The Future of Chinese Capital Markets

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Abstract

In 2015 China's State Council approved to shift to a US style registration system for stock market flotations. The new registration system replaces the current IPO approval which has been criticised for its complexity and strict requirements. Meanwhile, China has created a more-favourable environment to attract the relisting of Chinese technology companies listed overseas and enable mutual market access between the mainland and Hong Kong via a 'Stock Connect' link, opening Chinese equity markets to international investors. The paper aims to analyse the recent stock market reforms in China and how such changes affect the future of Chinese capital markets. It covers the recent IPO reform and the new initiatives to attract Chinese technology companies to list or relist domestically, as well the internationalisation of Chinese capital markets.

1. Introduction

China's capital markets have gone through nearly 40-year development since the introduction of the reform and opening-up policy. Chinese stock markets were not initially an attractive financing option for most private Chinese enterprises. The Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) were established in the 1990s as arms of the central government to solve the capital shortages problems of state-owned enterprise (SOEs) and sell shares to outside investors thereby raising the value of the government's stake in these companies.[529] In recent years, however, Chinese domestic stock exchanges have started to become more competitive in the face of overseas stock exchanges which have historically dominated world-wide capital markets. In 2009 China became the world's biggest source of companies going public, both in number and value terms. 183 Chinese initial public offerings (IPOs) raised more than $55 billion, compared with $24 billion raised by US IPOs.[530] In September 2016 the stock exchanges of Shanghai, Hong Kong and Shenzhen ranked globally 4th, 7th and 8th, respectively.[531] China's capital markets have become a dynamic component of China's financial system and one of the major driving forces behind economic and social reforms.[532]

The Chinese regulators place a greater emphasis on maintaining the stability of capital markets by intervening and reasserting control of the markets through the 'national team'. But people cast doubt on the effects of such intervention as policies pursued by the government in search of new sources of growth are at least partly to blame for the creation of the bubble that burst in the summer of 2015.[533] Even worse, on 7 January 2016, the China Securities Regulatory Commission (CSRC) suspended new stock market rules after only four days because they were

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529 Zhen, Yong, *China's Capital Markets* (Chandos Publishing, 2013), 1; and Wong, Sonia, 'China's Stock Market: A Marriage of Capitalism and Socialism' (2006) 26 *Cato Journal* 389, 391-92.

530 Kwok, Vivian Wai-yin, 'China: The World's Biggest IPO Market', *Forbes*, 29 September 2009, available at <http://www.forbes.com/2009/09/29/china-nasdaq-ipo-markets-equity-second-board.html> accessed 15 November 2016.

531 Securities and Futures Commission (SFC) of Hong Kong, 'Market Capitalisation of the World's Top Stock Exchanges (as at the end of September 2016)' (2016), available at <http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/a01.pdf> accessed 15 November 2016.

532 CSRC, 'China Capital Markets Development Report' (2008), 153, available at <http://www.csrc.gov.cn/pub/csrc_en/Informations/publication/200911/P020091103520222505841.pdf> accessed 15 November 2016.

533 Shen, Samuel and Sweeney, Pete, 'China Stock Regulator Probes Market Impact of Automated Trading', Reuters, 31 July 2015, available at <http://uk.reuters.com/article/us-china-stocks-csrc-idUKKCN0Q505J20150731> accessed 20 November 2016.

fuelling sharp trading losses.[534] China's dramatic and short-lived experience with market circuit breakers has revived debate about whether existing financial systems in China are able to accommodate the growth of capital markets so as to support a sustainable economy.

Despite some unsatisfied government intervention in markets, China has determined to reform its capital markets which is embedded in the national policy. A pledge to allow the 'market to play a decisive role' in economy in the Third Plenum of the Chinese Communist Party's 18th Congress in 2013 has been seen as a major innovation in China's stock market.[535] It helps to accelerate the development of direct financing and to provide investors with more diversified investment channels.[536] One year later, the State Council promulgated the *Opinions on the Sound Development of Capital Markets*, which was instrumental in providing a roadmap and guideline regarding to capital market development for the next 5 - 10 years in the 'new normal' phase.[537] The *Opinions* stated the development of capital markets had to be centred around economic needs. It set up a framework for multi-layered capital markets, and laid out the principles and direction of registration-based IPO reform.

This article aims to provide a comprehensive review of the recent regulatory reforms and the implications for the future evolution of Chinese capital markets. After this introduction, it is divided into five sections, covering the recent IPO reform and the new initiatives to attract Chinese technology companies listed or relisted domestically, as well the internationalisation of Chinese capital markets.

2. From a Merit-based Regulation towards a Disclosure-based Regulation

Internationally, there are two main approaches to regulate securities offerings, the first of which is disclosure-based (also known as the registration system) and the other merits-based (also known as the approval system). The disclose-based model, adopted by most advanced economies like the US, UK, Australia and Hong Kong, requires adequate disclosure with respect to the transaction and imposing sanctions for false or misleading statements. By contrast, under the merit-based model, the regulatory authorities seek to protect the investor from abuse and ensure that the securities are offered to them at a fair price by intervening substantively in the offering process.[538] The public offering and listing, cannot proceed until the securities have been 'approved' by the authority, which is employed by China, Sweden and Switzerland.

[534] Zhai, Keith, 'China Suspends Stock Circuit Breaker Days After Introduction', Bloomberg, 7 January 2016, available at < http://www.bloomberg.com/news/articles/2016-01-07/china-stock-regulator-said-to-call-unscheduled-meeting-on-market> accessed 20 November 2016.

[535] Allen, Franklin and Qian, Jun, 'China's Financial System and the Law' (2014) 47 *Cornell International Law Journal* 499, 529. For the details on the pledge, see Chinese government's website <http://english.cntv.cn/special/18thcpcsession/homepage/index.shtml> accessed 20 November 2016.

[536] CSRC, 'Implement the State Council's Guiding Opinions on Launching the Pilot Programme for Preferred Shares', 30 November 2013, available at <http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201402/t20140211_243686.htm> accessed 24 November 2016.

[537] CSRC, 'Annual Report 2014' (2015), 1, available at <http://www.csrc.gov.cn/pub/csrc_en/about/annual/> accessed 15 November 2016.

[538] Merit regulation has been defined as '…a regulatory system that authorizes [the regulator] to deny registration to a securities offering unless the substantive terms of the offering and the associated transactions (i) ensure a fair relation between promoters and public investors, and (ii) provide public investors with a reasonable relation of risk to returns.' In the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, 'Report on State Merit Regulation of Securities Offerings' (1986) 41 *Business Lawyer* 785, 829.

In the view of Leng, However, there is no huge difference between the two systems except regulatory resources.[539] Both systems concern the principle of mandatory information disclosure as the prerequisite for a public listing of securities and the information on the issuer's ability to make continuing profits and the risk factors in the prospectus. The main differences of the two systems lie in the input of regulatory resources. The regulators in the US and UK only conduct a very limited review of intending issuers' substantive credentials and focus on a close examination of disclosure in the prospectus and imposition of liability ex-post. Upon approval, intending issuers can decide when to enter the IPO market, leaving the market to decide the size of the offering and the level of the offering price.

In China, before the merit-based approval system, the quota system had been operated since 1993 with the intention of curbing the potential excessive investment demand in a premature market. The CSRC would review each listing of applicant and channel the funds to important SOE sectors such as energy, natural resources, manufacturing and heavy industry. However, the quota system was replaced by an approval system in 2001 owing to the heavy criticism on its manipulation of market sentiment and the vulnerability of corruption.[540]

Article 10(1) of China's *Securities Law 2014*[541] empowers the CSRC to conduct substantial examination of the efficacy or equity of the proposed offerings. A public issuance of securities shall meet the requirements prescribed in laws and administrative regulations and shall be reported to the CSRC under the State Council or the department authorised by the State Council for verification and approval according to law. Without any examination and approval according to law, no entity or individual may make a public issuance of any securities.[542] The Securities Law then sets out substantive approval requirements for public offerings.[543] The CSRC distinguishes IPO and subsequent offerings when it comes to the substantial criterial of review and approval. Specifically, IPO is governed by the *Measures for the Administration of Initial Public Offering and Listing of Stocks* and the subsequent offerings are regulated by the *Measures for Securities Offerings by Listed Companies*. The application documents are subject to the review and examination of the Public Offering Review Committee, which comprises both the CSRC staff and external experts. The Committee members vote by majority when recommending to the CSRC for a public offering.[544] Taking into consideration of the recommendation of the Committee, the CSRC finally decides whether or not to approve a public offering.

[539] Leng, Jing, 'Liberalising Capital Market Entry in China: Building a Registration System' in Hu, Jiaxing et al (eds), *Finance, Rule of Law and Development in Asia: Perspectives from Singapore, Hong Kong and Mainland China* (Martinus Nijhoff, 2016), 391-92.

[540] Huang, Flora, 'In Defence of China's Public Enforcement in Equity Market' (2010) 21(1) *International Company and Commercial Law Review* 327, 331.

[541] China's *Securities Law* was enacted in 1999 and revised in 2005 and 2014. The Amendment to the Securities Law paves way for the reform of the new share sales mechanism. See Li, Xiang, 'Amendment to Securities Law to Get Green Light', China Daily, 11 March 2015, available at <http://www.chinadaily.com.cn/bizchina/2015-03/11/content_19775585.htm> accessed 20 November 2016.

[542] Art 10(1) *Chinese Securities Law 2014*.

[543] Ibid, Art 13: the issuer must (1) have a complete and well-operated organisation; (2) have the capacity of making profits successively and a sound financial status; (3) have no false record in its financial statements over the latest 3 years and have no other major irregularity; and (4) meet any other requirements as prescribed by the CSRC.

[544] Art 3 *Measures of CSRC Public Offering Review Committee 2009*. The number of the Committee member reduces from 80 to current 25. 5 of them are the CSRC staff and the rest are from government agencies, stock exchanges and academia.

The operation of the merit-based system has long been criticised as one of the fundamental deficiencies in China's stock market.[545] Merit review and approval essentially represented a form of state 'paternalism' in which they replace investors' value judgement with those of the securities regulators.[546] They 'unnecessary constrain' the freedom of entrepreneurs and impede the flow of capital to its most efficient use.[547] Therefore, China follows the word-wide trend, in particular in the Asia-pacific region such as Japan, Malaysia and Singapore, to move from a merit-based approach to a disclosure-based one to regulate the issuers.[548]

After the Third Plenary Session of the 18th Central Committee, the CSRC incorporated the decision of the Committee into its *Opinions on Further Developing IPO System Reform*.[549] And then the State Council published a new guideline (New Nine Measures) setting various capital market reform goals with placed the IPO registration system at the top of its agenda.[550] In December 2015 China's State Council approved to shift to a US-style registration system for stock market flotations, removing a stumbling block that has distorted supply and demand, and artificially inflated valuations of new stock offerings.[551]

The new registration system replaces the current IPO approval process by the CSRC, which has been criticised for its complexity and strict requirements. The changes are expected to help companies raise money more efficiently and reduce the involvement of regulators in the capital market.[552] But the State Council announced that the stock exchanges had to wait for at least two years to adopt the new registration system for IPOs, after receiving approval from the Standing Committee of the National People's Congress.[553] The CSRC also responded that the reform would be gradual and would not lead to a big increase in the number of IPOs.

3. Keep Chinese Technology Companies to Stay Home

With many premium technology companies, such as Alibaba, Sohu, Baidu and Youku listing overseas particularly in the US, Chinese regulators are compelled to provide more-favourable regulations to attract their listing or relisting on domestic markets. They also point to the stunning success of companies such as Beijing Baofeng Technology Company, whose shares have skyrocketed more than 3,600% since listing in China in March 2015.[554]

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545 Hong, Shen, 'Reforms Could Put China's IPO Market Back in Business', *Wall Street Journal*, 15 November 2013, available at <http://blogs.wsj.com/chinarealtime/2013/11/15/reforms-could-put-chinas-ipo-market-back-in-business> accessed 24 November 2016.

546 Huang, Hui 'The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis' (2011) *Hong Kong Law Journal* 261, 268.

547 Campbell, Rutheford 'An Open Attack on the Nonsense of Blue Sky Regulation' (1985) 10 *Journal of Corporation Law* 553, 565

548 HKEx, 'Disclosure-Based Regulation' (2000), available at <http://www.hkex.com.hk/eng/stat/research/rpaper/Documents/DBR.pdf> accessed 10 November 2016.

549 CSRC released the Opinions 13 November 2014, available at <http://www.csrc.gov.cn/pub/csrcen/newsfacts/release/2014 02/t20140214_243817.html> accessed 24 November 2016.

550 Lan, XInzhen, 'Unlocking the Stock Market', 27 May 2014, available at <http://www.china.org.cn/opinion/2014-05/27/content_32502442.htm> accessed 24 November 2016.

551 Xinhua News, 'Lawmakers Give Nod to Registration-based Stock Listing', 27 December 2015, available at <http://www.china.org.cn/business/2015-12/27/content_37406429.htm> accessed 24 November 2016.

552 Reuters, 'LSE and Haitong Securities to Work to Bring Chinese Firms to London', 10 June 2015.

553 Chen, Judy et al., 'China's Cabinet Outlines Two-Year Timetable for IPO Overhaul', Bloomberg News, 10 December 2015, available at <http://www.bloomberg.com/news/articles/2015-12-09/china-s-cabinet-outlines-two-year-timetable-for-ipo-overhaul> accessed 24 November 2016.

554 Li, Yuan, 'Chinese Tech Firms Aim to Stay Home', *Wall Street Journal*, 28 May 2015.

However, the biggest barrier to keep the internet and innovation companies listed domestically is regulatory rules which ban significant foreign ownership of such companies. The *Catalogue for the Guidance of Foreign Investment Industries*[555] classifies industries in which foreign investment is encouraged, restricted or prohibited. In order to get around these restrictions or prohibitions, Chinese companies often use 'Variable Interest Entity' (VIE), allowing them to acquire foreign capital despite a ban on foreign investment in the relevant sectors. The term of VIE is initially used by the US Financial Accounting Standards Board (FASB) in FIN 46[556] to refer to an entity in which the investor holds a controlling interest that is not based on the majority of voting rights. The US General Accepted Accounting Principles require the reporting entity to consolidate the financials of the VIE after the Enron scandal, provided that the reporting entity is a primary beneficiary of the VIE. This type of legislation in the US intends to prevent the off-balance-sheet liabilities hidden in the reporting company's special purpose entities (SPE) from going undetected and causing systemic risks.[557]

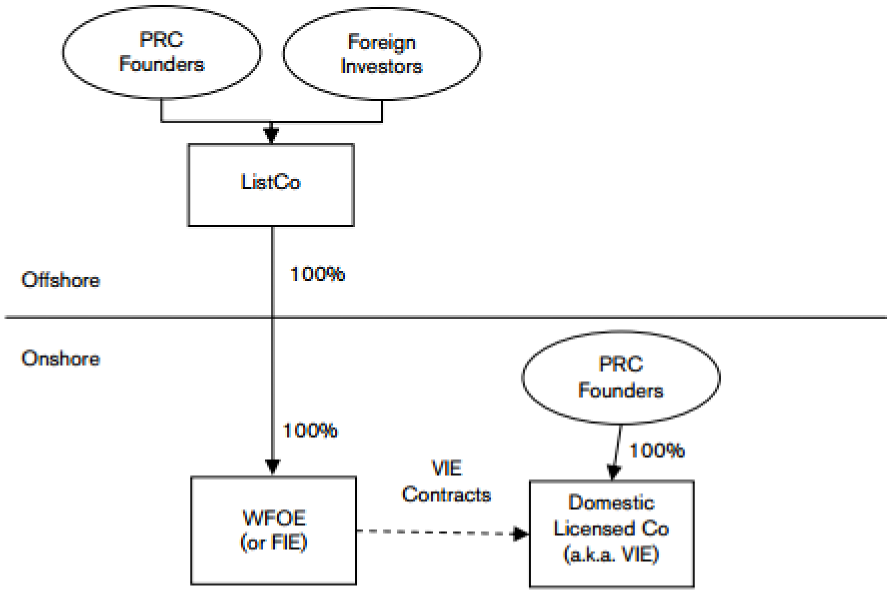
Under a typical VIE Structure (see Figure 1), the foreign investor will establish jointly with a domestic partner (PRC Founders) an offshore entity (ListCo) to directly or indirectly own a wholly foreign-owned enterprise (WFOE) or similar Foreign-invested Enterprise (FIE) in China. This foreign-controlled WFOE (or FIE) has control over the ownership and management of a domestic licensed company that holds the necessary license(s) to operate in a sector where FDI is restricted or prohibited (the 'Domestic Licensed Co', also commonly referred to as the VIE.

[555] It was promulgated by the State Planning Commission (SPC), State Economic and Trade Commission (SETC) and the Ministry of Commerce (MOFCOM) in 1995 and revised several times. Now it has the latest version of 2015

[556] FIN 46, Consolidation of Variable Interest Entities, was issued in January 2003 and revised by FIN 46R in December 2003. FIN 46R was then replaced by a new accounting standard, FASB Statement 167, in June 2009 in the aftermath of the global Financial crisis.

[557] Steel, James, 'Variable Interest Entities (VIEs), Qihoo 360 and China' (Hedge Fund Consulting and Short Equity Research, May 2012, available at <www.shortzilla.com/variable-interest-entities-vie-qihoo-360-and-china> accessed 1 November 2016; and Chen & Co Law Firm, 'In Focus: Variable Interest Entities (VIEs) - Part I' (2013), available at <http://www.chenandco.com/publications/VIEs-english.pdf> accessed 1 November 2016.

Figure 1 – Typical VIE Structure



Source: Cadwalader, Wickersham & Taft LLP, 'Understanding the VIE Structure: Necessary Elements for Success and the Legal Risks Involved' (2011).

The VIE has been used in China to serve two purposes: firstly, to circumvent restrictions on foreign investment in specific industries; secondly, to restructure a 'round-trip investment' by using a controlled offshore company to acquire the affiliated domestic enterprise. The 'round-trip investment' is defined as direct investment activities carried out within China by a Chinese domestic resident directly or indirectly via a special vehicle purpose.[558] This broad definition apparently includes round-trip investments by way of VIE structures. Motives for China's round-trip investment are not only tax advantages and fiscal incentives, but also related to the safety and risk management of capital.[559] Although the China's State Administration of Foreign Exchange (SAFE) has agreed to register the SPV and its round-trip investment (i.e., establishment of the WFOE) since 2014, the SAFE makes clear that it shall not be deemed to have endorsed the legality of VIE[560] The SAFE's Circular 37 is a required registration application that allows the Chinese government to regulate many of the shareholding arrangements, foreign currency flows, and tax issues associated with VIE structures and round-trip Investments.

558 *The Notice of the State Administration of Foreign Exchange on Relevant Issues Concerning Foreign Exchange Administration for Overseas Investment, Financing and Round Trip Investment Undertaken by Domestic Residents via Special Purpose Vehicles* (Circular 37), which was released on 14 July 2014.

559 Geng, Xiao. 'Round-Tripping Foreign Direct Investment in the People's Republic of China' (2004) ADBI Research Policy Brief No.10 Private Sector Development, 10, available at <http://www.adb.org/sites/default/files/publication/157279/adbi-rpb10.pdf> accessed 22 November 2016.

560 McDermott Will & Emery, 'New SAFE Rules Facilitate Registration for Overseas Financing and Investment by Chinese Domestic Residents', 22 July 2014, available at <https://www.mwe.com/en/thought-leadership/publications/2014/07/new-safe-rules-facilitate-registration-for-overs> accessed 21 November 2016.

The VIE structure not only exacerbates the agency costs within the company,[561] but also may pose a substantial risk to foreign investors as it is technically illegal under Chinese law.[562] In July 2006, the China's Ministry of Information and Industry enacted the *Circular on Strengthening the Administration of Foreign Investment in Operating Value-added Telecommunication Business*, which provides that domestic telecom companies are not allowed to lease, transfer, or sell licences relating to the telecom business to foreign investors.[563] In the same year, the *Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* (the M&A Rules) in 2006 require central government approvals from the China's Ministry of Commerce (MOFCOM) and the CSRC for cross-border acquisitions of Chinese assets or equity.[564] Following the 2006 M&A Rules, it became necessary to set up an offshore entity and WFOE prior to any onshore acquisition. Failure to set up the aforementioned entities in the correct order risks violating the 2006 M&A Rules.

The recent arbitration and judiciary decisions also have significantly deepened the worries concerning the legality of VIEs. In 2010-2013 the VIE agreements were void by the China International Economic and Trade Arbitration Commission and the Supreme People's Court on the grounds that they violated Chinese law that prohibits foreign investors from controlling and participating in the FDI restricted business and constituted 'concealing illegal intentions with a lawful form'.[565]

Recently the new drafted Foreign Investment Law (FIL) marks a significant move to relax its regulation on foreign investment with a particular focus on VIEs, which is currently under consideration and is submitted to the National People's Congress this year for approval.[566] The draft FIL proposes to replace the absolute restrictions and prohibitions on investment in certain industries with a new rule allowing foreigners to invest in such industries as long as businesses are majority-owned by Chinese citizens. It means that the VIE structure will no longer be needed for foreign investors to invest in a company within a restricted or prohibited industry, as long as they do not take a controlling position in the company. But the existing VIE structure may not be automatically grandfathered until the Ministry of Commerce (MOFCOM) reviews existing VIE structures and validates as appropriate.

However, concerns remain over the level of the Chinese government's intervention in the review process.[567] One the one hand, the government are opening up and relaxing the approval

[561] Chinese entities operating in sensitive sectors pay a high price in terms of valuation discounts for regulation prohibiting international ownership. Hopkins, Justin *et al.* (2016), 'When Enron Met Alibaba: The Rise of VIEs in China', working paper, Darden Graduate School of Business, University of Virginia.

[562] Gough, Neil, 'In China, Concern about a Chill on Foreign Investments', *New York Times*, 2 June 2013.

[563] For the original Chinese version, see MOFCOM's website at <http://www.mofcom.gov.cn/article/b/g/200608/20060802960777.shtml> accessed 15 November 2016.

[564] See MOFCOM's website at <http://english.mofcom.gov.cn/article/policyrelease/announcement/201003/20100306819130.shtml> accessed at 15 November 2016.

[565] Wong, Gillian and Osawa, Juro, 'How China's New Foreign Investment Rules Might Play Out', *Wall Street Journal*, 22 January 2015, available at <http://blogs.wsj.com/digits/2015/01/22/how-chinas-new-vie-rules-might-play-out> accessed 20 November 2016.

[566] China Briefing, 'China's Upcoming 2016 Foreign Investment Law Revisions to Boost Service Sector', 4 April 2016, available at < http://www.china-briefing.com/news/2016/04/04/chinas-upcoming-2016-foreign-investment-law-revisions-to-boost-service-sector.html> accessed 20 November 2016.For the full text of FIL and the Explanatory Note, see the MOFCOM's website, at: <http://www.mofcom.gov.cn/article/ae/ag/201501/20150100871007.shtml> accessed 20 November 2016.

[567] Russell, Chris, 'Rules of the Game: Changes in China's Foreign Investment Law', CKGSB Knowledge, 25 June 2015, available at

requirements for foreign investment generally, but on the other hand they are strengthening their ability to intervene, for example through the national security review. The draft FIL provides that any foreign investment that gives rise to or could give rise to national security concerns will be subject to a national security review. The result of a review would not be subject to any administrative or judicial review. This is significantly broader than the scope of China's existing rules in this area where a review is required only where the investment is in certain sensitive sectors or locations and involves certain types of transactions. This new broader ambit would add uncertainty into new investment projects as investors would not know for sure whether or not the additional time and cost of a national security review process will need to be factored into their establishment process.[568] It also gives rise to concerns that the discretion to require a national security review will be exercised for purely political reasons.

4. China's Stock Exchanges – Compete and Connect

To further encourage the relisting of overseas-traded Chinese companies on domestic markets, China announced to create the Strategic Emerging Industries Board in the SHSE in 2015 to give the green light to innovative companies. But it will be formally established after China formally switches its approval system for IPOs to allow corporate leaders and market conditions, rather than regulators, to determine the size and timing of IPOs. The new board is considering more relaxed criteria, such as waiving requirements on revenue and allowing unprofitable applicants listing.[569] It will also host companies in sectors favoured by China for building an innovation-driven economy, including computer science, information technology, renewable energy and bioscience.

However, Shanghai new board will face challenges in positioning itself to compete for the pie of emerging industries, not only with overseas exchanges such as the New York Stock Exchange and Nasdaq, but also with China's own exchanges. The SZSE established the Small and Medium Enterprise (SME) board to lower the entry barriers for enterprises in relatively mature stage of development in 2004, and its own Nasdaq style of ChiNext for innovative growth enterprises in 2009.[570] In May 2016 the Shenzhen's SME board for mostly non-state companies first took over Shanghai - China's oldest bourse as the top of turnover rakings for China's four major trading venues.[571] The ChiNext now had 809 listed companies in November 2016, and the turnover is almost as high as those in the main board at over RMB100 billion a day.[572]

Then the Chinese National Equities Exchange and Quotations (NEEQ) in Beijing, a market generally referred to as the new third board, was designed for the transfer of stakes in unlisted companies and other over-the-counter transactions in 2012. It had 9,723 companies including

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<http://knowledge.ckgsb.edu.cn/2015/06/25/finance-and-investment/rules-of-the-game-changes-in-chinas-foreign-investment-law> accessed 22 November 2016.

568 Canfield, Miller, 'China's Draft Foreign Investment Law Could be A Game Changer?' Lexology, 8 June 2015, available at <http://www.lexology.com/library/detail.aspx?g=f04759a2-f938-4893-8382-e07d6e813958> accessed 22 November 2016.

569 Hong, Shen, 'Shanghai Stock Exchange Planning Startup Market', Wall Street Journal, 19 May 2015, available at < http://www.wsj.com/articles/shanghai-stock-exchange-planning-startup-market-1432035751> accessed 26 November 2016.

570 For the differences between the SME board and ChiNext, see the website of SZSE, available at <https://www.szse.cn/main/en/ListingatSZSE/ListingQA> accessed 24 November 2016. See also, Yeung, Horace, 'Just Another Casino? The Case of Launching the Growth Enterprise Board in China' (2010), 21(2) *International Company and Commercial Law Review* 68, for the development of ChiNext.

571 Bloomberg, 'Sorry Shanghai, There's a New China Stock Exchange King', 27 June 2016, available at <http://www.bloomberg.com/news/articles/2016-06-27/tiny-stocks-trade-like-giants-on-china-s-new-king-of-exchanges> accessed 24 November 2016.

572 SZSE, 'Market Overview, available at <http://www.szse.cn/main/en/MarketStatistics/MarketOverview> accessed 24 November 2016.

many technology, biochemical and new industry stocks in November 2016.[573] In terms of the number of listings, it has more than the combined number of 3,000 companies listed in Shanghai and Shenzhen in the same period.

Hong Kong launched the Growth Enterprise Market (GEM) in 1999 to provide a fund-raising venue for technology industries. But its track record is not so great as it can only attract 250 companies to list compared with the 1,703 companies listed on the main board, as of 23 November 2016.[574] The turnover and market cap of the GEM accounted for about 1 per cent of the main board. The problem of the GEM is that its threshold is too high for new start-ups while most up and running companies would prefer to wait by producing a profit so they can list on the main board which enjoys a higher turnover and a better reputation.[575] For Hong Kong, the Securities and Futures Commission (SFC) chairman Carlson Tong Ka-shing said earlier they would review the GEM and other listing rules regime to make improvements. How to revamp the GEM and to let the city to compete with Shanghai's new board will definitely be something on the agenda.

While Chinese stock exchanges compete for the top venue for listings, they have worked intensively via the 'Stock Connect' link to build up a single market for a wider range of investors. Shanghai-Hong Kong Stock Connect was launched in 2014 to enable mutual market access by investors in the two markets through a controllable and expandable channel.[576] Shenzhen-Hong Kong Stock Connect would be also inaugurated by the end of 2016 to allow global investors access to the nation's new economy, particularly in sectors such as IT, high-end manufacturing and new materials, in contrast to the SHSE which is dominated by state-owned banks and oil companies.

Stock Connect allows mainland investors to buy Hong Kong-listed equities directly and waive the need for investment licenses for global investment funds looking to trade mainland shares. The scheme creates a single Chinese stock market that ranks as one of the three biggest in the world by market capitalisation and daily trading turnover. The move may help diversify the portfolios of Chinese investors, increase efficiencies for trading in Chinese companies that are dual-listed on both exchanges, and prompt rapid inclusion of Chinese stocks in global benchmark stock indices.[577] It will also help to build Hong Kong into a comprehensive financial centre that can serve as an offshore wealth management centre for mainland investors, an offshore pricing centre for the Renminbi and global asset classes for the mainland.[578]

Given that a number of equities are dual-listed in both Hong Kong and mainland China, a hurdle facing Stock Connect is a share price gap between the two markets.[579] There are three share classes in China: A-shares (local Chinese companies denominated in RMB), B-shares (shares listed on mainland Chinese exchanges in foreign currencies) and H-shares (the shares of companies incorporated in mainland China that are traded in Hong Kong). Because H-

[573] The website of the NEEQ, available at <http://www.neeq.com.cn> accessed 24 November 2016.

[574] HKEx, 'Market Highlights', available at <http://www.hkex.com.hk/eng/csm/highlight.asp?LangCode=en> accessed 24 November 2016.

[575] Yiu, Enoch, 'Shanghai New Board Has to Compete with Shenzhen, Beijing and Hong Kong', *South China Morning Post*, 28 December 2015.

[576] HKEx, 'Shanghai-Hong Kong Stock Connect', 12 August 2016, available at <http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/Investor_FAQ_En.pdf> accessed 25 November 2016.

[577] Goldman Sachs, 'SH-HK Connect: New Regime, Unprecedented Opportunity' 11 September 2014, available at <http://www.goldmansachs.com/our-thinking/pages/stock-connect/report.pdf> accessed 26 November 2016.

[578] HKEx, 'HKEX Set for Another Step Forward in Mutual Market Access' 16 August 2016, available at <https://www.hkex.com.hk/eng/newsconsul/hkexnews/2016/1608162news.htm> accessed 26 November 2016.

[579] Huang, Flora and Horace Yeung, *Chinese Companies and the Hong Kong Stock Market* (Routledge, 2014), 189-193.

shares are traded internationally and A-shares domestically, shares of the same company have often been traded at quite different price levels. At some times A-shares, because of the sheer scale of domestic demand, have been valued higher than H-shares, and at some times the other way around. As a consequence of investors directing their orders to the most attractively priced venue, price differences in dual-listed shares is likely to narrow as the programme develops. The average price gap in dual-listed stocks in both the mainland and Hong Kong has narrowed to 21 per cent from as much as 46 per cent.[580]

5. Internationalisation of Stock Exchanges

Traditional scholarship indicates that one of the most common reasons for companies to cross-list in reputational stock exchanges is to receive premium investor protection – the bonding hypothesis.[581] However, there is a new trend of reverse cross-listing in the global capital markets, which runs in the opposite direction - companies from stronger perceived investor protection regimes, such as the US and UK, may still list in weaker perceived investor protection regimes, such as India or China. This type of cross-listing particularly exists in banking and financial services with high levels of customer or suppler trust, or manufacturing or restaurant services in which there is an urgent need to raise local currency finance where that currency is non- or partially-convertible.[582]

To attract foreign investments, the CSRC and the SHSE prepared to establish an 'International Board', allowing qualified overseas companies to sell RMB-backed A shares to in Chinese domestic markets. It also would allow overseas-registered Chinese companies like China Mobile and Lenovo to list their shares in China. The promotion of the International Board, was officially and publicly announced by China's State Council in the *Opinions on Promoting Shanghai to Two Centers* (Guo Fa No. 200919) and was listed as one of the seven most important working assignments of the CSRC. By attracting profitable companies from across the world to be listed on the SHSE, Chinese investors will be able to share the dividends derived from foreign listed companies and to expedite the internationalisation process of the RMB. But the launch of International Board has been still in the endless delay since 2009. The 2013 announcement about the establishment of a new 'China (Shanghai) Pilot Free Trade Zone' led to a frenzy in China and abroad about that Zone being approved as the venue for the Shanghai's international board, but it was subsequently denied by the CSRC and SHSE.[583]

There are abundant issues resulting in the delay of the establishment of International Board. One of the biggest difficulties stems from the continued constraints on convertibility of the RMB on the capital account.[584] A foreseeable challenge will be to cross-border exchange-traded funds, China depository receipts, and foreign enterprise secondary offerings because they are all restricted by China's foreign exchange control. These restraints have operated since the very start of China's reform and opening to the outside world policy, and it appears that China

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580 Ren, Daniel, 'Price Gap Narrows between Shenzhen and Hong Kong Stocks Ahead of Connect Plan', South China Morning Post, 21 October 2016, available at <http://www.scmp.com/business/companies/article/2039019/price-gap-narrows-between-shenzhen-and-hong-kong-stocks-ahead> accessed 26 November 2016.

581 The bonding hypothesis was proposed by Coffee and Stulz, see Coffee, John, 'The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications' (1999), 93 *Northwestern University Law Review* 641; Coffee, John, 'Racing towards the Top? The Impact of Cross-listings and Stock Market Competition on International Corporate Governance' (2002), 102 *Columbia Law Review* 1757; Stulz, Rene, 'Globalisation, Corporate Finance, and the Cost of Capital' (1999), 12 *Journal of Applied Corporate Finance* 8.

582 Howson, Nicholas and Khanna, Vikramaditya, 'Reverse Cross-listings – the Coming Race to List in Emerging Markets and an Enhanced Understanding of Classical Bonding' (2014) 47 *Cornell International Law Journal* 607, 619.

583 Zhao, Qian, 'SSE Denies International Board Rumours', *Global Times*, 10 November 2013, available at <http://www.globaltimes.cn/content/817009.shtml>accessed 20 November 2016.

584 Howson and Khanna (2014), see note 53, 619.

is moving inexorably towards the final elimination of those constraints. Next, some major legal problems must be tackled before the launch of the board as the current company law and securities law do not cover foreign companies, or overseas registered companies.[585] Last but not least, how to coordinate the relationship with Hong Kong also affects the implementation of the international board. Presently RMB is nonconvertible and is limited by the A-share market, therefore international investors make investments in China through Hong Kong. The International Board will make Shanghai a financial centre for foreign investment, which may threaten Hong Kong's status as a platform for foreign investors to circumvent Chinese regulations.[586]

6. Conclusion – 'One Country, One Market'

China has been counting on innovation and consumption to revive its slowing economy. Reform of the issuance system of new shares and lessening the investment and listing regulations for overseas issuers are at the core of China's capital market development. The reform can enhance issuance efficiency, optimise resource allocation and open-up domestic markets for international investors.[587] It is of great significance for the sound development and further improvement of the capital market. Analysts have predicted that acceleration of the stock market reform will further open-up and enhance the A-share market, which would result in China becoming a champion in the IPO market in 2016.[588]

The Shanghai-Hong Kong Stock Connect creates the second biggest stock market in the world, with a combined market capitalisation of over US$7 trillion and annual turnover of more than US$9 trillion.[589] By adding the soon-launch of Shenzhen-Hong Kong Stock Connect and Shanghai's International Board, China will further liberalise its capital account to international investors and build up a single Chinese market by consolidating the strengths of the three stock exchanges. The stock exchanges also will likely derive greater economies-of-scale advantages from integration, both in their operations and in their trading of stock. On the operational side, integration can generate trading efficiencies by enhancing market liquidity and minimising market fragmentation.

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[585] China Daily, 'CSRC Mulls International Board', 29 November 2010, available at <http://china.org.cn/business/2010-11/29/content_21444669.htm>.

[586] Cheng, David and Sun, Shelly, 'Shanghai's International Board', Nixon Peabody LLP, 10 June 2010, available at <http://www.nixonpeabody.com/files/China_Alert_06_10_2010.pdf> accessed 20 November 2016.

[587] Su, Chen and Yu, Jing, 'Market-Oriented Reform of China's IPO System and Information Disclosure Regulations' in Chen et al. (eds), *The Chinese Stock Market Volume 1* (Palgrave Macmillan, 2015), 39.

[588] Xinhua Finance, 'China Could be the Top IPO Market in 2016', 4 January 2016, available at < http://en.xfafinance.com/html/Markets/Stocks/2016/183829.shtml> accessed 26 November 2016.

[589] Wright, Chris, 'One Country, One Market? Making Money from Shanghai-Hong Kong Stock Connect', Forbes, 11 November 2014, available at < http://www.forbes.com/sites/chriswright/2014/11/11/one-country-one-market-making-money-from-shanghai-hong-kong-stock-connect/#20a579816b83> accessed 28 November 2016.