statistics.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/e_2022-Market-Statistics.pdf)>.

<sup>9</sup>Under special circumstances, certain red-chips are allowed to issue shares directly to achieve a Chinese listing. However, Chinese authorities do not define the circumstances under which red-chips are allowed to issue shares instead of CDRs. See Notice of Issuing CDRs 2018 (n 8), Art 4.

<sup>10</sup>Ibid.

satisfied the listing needs of target issuers on the demand side, i.e. the red-chips? If so, to what extent? If not, what are the barriers and implications?

Aiming to examine China's securities regulation reform of introducing CDRs to accommodate red-chips, this article proceeds as follows: Section 2 canvasses the context of accommodating red-chips in the Chinese securities market. Section 3 examines the functioning of CDRs and looks into the post-reform market landscape of red-chips' use of CDRs, based on hand-collected data. Section 4 explains the sparse use of CDRs in two dimensions, i.e. China's over reliance on market entry regulation for investor protection and China's political economy of prioritizing Hong Kong's securities market development. Based on the findings of Section 4, Section 5 seeks policy implications. Section 6 concludes.

## **II. The context of accommodating red-chips in the Chinese securities market**

The Chinese securities market has achieved some profound successes over the past three decades, but it has missed a multitude of red-chips which have floated overseas, predominantly in Hong Kong and the US. Red-chips usually have a big business scale and large market share, and perhaps more importantly, the potential and ability to develop a large market capitalization. The Hong Kong/US-listed red-chips include many 'big-tech companies' with tremendous business achievement,<sup>11</sup> such as Baidu, Alibaba, Tencent and Xiaomi, the Chinese equivalent to 'GAFA'.<sup>12</sup> However, owing to their overseas listings, red-chips' business success cannot be shared by either the Chinese securities market or domestic investors. Therefore, it bears economic importance to retain red-chips in the Chinese securities market. In a broader sense, against the backdrop of its recent economic slowdown, China has the motivation to retain unlisted red-chips at home and channel overseas-listed red-chips back to its securities market to underpin market growth.<sup>13</sup>

On these grounds, making the Chinese bourses the flotation venue of choices for unlisted red-chips and facilitating certain overseas-listed red-chips to come back home are vital driving forces behind the recent regulatory changes in the Chinese securities market. This section canvasses the economic significance of conducting regulatory competition for listing red-chips to explain such a policy goal so as to provide a context for the whole article.

### **A. For red-chips as issuers**

Issuers may float their shares in a regulated stock exchange for a variety of reasons. An important advantage of going public is to raise capital that is otherwise not available. Securities markets can 'help companies that are in need of capital raise money from investors who have it'.<sup>14</sup> It is particularly the case when companies need funding to cover the

<sup>11</sup>Big-tech companies are defined in Rana Foroohar, 'We need to talk about Big Tech' (Financial Times, 3 October 2017), <<https://www.ft.com/content/64a20c34-a769-11e7-93c5-648314d2c72c>>.

<sup>12</sup>GAFA is in short for Google (now renamed to Alphabet), Amazon, Facebook (now renamed to Meta) and Apple.

<sup>13</sup>See Chunxiang Ouyang, 'Qingmin Yan (Vice-Chairman of the CSRC): China will soon introduce Chinese Depositary Receipts and select a batch of unicorn enterprises' (China Securities Journal, 15 March 2018), <[http://www.cs.com.cn/zt/2018lh/04/201803/t20180315\\_5745837.html](http://www.cs.com.cn/zt/2018lh/04/201803/t20180315_5745837.html)>.

<sup>14</sup>William Wright and Tracy Blackwell, 'Stock Exchanges Can Reunite Society with Capitalism' (The Daily Telegraph, 12 June 2019), <<https://www.pensioncorporation.com/content/dam/pic/corporate/documents/news-and-insight/insight/2019/Daily-Telegraph-Stock-exchanges-can-reunite-society-with-capitalism.pdf.downloadasset.pdf>>.

research and development (R&D) costs for innovative but uncertain projects. Where lenders such as banks hesitate to offer debt financing, securities market investors, upon expecting the potential share price rise in thriving companies, may be happy to bear the risks of buying into those companies for investment returns.<sup>15</sup>

Also, for owners of a company, publicly traded shares in a securities market provide them with a means of paying for acquisition activities which would be unavailable if the company stayed privately held.<sup>16</sup> For instance, Youku Inc, a former US-listed red-chip engaging in China's online video industry, acquired its competitor Tudou Inc in 2012 by using its then listed shares as the acquisition currency.<sup>17</sup>

In addition, many red-chips are backed by private equity funds and are often contractually obliged to go public in a prescribed period. Only by achieving a successful exit can involved fund managers return the profits to the fund investors and get carried interest themselves, and thus, fund managers often orchestrate fund exit arrangements as early as making an investment.<sup>18</sup> In China's private equity market, fund managers often use a value adjustment mechanism (VAM) to ensure investment returns. Under a VAM, the investee is required to cross a given financial threshold or achieve an initial public offering (IPO) at a given market valuation within a prescribed time agreed in the fund investment agreement, which would otherwise compensate the fund by cash or extra equity stake<sup>19</sup> or buy back the fund's equity stake at a price equal to its initial payment plus a prescribed annual compound interest no lower than the hurdle rate. Even though there are other exit routes apart from IPO, such as a trade sale to a buyer in the investee's same industry and a secondary sale to another private equity fund,<sup>20</sup> the contractual obligation under a VAM sometimes serves as an effective driver to move red-chips backed by private equity funds to securities markets.

Notwithstanding the benefits and motivations of going public in the general sense, it does not mean red-chips need to float in China, in particular, given that they usually have a big business size with the capacity to pursue jurisdictional shopping. However, reforming the Chinese securities market has provided an alternative venue for red-chips to avail the benefits of flotation. Moreover, the average price/earnings (P/E) ratios of the Shanghai Stock Exchange Sci-tech Innovation Board (SSE STAR Board) and SZSE ChiNext Board are 2-3 times larger than their US and Hong Kong counterparts.<sup>21</sup> Thus, going public domestically would grant red-chips a much larger market capitalization than floating overseas, *ceteris paribus*. Apart from the general and special benefits of going public domestically for red-chips as issuers, accommodating red-chips may also be in the interests of Chinese investors.

<sup>15</sup>Bobby V Reddy, 'Finding the British Google: Relaxing the Prohibition of Dual-Class Stock from the Premium-Tier of the London Stock Exchange' (2020) 79 Cambridge Law Journal 315, 318.

<sup>16</sup>Ugur Celikyurt, Merih Sevilir and Anil Shivdasani, 'Going Public to Acquire? The Acquisition Motive in IPOs' (2010) 96 Journal of Financial Economics 345, 346 and 362.

<sup>17</sup>See Gao Yuan, 'Youku, Tudou Announced Completion of Merger' (China Daily, 24 August 2012), <[https://www.chinadaily.com.cn/business/2012-08/24/content\\_16059726.htm](https://www.chinadaily.com.cn/business/2012-08/24/content_16059726.htm)>.

<sup>18</sup>Philip Sanderson and Ropes & Gray, 'Preparing for exit' in David Walker (ed), *Private Equity Exits: A Practical Analysis* (2nd edn, Globe Law and Business Limited) 7.

<sup>19</sup>See Terence Foo, 'Chinese Courts Rule on Value Adjustment Mechanism – Impact on PE Investments', <[https://www.cliffordchance.com/briefings/2013-01/chinese\\_courts\\_ruleonvalueadjustmentmechanis.html](https://www.cliffordchance.com/briefings/2013-01/chinese_courts_ruleonvalueadjustmentmechanis.html)>.

<sup>20</sup>Darryl J Cooke, *Private Equity: Law and Practice* (4th edn, Sweet & Maxwell 2018) 207.

<sup>21</sup>In developed securities markets, the price/earnings ratio is usually between 15 and 20, see Robin Hui Huang, *Securities and Capital Markets Law in China* (OUP 2014) 19. However, as at 31 December 2021, the price/earnings ratio of the SSE STAR Board and SZSE ChiNext Board were 62.30 and 52.51 respectively. Source: SSE and SZSE official websites.

## **B. For Chinese investors**

Investors in the Chinese securities market can be divided into domestic investors and foreign investors. China has not fully opened its securities market to foreign investors thus far. Instead, foreign investors can access the Chinese securities market via limited routes.<sup>22</sup> Although China has been increasingly opening up its securities market to foreign investors, domestic investors remain the mainstay of the investor base. Take the SSE for example: at the end of 2022, Chinese investors' hold value accounted for 97.3 per cent of the total market capitalization of the SSE.<sup>23</sup> Given that, this subsection considers the benefits of accommodating red-chips from the perspective of Chinese investors.

For many investors, in particular retail investors, buying into publicly traded companies represents 'the cheapest and most accessible way' that they can participate in the growth of those companies.<sup>24</sup> As Chinese investors form the main investor base of the Chinese securities market, accommodating red-chips' IPOs would mean that Chinese investors would have the opportunity to share in those red-chips' business success. On 31 December 2019, 19 of the top 20 US-listed Chinese red-chips in market capitalization had a last sale above the IPO price; of these, the last sale of all the top five was at least 1.85 times of their respective IPO price.<sup>25</sup> It means that if those red-chips were listed domestically, Chinese investors would have had opportunities to share in a substantial proportion of their business upside.

Apart from retaining unlisted red-chips in the Chinese securities market to enable domestic investors to get in at the ground floor with IPOs, bringing overseas-listed red-chips home, such as by a two-step delisting (from their overseas listing venue) and relisting (in a Chinese bourse) process, can provide Chinese investors with opportunities to participate in their future business growth. In a similar vein, if certain overseas-listed red-chips return partially to the Chinese securities market through conducting Chinese secondary public offerings (SPOs), this can offer opportunities to Chinese investors to share in these red-chips' future business success.

## **C. For the Chinese securities market**

Entering into the regulatory competition for listing red-chips is also meaningful to the Chinese securities market. The Chinese securities market has achieved remarkable development over the past three decades, which has nevertheless presented some weaknesses as well. In the post-financial crisis era, the number of companies listed in China increased steadily (except for 2013, in which the number declined slightly as compared to 2012).<sup>26</sup> However, those listed companies have a relatively small average business size.

<sup>22</sup>The available routes for foreign investors to access China's A-share market are to get licensed under the Qualified Foreign Institutional Investor (QFII) scheme and trade the shares of selected issuers listed in China via the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Shanghai-London Stock Connect.

<sup>23</sup>SSE, 'Shanghai Stock Exchange Statistics Annual 2023', 745 <<http://www.sse.com.cn/aboutus/publication/yearly/documents/c/5733825.pdf>>.

<sup>24</sup>Duncan Lamont, 'What is the Point of the Equity Market?' (Schroeders, 4 November 2019), <<https://www.schroders.com/en-gb/uk/intermediary/insights/what-is-the-point-of-the-equity-market/>>.

<sup>25</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

<sup>26</sup>See details in the China Securities Regulatory Commission Annual Reports 2009–2022, available at <[http://www.csrc.gov.cn/csrc/c100024/common\\_list.shtml](http://www.csrc.gov.cn/csrc/c100024/common_list.shtml)>.

At the end of 2019, the Chinese securities market had 3,777 listed companies with a total market capitalization of RMB 59.29 trillion (US\$ 8.47 trillion),<sup>27</sup> compared to 5,524 companies listed in the US<sup>28</sup> with a combined market capitalization of US\$ 33.91 trillion.<sup>29</sup> This means that the average size of companies quoted in the Chinese securities market (US\$ 2.24 billion) was merely around one-third of the average market value of US-listed companies (US\$ 6.13 billion).<sup>30</sup>

The comparison between companies quoted in China and red-chips listed in the US is more indicative. On 31 December 2019, 147 red-chips were listed in the US with a market capitalization of US\$ 7.14 billion on average, which was larger than the average market value of companies publicly traded in the US (US\$ 6.13 billion).<sup>31</sup> More importantly, the 147 red-chips had a combined market capitalization of US\$ 1,049.4 billion, equating to 3.9 per cent of the 3,777 companies listed in China in number but 12.4 per cent in market capitalization.<sup>32</sup> In other words, Chinese companies listed in the domestic bourses were much smaller than their red-chip counterparts listed in the US. This informs Chinese authorities of the economic importance of conducting regulatory competition for listing red-chips to underpin market development.

In a broader sense, a sizeable securities market is beneficial to China's economy. It is considered that the depth and sophistication of a nation's securities market have connections with its economic prosperity.<sup>33</sup> The securities market is an integral part of a nation's financial ecosystem, and its boom is meaningful in many aspects, such as attracting investment, creating jobs<sup>34</sup> and making spill-over contributions to professional firms that provide listing-related services.<sup>35</sup>

In the case of China, a thriving securities market is vital to the nation's economy in some facets. First, China needs the securities market to pool a large amount of extra-printed money so as to ease the nation's inflation pressure. For a long time, the Chinese real estate industry has played a crucial role in pooling money against inflation. However, in the context of the Chinese real estate industry's recent stagnation, it is hoped that the securities market could take over the role.<sup>36</sup> For this purpose, a strong securities market with colossal aggregate market capitalization would be essential, which would require more large issuers to be accommodated.

Moreover, China has undergone a bear securities market for over a decade, and thus, introducing more high-quality issuers is conducive to improving China's investment

<sup>27</sup>See China Securities Regulatory Commission Annual Report 2019, <<http://www.csrc.gov.cn/csrc/c100024/c1492180/1492180/files/053431bc54c14cb19d3938cec61232c7.pdf>>. The exchange rate from US\$ to RMB used in this article is 7:1.

<sup>28</sup>Statista, 'Comparison of the number of listed companies on the New York Stock Exchange (NYSE) and NASDAQ from 2018 to 3rd quarter 2022, by domicile', <<https://www.statista.com/statistics/1277216/nyse-nasdaq-comparison-number-listed-companies/>>.

<sup>29</sup>Siblis Research, 'Total Market Value of the US Stock Market', <<https://siblisresearch.com/data/us-stock-market-value/>>.

<sup>30</sup>The figures are calculated by the authors.

<sup>31</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

<sup>32</sup>Ibid.

<sup>33</sup>Eilis Ferran, *Building an EU Securities Market* (CUP 2004) 12.

<sup>34</sup>European Commission, 'Proposal for a Regulation Amending Regulations (EU) No 596/2014 and (EU) 2017/1129 as Regards the Promotion of the Use of SME Growth Markets, COM (2018) 331 Final (2014) 1.

<sup>35</sup>Robin Hui Huang, Wei Zhang and Kevin Siu Cheung Lee, 'The (re)Introduction of Dual-Class Share Structures in Hong Kong: A Historical and Comparative Analysis' (2020) 20 *Journal of Corporate Law Studies* 121, 129.

<sup>36</sup>For a discussion of the Chinese securities market's pooling (reservoir) effect, see Xin Zhang and Chen Xu, 'The Reservoir Effect of the Chinese Securities Market' (2007) 18 *Finance and Economy* 15.

atmosphere, market confidence and in turn capital formation and market liquidity.<sup>37</sup> This can also reinforce Shanghai's position as a global financial centre. Given that a global financial centre relies considerably upon the establishment of an internationally competitive financial ecosystem, a robust securities market with many sizeable issuers is thus an integral part.

However, the Chinese securities market, notwithstanding having the second largest market capitalization worldwide,<sup>38</sup> is not big in relation to China's economy. As shown in Figure 1 below, despite the number of domestic listed companies and the aggregate market capitalization of the Chinese securities market both went upward in the past decade, the ratio of the aggregate market capitalization of the Chinese securities market to China's Gross Domestic Product (GDP) did not keep the same pace which instead fluctuated with no upward trend. From a global perspective, compared to some major economies, China's market/GDP ratio was much smaller. At the end of 2022, China's market/GDP ratio was 65.1 per cent,<sup>39</sup> while the counterpart figure of the US was 158.4 per cent<sup>40</sup> and that of the UK was 90.6 per cent.<sup>41</sup> In this regard, it bears economic importance to expand the scale of the Chinese securities market, and listing red-chips is potentially a good option.

To conduct regulatory competition for listing red-chips, a good departure point is to understand red-chips' characteristics. Generally speaking, many red-chips have raised a large amount of foreign capital before going public, a crucial feature with multifaceted influence. First, through injecting huge capital into red-chips in exchange for large equity ownership and by using a VAM, pre-IPO foreign private equity funds may have obtained a significant say on choosing the listing venue, which may ask their investees to go public in a securities market with IPO regulatory certainty and efficiency. Secondly, pre-IPO equity financing may have largely diluted corporate founders' shareholding in red-chips, and as such, they may intend to use a dual-class share structure (DCSS) or equivalent to maintain such control as they have managed to retain. Thirdly, to raise foreign capital, red-chips may have used a variable interest entity (VIE) structure to 'satisfy' China's regulation of foreign investment, a vehicle with ambiguous legality in both Chinese regimes and regulatory practice.

As policy responses to red-chips' market needs, Chinese authorities established the SSE STAR Board in June 2019 with the implementation of the registration-based system to improve IPO regulatory certainty and efficiency,<sup>42</sup> the removal of the taboo of domestic

<sup>37</sup>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, 469.

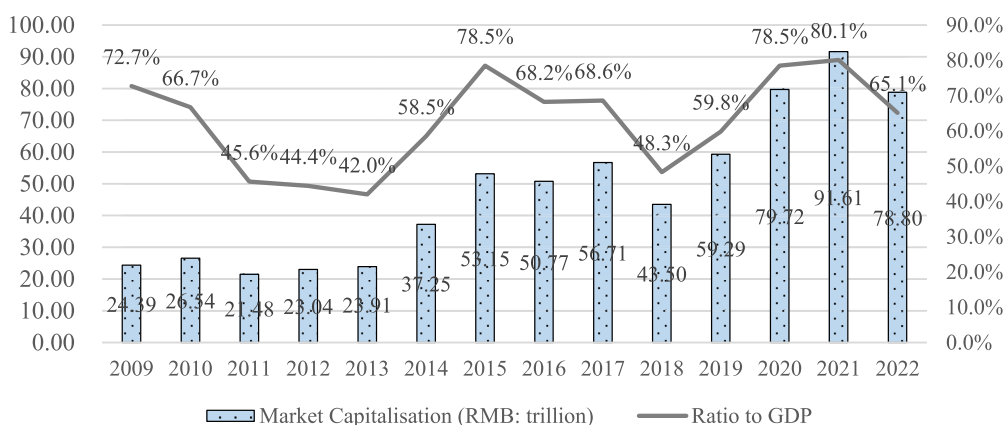
<sup>38</sup>See China Securities Regulatory Commission Annual Report 2019, 23 <<http://www.csrc.gov.cn/csrc/c100024/c1492180/1492180/files/053431bc54c14cb19d3938cec61232c7.pdf>>.

<sup>39</sup>See China Securities Regulatory Commission Annual Report 2022, 23 <<http://www.csrc.gov.cn/csrc/c100024/c7440731/7440731/files/%E4%B8%AD%E5%9B%BD%E8%AF%81%E5%88%B8%E7%9B%91%E7%9D%A3%E7%AE%A1%E7%90%86%E5%A7%94%E5%91%98%E4%BC%9A%E5%B9%B4%E6%8A%A5%EF%BC%882022%E5%B9%B4%EF%BC%89.pdf>>.

<sup>40</sup>World Bank, 'Market Capitalization of Listed Domestic Companies (% of GDP)', <<https://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS>>.

<sup>41</sup>CEIC, 'United Kingdom Market Capitalization: % of GDP', <<https://www.ceicdata.com/en/indicator/united-kingdom/market-capitalization--nominal-gdp>>.

<sup>42</sup>For a discussion of implementing the registration-based IPO system in the Chinese securities market, see Fa Chen and Lijun Zhao, 'The comprehensive implementation of the registration-based system of IPO regulation in China: practice, progress, problems and prospects' (2024) 32 Asia Pacific Law Review 1.



**Figure 1.** The Aggregate Securities Market Capitalization and Its Ratio to GDP.

The Figure is drawn by the authors. Data source: CSRC Annual Reports 2009-2022.

listing with a DCSS,<sup>43</sup> and the permission of domestic listings with a VIE structure.<sup>44</sup> Moreover, since red-chips are incorporated overseas, their Chinese flotation would have a *de facto* cross-border nature. However, China does not allow overseas-incorporated companies to issue shares in its securities market. Against this backdrop, CDRs have been introduced as a legal instrument to enable red-chips to achieve Chinese listings. The aforementioned policy and regulatory changes were subsequently conducted across the Chinese securities market. Each of these deserves a close examination; however, the focus of this article is on the introduction of CDRs.

### III. Introducing Chinese depositary receipts to accommodate red-chips and the post-reform market landscape

As a type of securities, DRs are financial certificates representing holders' equity stake, which are fungible with shares.<sup>45</sup> Since their birth nearly a century ago, DRs have been used widely in global securities markets and have become an important financial instrument for cross-border listings. For example, by 2015, 65 per cent of NYSE-listed companies and 32 per cent of NASDAQ-listed companies had been DR issuers, contributing to 82 per cent and 74 per cent of the total market capitalization of companies quoted on the NYSE and NASDAQ respectively.<sup>46</sup> To view from a Chinese perspective, the global DR market

<sup>43</sup>For a discussion of China's regulatory reform of introducing the DCSS, see Min Yan, 'Differentiated Voting Rights Arrangement under Dual-Class Share Structures in China: Expectation, Reality and Future' (2020) 28 Asia Pacific Law Review 337.

<sup>44</sup>For a discussion of China's regulatory reform of removing the taboo of VIE listings, see Fa Chen, 'Variable interest entity structures in China: Are legal uncertainties and risks to foreign investors part of China's regulatory policy?' (2021) 29 Asia Pacific Law Review 1.

<sup>45</sup>Regis E Moxley, 'The ADR: An Instrument of International Finance and a Tool of Arbitrage' (1963) 8 Villanova Law Review 19, 22. Strictly speaking, DRs can also represent debt securities. In this article, the discussion is limited to DRs that represent equity securities.

<sup>46</sup>Yifang Li and Dan Li, 'The Functioning of Depositary Receipts in Global Securities Markets and the Practice of China' (全球存托凭证运行概况及在我国的实践) (Shanghai Stock Exchange Research Report Series, No 78/2015), 5 <<http://www.sse.com.cn/aboutus/research/research/c/4009838.pdf>>.

reached a business scale of US\$ 2.9 trillion in 2016, of which approximately 30 per cent (exactly, US\$ 825.6 billion) was contributed by Chinese issuers.<sup>47</sup>

Notwithstanding their global popularity and economic importance, DRs have not been introduced in China until most recently. Instead, in the past three decades, China did not allow overseas-incorporated companies to float in its securities market. Such a regulatory policy represented a barrier to red-chips that have their listed shells-to-be incorporated overseas, which in turn meant the lack of market needs to employ CDRs as a trading instrument. However, as China has turned to enfranchise red-chips to float domestically, CDRs have been introduced as the trading instrument. This section first examines the functioning of CDRs as a novelty in the Chinese securities market and then looks into the market landscape of red-chips' use of CDRs in the post-reform era.

### ***A. Introducing CDRs and their functioning***

To enter into the arena of regulatory competition for listing red-chips, in March 2018, the CSRC issued a ministerial document concerning the allowance of red-chips to issue CDRs in the Chinese securities market on an experimental basis. This was subsequently forwarded by the General Office of the State Council for implementation,<sup>48</sup> thus opening the chapter on introducing CDRs in China. Upon establishing the SSE STAR Board in June 2019, CDR usage was ringfenced to the SSE STAR Board. However, the listing venue of CDRs was subsequently expanded to the SZSE ChiNext Board in June 2020, the Beijing Stock Exchange in September 2021 and the SSE/SZSE Main Board most recently in March 2023, marking the comprehensive acceptance of red-chips' listings with the use of CDRs across the Chinese securities market.

As fungible financial certificates representing holders' equity stake, CDRs have been modelled on their global counterparts, which have mainly four parties involved in their issuance and trading, i.e. the red-chip issuer, custodian bank, depositary bank and investors. As the starting point, a red-chip planning to issue CDRs enters into a depositary agreement with a depositary bank based in China.<sup>49</sup> The depositary bank then selects a custodian bank – which is local to the red-chip – to receive and safekeep the transfer of underlying shares from the red-chip.<sup>50</sup> Upon the custodian bank's confirmation of receipt of the underlying shares, the depositary bank issues CDRs that denote the equity stake of the red-chip's underlying shares to investors in the Chinese securities market.<sup>51</sup> In this way, the involved overseas-incorporated red-chip and China-based investors achieve cross-border transactions of the underlying shares (see [Figure 2](#)).

Under the CDR mechanism, investors holding CDRs have equal voting rights and economic interests to counterpart holders of shares. Nevertheless, the custodian bank is the registered owner of the underlying shares, i.e. the holder of legal title, whilst the depositary bank transmits dividends in the local currency to investors holding CDRs.<sup>52</sup> Also, the

<sup>47</sup>See BNY Mellon, 'The 2016 Depositary Receipt Market Review', 29 <<https://www.adrbnymellon.com/files/ms481653.pdf>>.

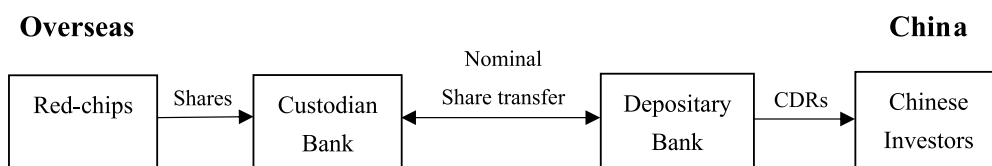
<sup>48</sup>Notice of Issuing CDRs 2018 (n 8).

<sup>49</sup>Measures for the Administration of the Offering and Trading of Depositary Receipts (for Trial Implementation) 2023 [存托凭证发行与交易管理办法（试行）] (Measures for CDRs 2023), Art 27(1).

<sup>50</sup>*Ibid*, Art 27(2).

<sup>51</sup>*Ibid*, Art 27(4).

<sup>52</sup>*Ibid*, Art 27(6).



**Figure 2.** The Issuance and Trading of CDRs.

The Figure is drawn by the authors.

depository bank is responsible for distributing notices of shareholder meetings and voting instructions, thereby enabling CDR holders to exercise the voting rights of the underlying shares that are evidenced by the CDRs.<sup>53</sup>

Introducing CDRs as the trading instrument has provided a relatively convenient route for overseas-incorporated red-chips to go public domestically without having to change their corporate structures. Given this, market expectations would be that such a regulatory reform would have helped the Chinese securities market accommodate many red-chips. However, the market practice has shown a different landscape.

### ***B. Red-chips' sparse Chinese listings with the use of CDRs in the post-reform era***

As at 31 December 2023, 536 Chinese companies were quoted on the SZSE ChiNext Board with none of them acting as a CDR issuer.<sup>54</sup> In parallel, from its establishment on 13 June 2019 to 31 December 2023, the SSE STAR Board accommodated 559 listed issuers; of these, only three were red-chip issuers.<sup>55</sup> Moreover, only one of these conducted CDR issuance, i.e. Ninebot Co (stock code: 689009), while the other two red-chip issuers achieved Chinese IPOs through stock offerings directly.<sup>56</sup> The sparse CDR usage is more striking when compared to the popularity of red-chips' US listings with the issuance of American depository receipts (ADRs) in the same period. From 13 June 2019 to 31 December 2023, 109 red-chips went public on either the NYSE or NASDAQ; of these, 64 companies issued ADRs (see Table 1).<sup>57</sup>

The empirical study above shows that compared to the US practice, the introduction of CDRs has not helped the Chinese securities market stand out from the regulatory competition for listing red-chips. Thus, the jurisdictional disparity implies that there may be barriers for red-chips to use CDRs. The following section canvasses the barriers.

## **IV. The barriers for red-chips to use Chinese depository receipts**

In light of the Chinese securities market's regulatory custom, when a crucial legal innovation is employed, Chinese authorities put a high reliance on market entry regulation to filter out potential issuers of bad quality, thereby reducing the incidence of market misconduct in the first place to ensure investor protection. Such a regulatory custom also

<sup>53</sup>Ibid, Art 27(5)(6)(7).

<sup>54</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

<sup>55</sup>Ibid.

<sup>56</sup>These two red-chips are China Resources Microelectronics Limited (stock symbol: 688396) and Galaxy Core Inc (stock symbol: 688728).

<sup>57</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

**Table 1.** Chinese Companies Listed in China or the US with DR Issuance\*

|                    | Period                | Number of CDR/ADR Issuers | Number of Total Chinese Issuers | DR Ratio |
|--------------------|-----------------------|---------------------------|---------------------------------|----------|
| SSE STAR Board     | 13/06/2019–31/12/2023 | 1                         | 559                             | 0.002%   |
| SZSE ChiNext Board | 12/06/2020–31/12/2023 | 0                         | 536                             | 0.0%     |
| NYSE & NASDAQ      | 13/06/2019–31/12/2023 | 64                        | 109                             | 58.72%   |
|                    | 12/06/2020–31/12/2023 | 43                        | 83                              | 51.81%   |

\*The Table is drawn by the authors. Data are hand-collected from the SSE, SZSE, NYSE and NASDAQ.

applies to the introduction of CDRs to accommodate red-chips. However, the other side of the coin is that overly strict market entry regulation may discourage or hinder certain issuers from going public domestically. Given that, the first part of this section examines whether and the extent to which China's reliance on market entry regulation may have affected CDR usage by red-chips.

Moreover, considering the fact that the Chinese securities market and its Hong Kong counterpart have largely overlapping target issuers, i.e. red-chips, the Chinese regulatory shift towards enfranchising red-chips' domestic flotation has inevitably intensified the Sino-Hong Kong securities market competition. However, regulatory competition between the Sino-Hong Kong securities markets must be put in China's political context for consideration.<sup>58</sup> Definitely, a zero-sum game – which means advancing the Chinese securities market at the cost of Hong Kong's development opportunities – is not a scenario that the Chinese central authority would like to see. Economically, Hong Kong has provided a preferred financing window for many Chinese companies<sup>59</sup> and played a significant role in the internationalization of China's currency over recent years. Politically, Beijing needs to maintain Hong Kong's continued economic prosperity to showcase the merits of the 'One Country, Two Systems' policy.<sup>60</sup> Therefore, Beijing will avoid a significant decline of Hong Kong's competitiveness as a global financial centre. The consideration of Hong Kong's economic interests has shaped China's recent securities market reforms in a way that has purposefully created policy differences for the HKEX at the cost of Chinese bourses' business opportunities. The political economy may also apply to the introduction of CDRs to accommodate red-chips' SPOs, as will be discussed in the second part of this section.

### ***A. Barriers to red-chips' Chinese IPOs: China's over reliance on market entry regulation for investor protection***

As mentioned above, the Chinese securities market relies on market entry regulation to ensure investor protection. This deals with the ability of both investors and issuers to access the securities market. For investors, it means participation restrictions.<sup>61</sup> Whilst

<sup>58</sup>Wang (n 3) 388.

<sup>59</sup>Kai Lyu, 'The Institutional Transformation of China's Stock Exchanges: A Comparative Perspective' (2015) 5 Accounting, Economics, and Law 43, 81.

<sup>60</sup>Jiangyu Wang, 'China's Regional Trade Agreements: The Law, Geopolitics, and Impact on the Multilateral Trading System' (2004) 8 Singapore Year Book of International Law 119, 130.

<sup>61</sup>John Armour and others, *Principles of Financial Regulation* (OUP 2016) 74.

from issuers' perspective, entry regulation imposes various requirements on initial compliance, e.g. financial thresholds, to decide their eligibility for market access.<sup>62</sup> In the Chinese securities market, red-chips' Chinese listings with CDR issuance are subject to two tiers of regulation, i.e. the regulation of red-chip listings and the regulation of CDR offerings. It should be clarified that these two regulatory tiers apply distinct sets of rules. For one thing, CDR usage is not the only available route for red-chips to float in the Chinese securities market. Instead, under special circumstances, certain red-chips are allowed to issue shares directly to achieve a Chinese listing.<sup>63</sup> For another, CDRs are also the trading instrument of the Shanghai-London Stock Connect, besides serving as the legal infrastructure of red-chips' Chinese flotation. Upon recognizing the distinction mentioned above, this subsection now discusses some noteworthy aspects of the regulatory rules that apply to red-chips' Chinese listings with CDR issuance, as follows:

First, red-chips seeking a Chinese IPO with CDR issuance are bound to the existing rules governing stock offerings, such as an incorporation history of at least three years,<sup>64</sup> stability of management,<sup>65</sup> executive qualification,<sup>66</sup> no major disputes in core assets<sup>67</sup> and equity ownership,<sup>68</sup> sound financial status and capacity for continuous operation,<sup>69</sup> and compliance records.<sup>70</sup> As CDRs bear fundraising functions, Chinese authorities have treated the issuance of CDRs equally to ordinary stocks in the aforesaid aspects. This equal treatment stays in line with the standard global practice such as that in the US.<sup>71</sup>

Moreover, the SSE STAR Board requires red-chips to meet a high financial threshold through either of the following routes: (i) no lower than RMB 10 billion in expected market valuation; or (ii) no lower than RMB five billion in expected market valuation with no less than RMB 500 million in revenue in the most recent year,<sup>72</sup> which are much higher than 'ordinary' flotation.<sup>73</sup> Besides, red-chips must have a rapid growth in revenue from business operation unless obtaining an exemption.<sup>74</sup> Apart from meeting

<sup>62</sup>Ibid.

<sup>63</sup>Notice of Issuing CDRs 2018 (n 8), Art 4.

<sup>64</sup>Measures for CDRs 2023 (n 49), Art 5(2).

<sup>65</sup>Ibid, Art 5(3).

<sup>66</sup>Ibid, Art 5(6).

<sup>67</sup>Ibid, Art 5(2).

<sup>68</sup>Ibid, Art 5(3).

<sup>69</sup>Ibid, Art 5(1) and Securities Law of China 2019, Art 12(2).

<sup>70</sup>Measures for CDRs 2023 (n 49), Art 5(5)(6).

<sup>71</sup>ADRs can be classified into Level I, Level II and Level III programmes, according to the different listing venues and reporting and disclosing obligations associated. Level I ADRs are traded in the US over-the-counter (OTC) market with the underlying shares exempted from registration at the SEC, nor is the issuer bound to file annual reports. Level II ADRs are listed on US stock exchanges while issuers are bound to the issuance of annual reports, plus adherence to the listing requirements of the exchange wherein involved ADRs are listed and traded. Different from their Level I and Level II counterparts, Level III ADRs are used for fundraising and are thus subject to the most cumbersome reporting and disclosure requirements. Under a Level III ADR programme, both the underlying shares and ADRs need to be registered at the SEC. Meanwhile, issuers are bound to submit a prospectus (Form F-1) and annual reports (Form F-20) and conduct periodic information disclosure (Form 6-K). Besides, Level III ADRs are listed and traded on US stock exchanges. On these grounds, Level III ADR offerings which bear fundraising functions are treated equally to the issuance of ordinary shares in the US. See Guy P Lander, 'American Depositary Receipts' (1995) 29 International Lawyer 897, 912; Mark A Saunders, 'American Depositary Receipts: An Introduction to U.S. Capital Markets for Foreign Companies' (1993) 17 Fordham International Law Journal 48, 62; BNY Mellon, 'DR Basics and Benefits', <<https://www.adrbny.com/resources/dr-basics>>.

<sup>72</sup>SSE STAR Board Listing Rules 2020, r 2.1.3.

<sup>73</sup>As for the financial criteria of ordinary listing on the SSE STAR Board, see *ibid*, r 2.1.2.

<sup>74</sup>The revenue growth requirement can be satisfied by meeting any of the following standards: (i) no less than RMB 500 million in revenue from business operation in the most recent year and over 10% of the Compound Annual Growth Rate in revenue from business operation in the most recent three years; (ii) over 20% of the Compound Annual Growth Rate

the aforesaid financial criteria, eligible red-chips seeking to float on the SZSE ChiNext Board were required to have positive net profits.<sup>75</sup> As such, by picking out potential issuers of high quality, the stringent financial requirements are used as an approach to safeguarding investors.

It is worth noting that apart from the regulation on the issuer side, Chinese authorities also employ a number of measures to regulate other involved parties. For example, depositary banks should not serve as the sponsor in the CDR issuance process, thereby avoiding conflicts of interest.<sup>76</sup> Besides, the Depositary Agreement in CDR issuance is subject to the jurisdiction of Chinese courts with Chinese laws to be used as the governing laws in the event of dispute resolution.<sup>77</sup> Moreover, the China Securities Investor Services Centre, an investor protection institute with a quasi-official background, is allowed to support investors in initiating civil lawsuits against market misconduct in CDR offering and trading.<sup>78</sup> Given this article's focus on market entry regulation on the issuer side, the regulatory rules imposed on other involved parties will not be discussed in detail, which are instead briefly mentioned here for the completeness of the regulatory picture.

As stated above, the financial standards of red-chips' Chinese listings are much harsher than 'ordinary' flotation via stock offerings. By comparison, in the US, even the financial requirements of the NYSE and NASDAQ premium segments are more lenient than their Chinese counterparts (see Table 2). Thus, compared to ADR issuance in the US, the harsh financial requirements of red-chips' CDR usage may have hindered certain red-chips from going public domestically. To verify this hypothesis, this article examines the corporate filings of the US-listed red-chips with ADR usage and finds empirical evidence as follows:

From the establishment of the SSE STAR Board on 13 June 2019 to 31 December 2023, 64 red-chips went public in the US with ADR issuance.<sup>79</sup> A further examination of their initial market capitalization and pre-IPO revenue finds that 27 of the 64 red-chips (42.2 per cent) did not meet the financial requirements of listing with CDR issuance on the SSE STAR Board.<sup>80</sup> Likewise, from 12 June 2020 to 31 December 2023, 38 of the 43 US-listed red-chips with ADR issuance (88.4 per cent) did not satisfy the financial requirements of flotation on the SZSE ChiNext Board with CDR issuance.<sup>81</sup> Based on the empirical findings above, it could be seen that the harsh financial requirements may have considerably impeded the Chinese securities market from accommodating red-chips. Moreover, compared to the SSE STAR Board, the requirement for positive net profits on the SZSE ChiNext Board may have further generated barriers to CDR usage.

This subsection has discussed the role that CDRs play in enabling unlisted red-chips to conduct a Chinese IPO and the regulatory barriers to accommodating red-chips with CDR

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in revenue from business operation in the most recent three years if the revenue from business operation in the most recent year was less than RMB 500 million; (iii) the Compound Annual Growth Rate in revenue from business operation in the most recent three years was higher than comparable companies in the same industry over the same period, if the industry was in a downward cycle that was affected by industry periodical fluctuation. See Notice on Matters Concerning Red-chip Companies' Applications for Stock Issuance and Listing on the STAR Board 2020, Art 3.

<sup>75</sup>SZSE ChiNext Board Listing Rules 2020, r 2.1.3. The requirement of net profits was removed in the 2023 revision.

<sup>76</sup>Measures for CDRs 2023 (n 49), Art 33.

<sup>77</sup>Ibid, Art 28(16)(17).

<sup>78</sup>Ibid, Art 37.

<sup>79</sup>Data are hand-collected. See details in this article's datasets at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

<sup>80</sup>Ibid.

<sup>81</sup>Ibid.

**Table 2.** Comparison of the Financial Standards of Red-chips' Listings in China and the US.

|                         | Routes | Market capitalization | Revenue      | Cash flows    | Pre-tax earnings | Total assets | Other requirements       |
|-------------------------|--------|-----------------------|--------------|---------------|------------------|--------------|--------------------------|
| STAR & ChiNext (RMB)    | 1      | ≥10 billion           | –            | –             | –                | –            | –                        |
|                         | 2      | ≥5 billion            | ≥500 million | –             | –                | –            | –                        |
| NYSE Market (US\$)      | 1      | ≥750 million          | ≥75 million  | –             | –                | –            | –                        |
|                         | 2      | ≥500 million          | ≥100 million | ≥100 million  | –                | –            | –                        |
|                         | 3      | –                     | –            | –             | ≥100 million     | –            | –                        |
| NASDAQ GS Market (US\$) | 1      | ≥160 million          | –            | –             | –                | ≥80 million  | ≥55 million <sup>♦</sup> |
|                         | 2      | ≥850 million          | ≥90 million  | –             | –                | –            | –                        |
|                         | 3      | ≥550 million          | ≥110 million | ≥27.5 million | –                | –            | –                        |

<sup>♦</sup>stockholders' equity of no less than US\$ 55 million.

The Table is drawn by the authors. Source: SSE STAR Board Listing Rules 2020, r 2.1.3; SZSE ChiNext Board Listing Rules 2023, r 2.1.3; NYSE Listed Company Manual, r 103.01(B); NASDAQ Stock Market Rules, r 5315.

usage. In parallel, CDRs can also be used by overseas-listed red-chips to conduct a Chinese SPO, which is the subject matter of the next subsection.

### ***B. Barriers to red-chips' Chinese SPOs: China's political economy of prioritizing Hong Kong's securities market development***

Before the introduction of the CDR mechanism, the only available route for overseas-listed red-chips to come back to the Chinese securities market was to conduct a two-step delisting and relisting process. In detail, under the two-step process, overseas-listed red-chips need to go private from their overseas listing venues and then list their China-based operating entity domestically. Alternatively, after the privatization step, involved companies can carry out a reverse merger with an existing Chinese listed company rather than an IPO, known as 'back-door listing' or 'borrowing-shell listing' in the Chinese legal parlance.<sup>82</sup> No matter which route is used, the two-step process is time-consuming and complex. For example, Focus Media Holding Co, a red-chip initially listed on the NASDAQ, completed its US\$ 3.7 billion privatization on 24 May 2013.<sup>83</sup> After the privatization, it took Focus Media over two years to reorganize its corporate structure and reach a deal with an SZSE-listed company, i.e. Hedy Holding, regarding an asset swap programme that allowed Focus Media to float on the SZSE via a back-door listing.<sup>84</sup> Eventually, Focus Media was listed on the SZSE on 29 December 2015.

The Focus Media case reflects the time cost of the two-step delisting and relisting process. Upon introducing the CDR mechanism, overseas-listed red-chips are now able

<sup>82</sup>Chien-Chung Lin, Huan-Ting Wu and Yang Li, 'Insiders and Their Trading Games in China: Law, Enforcement Data, and a Puzzling Question' (2022) 47 The Journal of Corporation Law 715, 741 (footnote 81).

<sup>83</sup>See Josh Nobel and Emily Steel, 'Focus Media agrees \$5.7bn buyout deal' (Financial Times, 19 December 2012), <<https://www.ft.com/content/4dfa6daa-49db-11e2-a625-00144feab49a>>; see also Focus Media's SC 13E3/A Form filed on the SEC on 24 May 2013, <<https://www.sec.gov/Archives/edgar/data/1330017/000119312513234271/d461081dsc13e3a.htm>>.

<sup>84</sup>See Neil Gough, 'Focus Media Reaches \$5.7 Billion Deal to List in Shenzhen' (New York Times, 3 June 2015), <<https://www.nytimes.com/2015/06/04/business/dealbook/focus-media-in-shenzhen-listing-deal.html>>.

to access the Chinese securities market without having to conduct the afore-discussed two-step delisting and relisting process. Instead, they can carry out an SPO with CDR issuance to raise extra funds to enlarge their market capitalization and float on the SSE/SZSE to broaden their investor base.<sup>85</sup> Accordingly, both Chinese state and private investors can buy into certain overseas-listed red-chips to share in their business success. Soon after the promulgation of the CDR regime in March 2018, some overseas-listed red-chips, e.g. Alibaba and JD.com, publicly expressed their intense interest in conducting an SPO with CDR issuance to 'return' to the Chinese securities market.<sup>86</sup> As of the end of 2023, however, neither the SSE nor SZSE welcomed an SPO of any red-chips. Yet, this situation is not the outcome of legal or regulatory impediments but is likely the result of China's political economy of prioritizing Hong Kong's securities market development.

In fact, the plan of employing DRs to serve red-chips' SPO needs was initially proposed by Hong Kong in 2001, considering that many HKEX-listed red-chips had shown a strong desire to conduct an SPO in the Chinese securities market for extra fundraising.<sup>87</sup> Eventually, Hong Kong carried out a legal reform to accommodate red-chips' SPOs in April 2018, nearly concurrently with the introduction of the CDR mechanism in its motherland.<sup>88</sup> As such, the Chinese stock exchanges appeared to stand at the same starting line to compete for red-chips' SPOs, compared with the HKEX. In reality, however, Chinese authorities did not promulgate ancillary and supporting rules regarding Chinese SPOs with CDR issuance until April 2020.<sup>89</sup> This policy difference has benefitted the Hong Kong securities market to secure business opportunities without competitive pressure for two years. As a result, the HKEX has successfully accommodated the SPOs of many US-listed red-chips, such as Alibaba, JD and Baidu.<sup>90</sup>

Due to the absence of an official say, the intention behind the aforementioned two-year gap is unclear.<sup>91</sup> Nevertheless, it should be noted that China's recent securities market reforms have largely transplanted Hong Kong's experience but have left policy room for the HKEX in many important aspects to avoid a race to the bottom in the regulatory competition. Typically, the financial thresholds for issuers with a VIE structure to go public in Chinese bourses have been set at a much higher level than their Hong Kong counterparts.<sup>92</sup> Hence, in light of China's political economy of maintaining Hong Kong's financial prosperity, the two-year gap appeared to be purposefully created to mitigate

<sup>85</sup>Ye and Lu (n 37) 468.

<sup>86</sup>See Ting Chen, 'Alibaba, JingDong.com, Baidu and Xiaomi Are Pursuing the First CDR' (First Finance, 7 June 2018), <<https://www.yicai.com/news/5429743.html>>.

<sup>87</sup>See Yu Du, 'Demystifying Unicorn Enterprises' (National Business Daily, 13 March 2018), <<http://www.nbd.com.cn/articles/2018-03-13/1198546.html>>.

<sup>88</sup>HKEX Main Board Listing Rules, Ch 19C. Before the 2018 revision of the listing regime, red-chips' application for an SPO in Hong Kong was not allowed, see SFC and HKEX, 'Joint policy statement regarding the listing of overseas companies', Art 94.

<sup>89</sup>Announcement on the Arrangements for Domestic Listings of Innovative Pilot Red-chip Companies 2020.

<sup>90</sup>Red-chips that have conducted an SPO on the HKEX include BABA (2019), NETS (2020), JD (2020), YUMC (2020), HTHT (2020), ZLAB (2020), BZUN (2020), ZTO (2020), GDS (2020), EDU (2020), ATHM (2021), BIDU (2021), BILI (2021), TCOM (2021) and WB (2021). Data as of 31 December 2021, source: HKEX.

<sup>91</sup>In a meeting held in 2020, the authors consulted Hao Fu (Director of the SSE International Development Department) about this issue. Fu agreed with the authors' analysis of China's position of prioritizing the HKEX's market development by creating various policy differences, but at the same time claimed that he did not represent the SSE on this issue.

<sup>92</sup>See SSE STAR Board Listing Rules, r 2.13; SZSE ChiNext Board Listing Rules, r 2.1.3.

the regulatory competition for listing red-chips and thereby to prioritize Hong Kong's securities market development.

It should be noted that Chinese authorities initially required red-chips seeking an SPO in the Chinese securities market with CDR issuance to have a minimum market capitalization of RMB 200 billion.<sup>93</sup> After many US-listed red-chips carried out an SPO on the HKEX, however, quite a few target issuers were left to the Chinese securities market. The changed market situation is the background against which moves by Chinese authorities to introduce a more lenient financial standard (i.e. RMB 20 billion) in April 2020 to enlarge the target issuer group are to be considered (see [Figure 3](#)).

From the discussion above, it could be seen that against the backdrop of introducing CDRs as a trading instrument to accommodate red-chips, Chinese authorities have put high reliance on market entry regulation on the issuer side to ensure investor protection which may have nevertheless discouraged or deterred certain red-chips from pursuing an IPO domestically. In parallel, CDRs have not been used by red-chips to conduct Chinese SPOs due perhaps to China's political economy of mitigating the regulatory competition to prioritize Hong Kong's securities market development. Based on these findings, the next section will turn to seek policy implications.

## V. Policy implications

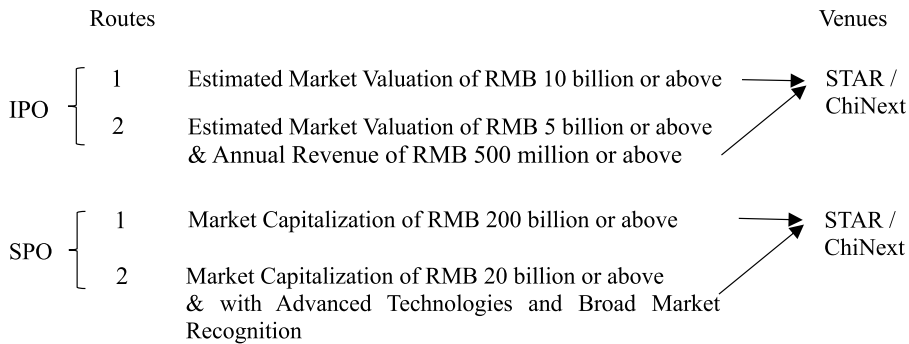
Considering the initial purposes of conducting regulatory competition for listing red-chips, the sparse use of CDRs in the post-reform era may suggest the Chinese policy-makers relax the market entry regulation. However, the attractiveness to issuers and the protection of investors may represent competing interests in securities markets.<sup>94</sup> Thus, relaxing market entry regulation should be put in a broader context for consideration in order to better accommodate red-chips while not compromising investor protection. The first part of this section will canvass the supporting mechanisms in China's securities regulation, which may serve as legal bases for relaxing the market entry regulation on the issuer side. Moreover, to mitigate the regulatory competition between the Hong Kong securities market and its motherland counterpart for listing red-chips, establishing a Sino-Hong Kong common securities market based on the stock connects is a possible way forward. This is the theme of the second subsection.

### ***A. Relaxing market entry regulation to accommodate red-chips while relying on supporting mechanisms to safeguard investors***

To reinforce investor protection, Chinese authorities have created a couple of supporting mechanisms in recent securities regulation reforms, which may provide legal bases for some orientation away from market entry regulation on the issuer side. These include the introduction of a US-style securities class action mechanism, i.e. the special securities representative action (SSRA) mechanism, for investors to resort to *ex-post* remedy, the stipulation of stringent legal liabilities on private gatekeepers to ensure that gatekeeping

<sup>93</sup>Notice of Issuing CDRs 2018 (n 8), Art 3.

<sup>94</sup>Fa Chen, 'Reshaping the Stock Market to Accommodate Chinese Business Giants: The Reintroduction of Weighted Voting Shares in Hong Kong' (2022) 52 Hong Kong Law Journal 487, 504.



**Figure 3.** The Listing Venues of Chinese IPOs and SPOs with CDR Issuance.

The Figure is drawn by the authors. Sources: Announcement on the Arrangements for Domestic Listings of Innovative Pilot Red-chips 2020 [关于创新试点红筹企业在境内上市相关安排的公告2020]; Implementation Measures for the Supervision and Administration of Listing of Domestic Issuance of Stocks or Depositary Receipts by Innovative Pilot Enterprises 2023 [试点创新企业境内发行股票或存托凭证并上市监管工作实施办法2023], art 7; SSE STAR Board Listing Rules 2020, r 2.1.3; SZSE ChiNext Board Listing Rules 2023, r 2.1.3.

duties are duly performed, and the reliance on the mandatory delisting mechanism to achieve market cleanness.

Investor protection, as an important regulatory goal in securities markets, relies on both *ex-ante* regulation and *ex-post* remedies.<sup>95</sup> The former, exemplified by market entry regulation, functions by employing various *ex-ante* regulatory strategies to mitigate the incidence of opportunist behaviours.<sup>96</sup> By comparison, the latter, typically securities enforcement, redresses damaged value on a post-event basis to compensate affected investors while generating deterrence to discipline similar misconduct in the general sense.<sup>97</sup> *Ex-ante* regulation and *ex-post* remedy are to some extent complementary or alternative,<sup>98</sup> which means that the availability of effective *ex-post* remedy may ease the reliance on *ex-ante* regulation. As well reflected by the US experience, investor protection is not undermined by the shortage of *ex-ante* regulatory measures, which is instead embedded firmly in the robust securities enforcement.<sup>99</sup> In fact, China has transplanted the US experience concerning securities class actions by creating the SSRA mechanism, whereby similarly situated investors are enabled to seek legal recourse against market misbehaviours in a single lawsuit.<sup>100</sup> In November 2021, the first SSRA, i.e. *China Securities Investor Services Centre v Kangmei Pharmaceutical Co*,<sup>101</sup> was ruled by the court, which mandated involved insiders to compensate approximately RMB 2.5 billion for the affected investors, an amount even larger than the monetary settlement of the US securities class actions against Alibaba (US\$250 million, equivalent to RMB 1.75 billion).<sup>102</sup> In

<sup>95</sup> John Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6 *Journal of Empirical Legal Studies* 687, 687.

<sup>96</sup> John Armour and others, *Principles of Financial Regulation* (OUP 2016) 74.

<sup>97</sup> Konstantinos Sergakis, *The Law of Capital Markets in the EU: Disclosure and Enforcement* (Palgrave Macmillan 2018) 43.

<sup>98</sup> Armour and others, 'Private Enforcement' (n 95) 687.

<sup>99</sup> Chen, 'Does the dual-class share structure' (n 1) 176.

<sup>100</sup> Securities Law of China 2019, Art 95.

<sup>101</sup> *China Securities Investor Services Centre v Kangmei Pharmaceutical Co*, Intermediate People's Court of Guangzhou City, Guangdong Province [2020] Civil Judgment No 2171 (广东省广州市中级人民法院民事判决书 [2020] 粤01 民初 2171 号).

<sup>102</sup> ISS, 'Top 100 U.S. Class Action Settlements of All Time as of December 2019', <<https://www.issgovernance.com/library/the-top-100-us-class-action-settlements-of-all-time-as-of-december-2019/>>.

this way, Chinese authorities have shown a strong determination to ensure investor protection.<sup>103</sup> Moreover, the creation of the SSRA mechanism and its application in regulatory practice may provide a legal basis for some orientation away from market entry regulation, thereby opening up the Chinese securities market to red-chips without compromising investor protection.

Apart from creating the SSRA mechanism, China's recent securities regulation reforms have shown an increasing reliance on private gatekeepers to maintain market integrity. Private gatekeepers are familiar with listed issuers' situations and have relevant expertise, and thus, they are expected to perform prudently to find and avoid market opportunism.<sup>104</sup> However, in global securities markets, gatekeeper failure is not rare, which is due considerably to the inadequacy of legal deterrence.<sup>105</sup> Given this, Chinese authorities have stipulated strict liabilities on private gatekeepers. In light of the newly revised securities law, wrongdoing private gatekeepers would be levied legal sanctions ranging from correction of misbehaviours to the withdrawal of their licence, depending on the severity of their fault.<sup>106</sup> For instance, in the first SSRA, the involved accounting firm and accountant were held to bear joint and several liability (with the insiders to compensate RMB 2.5 billion for the affected investors) due to their negligence.<sup>107</sup> As such, this case has set a milestone in China's securities enforcement, and it is expected that private gatekeepers will be driven to play a significant role in avoiding market misbehaviours.<sup>108</sup> In turn, private gatekeepers' increasing involvement may help relax public regulators' reliance on market entry regulation towards opening up the Chinese securities market to red-chips.

Also, the use of the mandatory delisting mechanism may play a role in easing market entry regulation. As mentioned above, certain issuers are keen to resort to reverse acquisitions to achieve Chinese flotation. Such a situation has resulted in the reluctance of poorly performing quoted companies to undergo a delisting actively because they can sell themselves to potential issuers seeking to conduct a reverse acquisition.<sup>109</sup> This has generated the Chinese securities market some listed companies with low liquidity. Yet, the mandatory delisting mechanism was seldom enforced. Instead, Chinese authorities focused on quality control at the market entry stage and attempted to filter out 'bad' issuers to ensure market integrity.<sup>110</sup> In other words, China's securities regulation on the issuer side used to be 'strict entry and rare exit'. However, against the backdrop of implementing the package of securities market reforms, Chinese authorities have intensified the use of the mandatory delisting mechanism. According to the CSRC, the average number of mandatory delisted companies per year before 2019 was three,

<sup>103</sup>Fa Chen, 'The Chinese-Style Securities Class Action Mechanism for Investor Protection: Context, Content, Comparison and Consequence' (2022) 30 Asia Pacific Law Review 287, 307.

<sup>104</sup>Chen and Zhao (n 42) 19.

<sup>105</sup>John C Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (OUP 2006), Ch 3 (explaining gatekeeper failure).

<sup>106</sup>Measures for the Administration of the Registration of Initial Public Offerings 2023 (首次公开发行股票注册管理办法2023), Arts 61–64.

<sup>107</sup>*China Securities Investor Services Centre v Kangmei Pharmaceutical Co* (n 101).

<sup>108</sup>Chen, 'The Chinese-Style Securities Class Action Mechanism' (n 103) 305.

<sup>109</sup>SSE, 'Research on the delistings in major global capital markets and its implications for the STAR Board' (全球主要资本市场退市情况研究及对科创版的启示) (Shanghai Stock Exchange Research Report Series, No 001/2010).

<sup>110</sup>Chen, 'Reshaping the stock market' (n 94).

compared to nine in 2019 and 17 in 2021.<sup>111</sup> In this way, the effective use of the mandatory delisting mechanism for market cleanness may help ease the reliance on quality control at the market entry stage to ensure investor protection.

It should be noted that notwithstanding the feasibility of using the supporting mechanisms to maintain investor protection so as to deregulate the market entry requirements regarding CDRs, it does not mean deregulating CDR usage would definitely help the Chinese securities market stand out from the regulatory competition for listing red-chips. The competitiveness of a securities market is based on various regulatory factors as an ecosystem. As mentioned above, the P/E ratio of the Chinese securities market is much higher than the US and Hong Kong counterparts. It means that for pursuing listing premium, red-chips would consider the Chinese securities market as their first choice, *ceteris paribus*. Yet, in the post-reform era, the Chinese bourses have only accommodated a few red-chips. This signifies the existence of market entry barriers. Actually, apart from introducing the CDRs, Chinese authorities have also conducted other significant securities market reforms for accommodating red-chips, e.g. the removal of the taboo on listings with the use of a DCSS and/or a VIE structure, given the fact that many red-chips have also adopted such legal instruments. However, listings in the Chinese securities market with the use of these legal instruments are also subject to strict market entry requirements. For instance, issuers aiming to going public in China with the use of a DCSS and/or a VIE structure must meet a high financial threshold through either of the following routes: (i) no lower than RMB 10 billion in expected market capitalization; or (ii) no lower than RMB five billion in expected market capitalization with no less than RMB 500 million in revenue in the most recent year prior to listing.<sup>112</sup> Such harsh requirements may have in turn caused considerable market entry barriers to red-chips. As revealed by empirical studies, in the post-reform era, China's market entry regulation on the use of the DCSS may have blocked 70.2 per cent and 93.5 per cent of US-listed red-chips from going public domestically on the STAR Board and ChiNext Board respectively.<sup>113</sup> Hence, the market entry barriers may be multifaceted, and thus, simply relaxing the market entry regulation on CDRs without deregulating the use of the DCSS and VIE structure may not fully satisfy red-chips' market needs. Nevertheless, at least, the stringent market entry regulation on CDRs has represented considerable barriers, which is thus worth Chinese authorities' policy thinking of deregulation while putting a higher reliance on the supporting mechanisms to maintain investor protection.

### ***B. Constructing a Sino-Hong Kong common securities market based on stock connects***

To mitigate the Sino-Hong Kong regulatory competition for listing red-chips, state control is not the only option. Instead, building a common securities market based on the stock connects is a possible way forward. A common market, a notion originating from the EU, features the free flow of goods, service, capital and labour which is certainly accompanied by the harmonization of regulatory rules.<sup>114</sup> In light of this, a Sino-Hong Kong common

<sup>111</sup>See CSRC Annual Reports 2015–2021.

<sup>112</sup>SSE STAR Board Listing Rules 2023, rr 2.13 and 2.1.4; SZSE ChiNext Board Listing Rules 2023, rr 2.13 and 2.1.4.

<sup>113</sup>Chen, 'Does the Dual-Class Share Structure' (n 1) 174.

<sup>114</sup>Wang (n 3) 404.

securities market based on the stock connects would need free dual access of securities as goods, financial services and capital, which could help both sides accommodate red-chips while benefitting red-chips to avail themselves of the capital pools and investor bases of both sides.

Under the present Chinese and Hong Kong regulatory frameworks, conducting a dual-listing in the Chinese and Hong Kong securities markets, known as 'A + H dual-listing', is a route for red-chips to join the stock connects. However, the other side of the coin is that an A + H dual-listing is subject to dual-regulation with increased compliance costs, an impediment that may discourage certain red-chips from doing so. Given the above, this subsection looks into the functioning, benefits and demerits of the Sino-Hong Kong stock connects as a stepping stone towards a common securities market in accommodating red-chips. Considering that the Shenzhen-Hong Kong Stock Connect has copied the Shanghai-Hong Kong Stock Connect (SH-HK Connect) with the use of similar rules, this subsection mainly explores the SH-HK Connect to roughly represent the whole picture.

As early as 2011, the HKEX proposed a 'remote exchange participants' mechanism, under which Chinese securities brokers could trade shares of HKEX-listed issuers directly on behalf of Chinese investors.<sup>115</sup> Although this plan was shelved due to circumventing the then Chinese policy prohibiting domestic retail investors from accessing foreign securities markets,<sup>116</sup> it created a prototype of cross-border securities market connectivity. Afterwards, the SH-HK Connect was established in November 2014, followed by the establishment of the Shenzhen-Hong Kong Stock Connect in December 2016.

Since there is overlapping trading time between the Chinese and Hong Kong securities markets, eligible investors on both sides can trade securities on a timely basis. Take the southbound limb of the SH-HK Connect, i.e. the trading of securities listed on the HKEX by Chinese investors, as the illustrative example: the departure point is that an SSE-based investor entrusts a licensed Chinese broker to purchase the securities of a certain HKEX-listed company and conducts the payment in RMB, China's currency.<sup>117</sup> The payment will be converted into the Hong Kong local currency by the Shanghai subsidiary of the China Securities Depository and Clearing Co Ltd (ChinaClear, the central securities depository of China with the responsibility of providing securities clearing and settlement services) before being transferred to the HKEX-listed company via a designated broker, a purposefully-established subsidiary of the SSE that acts as the order routing facilitator for the southbound trading.<sup>118</sup> Upon receipt of the payment, the HKEX-listed company will transfer the underlying securities to ChinaClear's Hong Kong securities account, whereas the following transfer will be conducted on a nominal basis (see Figure 4).<sup>119</sup> The sale of underlying securities follows the reverse direction.

It should be noted that issuers participating in the stock connects are subject to market entry regulation. Under the northbound limb, only companies that have conducted a

<sup>115</sup>Lyu (n 59) 82.

<sup>116</sup>Qualified Chinese institutional investors have been permitted to purchase and trade shares listed on foreign stock exchanges since 2007, see Measures for the Administration of Overseas Securities Investment by Qualified Domestic Institutional Investors (for Trial Implementation) 2007.

<sup>117</sup>HKEX, 'Information Book for Investors', para 3.6 <[https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Investors/Investor\\_Book\\_En.pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Investors/Investor_Book_En.pdf)>.

<sup>118</sup>Provisions on Stock Connect Programmes between China and Hong Kong Securities Markets 2016, Arts 2 and 7.

<sup>119</sup>*ibid.*

dual-listing on the SSE and HKEX and companies indexed in the SSE 180 Stock Index or the SSE 380 Stock Index – which represents high-quality SSE-listed companies with a good business prospect – are permitted to participate in the SH-HK Connect.<sup>120</sup> As for the southbound limb, only companies that have conducted a dual-listing on the SSE and HKEX and companies quoted in the Hang Seng Composite LargeCap Index or the Hang Seng Composite MidCap Index – which denote HKEX-listed issuers that are of the best quality – are eligible to join the stock connects.<sup>121</sup> Therefore, by ringfencing issuers to high-quality market actors, it is expected to reduce the incidence of market misconduct under the stock connects.

As a stepping stone towards a common securities market, the stock connects have strength in accommodating red-chips. First of all, as A + H dual-listing is a way to join the stock connects, the benefits of accessing the capital pools and investor bases of both the Chinese and Hong Kong securities markets under the stock connects can encourage red-chips to pursue an A + H dual-listing. Accordingly, for the Sino-Hong Kong securities markets, the stock connects can help them attract red-chips. From investors' standpoint, the existence of cross-border regulatory cooperation under the stock connects, such as mutual assistance in enforcement,<sup>122</sup> can help safeguard their interests. Investors make investment decisions largely in light of the protection that the securities market can provide,<sup>123</sup> and their confidence and trust are important to the securities market pricing mechanism. In turn, investors' influence on the market valuation can determine issuers' choice of listing venue. In this regard, the cross-border regulatory cooperation under the stock connects can help both sides accommodate red-chips.

However, there are also some demerits that would need to be eliminated or harmonized. First and foremost, dual-listing is subject to dual-regulation. Under the circumstance that China and Hong Kong have different regulatory systems, the compliance burdens may discourage certain red-chips from conducting an A + H dual-listing. To resolve this problem, the stock connects may consider borrowing the HKEX's equivalence recognition mechanism.<sup>124</sup> As mentioned above, Hong Kong revised its listing regimes in 2018 to allow red-chips to conduct an SPO in the HKEX. However, compared to the US which is red-chips' primary listing destination, Hong Kong employs many *ex-ante* regulatory rules to safeguard investors. In order to resolve the potential regulatory conflicts, the Hong Kong authority has recognized the equivalence of the US regulatory rules and exempted qualified red-chips from being bound to the Hong Kong *ex-ante* regulatory

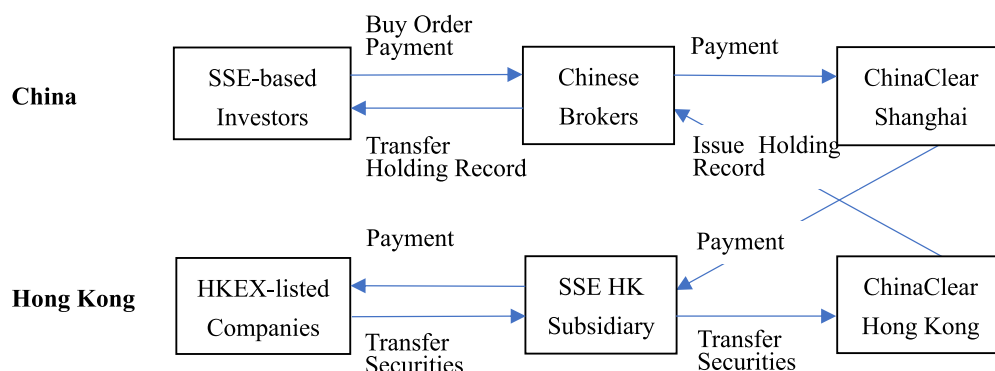
<sup>120</sup>Measures of the Shanghai Stock Exchange for the Implementation of the Shanghai-Hong Kong Stock Connect 2021 (Measures for SH-HK Connect 2021), Art 16. As for the Shenzhen-Hong Kong Stock Connect, eligible Chinese companies include issuers which are dual-listed on the SZSE and HKEX, and those are indexed in the SZSE Component Index and the SZSE Small/Mid Cap Innovation Index with a minimum market capitalization of RMB six billion, see HKEX, 'Stock Connect Another Milestone: Information Book for Market Participants', para 3.15 <[https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Market-Participants/EP\\_CP\\_Book\\_En-\(3\).pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Market-Participants/EP_CP_Book_En-(3).pdf)>.

<sup>121</sup>Measures for SH-HK Connect 2021 (n 120), Art 56.

<sup>122</sup>Memorandum between the China Securities Regulatory Commission and Hong Kong Securities and Futures Commission Concerning Strengthening Regulation and Enforcement under the Shanghai-Hong Kong Stock Connect 2014, Ch 6.

<sup>123</sup>Rafael La Porta and others, 'Investor protection and corporate governance' (2000) 58 Journal of Financial Economics 3, 5.

<sup>124</sup>Alternatively, the Sino-Hong Kong stock connects may consider borrowing the EU single market passport mechanism. Using the single market passport mechanism to eliminate regulatory barriers in the Sino-Hong Kong securities markets goes beyond the research scope of this article.



**Figure 4.** The Trading Process of the Shanghai-Hong Kong Stock Connect Southbound Limb.

\*The Figure is drawn by the authors. Source: Provisions on Stock Connect Programmes between Mainland China and Hong Kong Securities Markets 2016, art 2.

rules except for the disclosure requirements.<sup>125</sup> Considering that the equivalence recognition mechanism has already served as a legal infrastructure in the Hong Kong securities market, it may also be used by the stock connects to harmonize the Sino-Hong Kong regulatory conflicts in accommodating red-chips.

Secondly, the stock connects do not bear fundraising functions at present. However, red-chips may have post-IPO fundraising needs. Thus, it is necessary to go one step further to allow authorized red-chips under the stock connects to issue new securities in the future. As discussed above, some US-listed red-chips have conducted SPOs on the HKEX. Also, China has legalized the issuance of CDRs with fundraising functions. Thus, there are no legal barriers; instead, the issue lies in dual-regulation. Once again, equivalence recognition may be used to curtail red-chips' compliance costs and thus enhance the attractiveness of the Sino-Hong Kong common securities market.

The Sino-Hong Kong stock connects can enable authorized listed companies to access the capital pools and investor bases on both sides, and can thus encourage red-chips to conduct an A + H dual-listing which is a route to access the stock connects. However, the compliance burdens of dual-regulation and the lack of fundraising functions present some weaknesses of the stock connects, for which the existing legal infrastructures such as the equivalence recognition mechanism could be used as a potential solution. On top of these, the stock connects could serve as a stepping stone towards building a Sino-Hong Kong common securities market, which could help both sides accommodate red-chips based on market cooperation instead of mitigating the regulatory competition through state control. As articulated by Xiaojia Li, the former Chief Executive of the HKEX, that 'against the backdrop of launching the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, a common securities market is emerging'.<sup>126</sup>

<sup>125</sup>HKEX Main Board Listing Rules, r 19C.12.

<sup>126</sup>See Zhihao Luan, 'Xiaojia Li: The Financial Markets of Hong Kong and China have Entered a New Era of Common Market' (First Finance, 5 March 2015), <<https://www.yicai.com/news/4582216.html>>.

## VI. Conclusion

In order to underpin economic growth, China has entered into the arena of regulatory competition for listing red-chips by removing the long-standing taboo on red-chips' domestic flotation with the introduction of CDRs to serve as the listing and trading instrument. However, China has imposed stringent market entry regulation on CDR usage for quality control, thereby seeking to strike a balance between attracting red-chip issuers and protecting investors. In the post-reform era, red-chips' Chinese flotation with the use of CDRs is rare. For one thing, the overly strict market entry regulation may have hindered certain red-chips from pursuing an IPO with CDR usage in the Chinese securities market. For another, CDRs have not been used by red-chips to conduct Chinese SPOs due perhaps to China's political economy of prioritizing Hong Kong's securities market development at the cost of Chinese bourses' business opportunities.

Considering the initial purposes of conducting regulatory competition for listing red-chips, the post-reform landscape is well worth Chinese authorities' policy thinking. Although simply deregulating the use of CDRs may not generate a considerable difference in accommodating red-chips where other closely-related regulations on the use of the DCSS and VIE structure were not adjusted, the market practice has shown that the market entry regulation on CDRs may have caused substantial barriers which should thus be mitigated. For this purpose, in light of China's market realities, putting a higher reliance on supporting mechanisms, such as the use of the SSRA mechanism for *ex-post* remedy, could provide a legal basis for some orientation away from the market entry regulation without compromising investor protection.

Moreover, to mitigate the regulatory competition between the Mainland and Hong Kong securities markets for listing red-chips, state control is not the only option. Instead, building a Sino-Hong Kong common securities market based on the stock connects is a possible way forward, which could help both sides accommodate red-chips. However, the potential compliance costs from dual-regulation should not be ignored, for which the existing legal infrastructures in the HKEX, e.g. equivalence recognition, may be used as a solution. Also, given the fact that red-chips may have post-IPO fundraising needs, for building a Sino-Hong Kong common securities market to accommodate red-chips, it is crucial for the stock connects to develop fundraising functions in the future.

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No potential conflict of interest was reported by the authors.

## Data availability statement

The datasets of this article are the authors' original work, and are available at <<https://data.mendeley.com/datasets/wkx82j5cdz/1>>.

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