

SPECIAL INTEREST SERIES



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# The Shanghai International Board: Challenges and Opportunities



City of London Economic Development  
PO Box 270, Guildhall, London, EC2P 2EJ  
[www.cityoflondon.gov.uk/economicresearch](http://www.cityoflondon.gov.uk/economicresearch)

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PO Box 270, Guildhall  
London  
EC2P 2EJ

**<http://www.cityoflondon.gov.uk/economicresearch>**

# Table of Contents

<b>Executive Summary</b> .....	1
<b>1. Introduction</b> .....	3
<b>2. The outlook for financial sector reform</b> .....	5
<b>3. Background on China's capital markets</b> .....	9
• Overview .....	9
• Hong Kong .....	9
• Hong Kong's interplay with the Mainland economy .....	9
• The Hong Kong market depends on the Mainland .....	11
• Mainland capital markets: Shanghai and Shenzhen .....	13
<b>4. The Shanghai International Board</b> .....	16
• Background .....	16
• What is the Shanghai International Board.....	16
• The story so far .....	17
• Timeline .....	18
• Main features of the Shanghai International Board .....	19
• Potential listing candidates .....	20
• Pricing mechanism .....	22
• Market participants .....	24
• Case study: Lessons to be learnt from Japan .....	25
• Regulatory and institutional arrangements .....	26
<b>5. Conclusion</b> .....	30
• Implications for UK based firms .....	30
<b>6. Appendix</b> .....	31
<b>7. List of abbreviations</b> .....	33

## **Executive Summary**

This special interest paper for the City of London Corporation assesses the prospects for the Shanghai International Board and the opportunities and challenges it presents for UK-based firms. The main section looks into the likely scale, scope and framework of the Board, highlighting the challenges the government and the financial authorities face in implementing plans for the Board and how they are expected to resolve them. Separate chapters set out the background to the Board, examining how it fits in with China's longer-term financial sector goals and capital market development.

### **China's financial system does not match the size and status of its real economy**

Although China is the world's third-largest economy, its financial sector lags behind those in developed countries. Characterised by shallow capital markets and high levels of government control, China's financial system provides few investment options for local investors – including households with their high levels of savings – and limited capital-raising opportunities for domestic enterprises, which still rely heavily on bank financing. China's financial sector does not have a significant international presence.

### **Government plans for the financial sector are ambitious**

Beijing aims to build a more advanced financial system that has greater influence in the international arena. Its long-term goals include promoting financial deepening and increasing the sophistication of financial instruments for savers, borrowers and investors, as well as the eventual development of the renminbi (RMB) as an international reserve currency alongside the US dollar and the Euro.

### **The Shanghai International Board fits within these goals**

The implementation of the Shanghai International Board would be a step towards realising these goals. As a venue for RMB-denominated shares of foreign companies to be listed and traded on China's stock market, it would provide Chinese investors with wider options and increase usage of the RMB by non-Chinese firms. The Board would attract financial professionals and international financial intermediaries to Shanghai, thereby creating a critical mass of talent to spur the development of relevant financial sector infrastructure on the Mainland.

### **Hong Kong could be negatively affected by the Mainland's ambitions**

Hong Kong, which has been under Chinese sovereignty since the 1997 handover, has long been the pre-eminent venue for financial intermediation between large Chinese firms and foreign investors and derives the largest portion of its financial sector revenues from this type of business. As China aspires to elevate its status in the global financial system, Hong Kong is attempting to deepen its financial integration with Mainland China by becoming an offshore RMB trading centre and providing a wide array of RMB-denominated investment products. However, the Shanghai International Board will increase competition within China for listings and for related financial services over the medium term.

### **Details about the Board are not in the public domain**

Government authorities have released limited information on the Board to the public. As a result, market participants do not have a firm grasp of what the government intends for the Board in terms of its frame, scale and scope. Information gathered from our contact with policymakers, which is included in this special interest paper, demonstrates that by and large the Board is expected to follow accepted principles and standards for international boards. Foreign companies and red chip firms, the main targets for the Board, will list through initial public offerings (IPOs) of new shares denominated in RMB. The authorities will likely make several key adjustments to some of China's existing stock market conventions, such as the IPO pricing mechanism. New regulations in the areas of corporate governance, information disclosure and accounting standards are also expected to supplement China's existing regulations, which are widely considered to be costly and cumbersome. While the government will not relax capital controls to enable foreign investors to buy and trade shares freely on the exchange, they are expected to create a single exception to these controls in order to allow foreign firms that list to repatriate funds.

### **Timing is the biggest unknown**

The start date for implementation of the Board is a matter of wide speculation, with the anticipated dates ranging from 2011 to 2015. The government is likely to be cautious in rolling out the Board, initially conducting a small pilot programme before expanding it to include 20-30 companies over the subsequent five years, conditional on the success of the initial pilot phase. This slow start will take the pressure off other financial centres, including Hong Kong, as the Board is not likely to pose a short- to medium-term threat to their business activities.

### **Opportunities and challenges for UK-based firms stemming from the Board**

Although it is too early to predict the precise opportunities and challenges stemming from the Board for UK-based firms, there are broad areas in which City financial services firms could benefit – though, it must be stressed, many of these opportunities remain contingent on the authorities passing key rules and regulations. City accountancy firms in partnership with local Chinese firms may be able to raise their profile by providing technical support for auditing financial statements in line with international accounting standards. City law firms could expand their business by coordinating the new obligations of international companies on the Shanghai International Board with their existing obligations.

In addition, the Board may provide new underwriting opportunities for foreign-invested securities firms in China as they have an advantage in being more familiar with the structure and operations of international companies. Moreover, if blue chip financial companies from the City are among the first few listed firms on the Shanghai International Board, they could have opportunities to advise other foreign companies on carrying out IPOs on the Board.

## Chapter 1: Introduction

The City of London commissioned Trusted Sources to produce a special interest paper on the background to, and prospects for, the Shanghai International Board.

### Project design

The research strategy utilised focused desk research and made extensive use of findings from semi-structured interviews conducted with key government officials and market participants in Shanghai, Beijing, Hong Kong and London.

### Key questions

This special interest paper seeks to address a number of questions:

- What are the government's plans for the Shanghai International Board?
- What are the likely framework, scope and scale of the Board?
- What is the timeline for implementation?
- What challenges and opportunities will the Board pose to City firms?
- What will be the main impact of the Board on other financial centres, in particular London and Hong Kong?

### Desk research

This part of the research was designed to:

- Provide background information on the long-term financial sector development goals of the Chinese leadership and how the Shanghai International Board is potentially in keeping with these goals;
- Provide background information on China's capital markets;
- Assess the main issues that are likely to confront the Chinese government when setting up an international board;
- Identify key issues to form the subject material of interviews.

In addition to drawing on material available to Trusted Sources, the researchers analysed information from a range of sources, including:

- Publications and statistical sources of capital markets and key Chinese government departments and regulatory agencies, including the Shanghai Stock Exchange, the Hong Kong Stock Exchange, the Shenzhen Stock Exchange, the China Securities Regulatory Commission and the Shanghai Municipal Government;
- Legal documents and regulations on China's securities industry;
- Speeches made by key government officials;
- Academic publications.

### Interviews

The report made extensive use of findings from semi-structured interviews. The main purposes of the interviews were to:

- Shed light on government plans for the Board, at both the central and local levels;

- Closely examine the obstacles currently facing the authorities and how they are likely to be dealt with;
- Provide a current picture on how far plans for the Board have progressed;
- Flesh out potential challenges and opportunities for City firms stemming from the Board.

In total, 16 interviews were carried out with key policymakers, government officials, industry leaders and academics in Shanghai, Beijing, Hong Kong and London. All interview participants held senior positions within their organisations and were influential in the markets concerned. These interviews helped us to form the opinions expressed in this report as well as to help us identify key opportunities for the City of London. Because of the highly-sensitive nature of the Shanghai International Board, all interviews were conducted confidentially in order to allow participants to express their views on the Board freely. The information gathered in the interviews, which is incorporated in this paper, supports the main findings of the desk research and provides on-the-ground insights into the prospects for the Board.

## Chapter 2: Outlook for Financial Sector Reform

**Chinese authorities see an urgent need to build a more advanced financial system that would match the size and status of their country's real economy.** China's global economic significance has risen rapidly since the Asian financial crisis at the end of the 1990s. Driven by high rates of investment, China has achieved rapid domestic growth, significant trade surpluses and a record accumulation of foreign exchange reserves. Today China is the world's third-largest economy (behind the US and Japan) and the largest exporter, since overtaking Germany in 2009. It is also the largest producer and consumer in several key industrial sectors such as steel, electronic products and automobiles.

Nonetheless, China's financial development lags far behind these impressive achievements and its role in the global financial system remains marginal. Chinese banks are among the largest in the world measured by market capitalisation and size of balance sheets, but they have only a modest international presence and they play a limited role in global capital market activity. The Chinese yuan, or renminbi (RMB), is with few exceptions used only inside the country by virtue of its lack of convertibility owing to tight controls on capital flows in and out of China. Chinese capital markets are not yet a meaningful source of financing for foreign borrowers.

**Despite these shortcomings in financial sector development China has ambitious longer-term financial reform goals.** China aims for the RMB eventually to take its place as an international reserve currency alongside the US dollar and Euro. The internationalisation of the RMB would not only bring economic benefits; the ability to tap into the country's vast pools of domestic savings to provide capital for foreign borrowers would transform global capital markets and strengthen China's overall influence in myriad ways.

Even if such longer-term goals are known, there is much less clarity about China's strategy for achieving them. China's overarching domestic priorities are to sustain rapid growth to improve people's living standards and create jobs for those seeking employment. Implicit in these priorities is the desire to maintain political and social stability.

Financial reforms can help achieve these goals by promoting financial deepening and increasing the sophistication of financial instruments for savers, investors and borrowers. But such reforms also pose the risk that poorly implemented plans could undermine the economic stability that is the leadership's top goal. Indeed the lesson that China's leaders draw from the recent global financial crisis is that they have been right in taking a cautious approach to financial sector reform.

**China has undergone successive reorganisations of its financial sector since the 1980s.** It has set up a nearly complete institutional framework including:

- Large universal commercial banks involved in all domestic and international banking businesses;
- Participation of foreign banks in the domestic market (though limited);
- Trust and investment corporations;
- Brokerage and investment banks (securities companies);

- Stock exchanges, a bond market and a recently established derivatives market;
- Insurance companies;
- Pension funds.

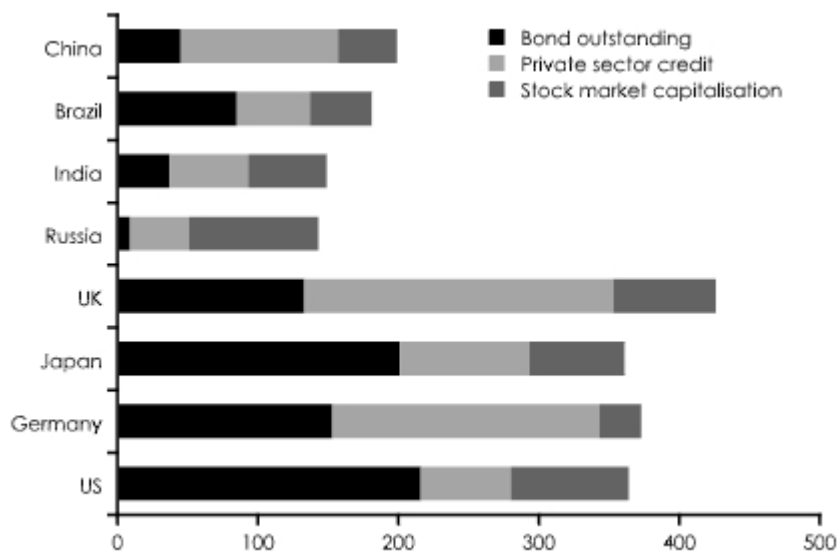
There is a comprehensive legal and supervisory system to oversee all financial activity comprising:

- A central bank, the People's Bank of China (PBoC);
- The China Banking Regulatory Commission (CBRC);
- The China Securities Regulatory Commission (CSRC);
- The China Insurance Regulatory Commission (CIRC).

**Despite possessing all the familiar banking and regulatory institutions, China's capital markets are tightly controlled.** The PBoC directly sets interest rates for lending and saving. Liquidity is controlled primarily by administrative measures such as loan quotas, not interest rates. Administrative controls also extend to nearly all international currency movements, with the result that developments in external capital markets have a very limited influence on domestic financial markets.

The reliance on direct controls on interest rates and capital flows is a major barrier to greater financial deepening. Chart 1 below highlights that China's markets are still shallow compared to those of industrial countries as measured in relation to nominal GDP.

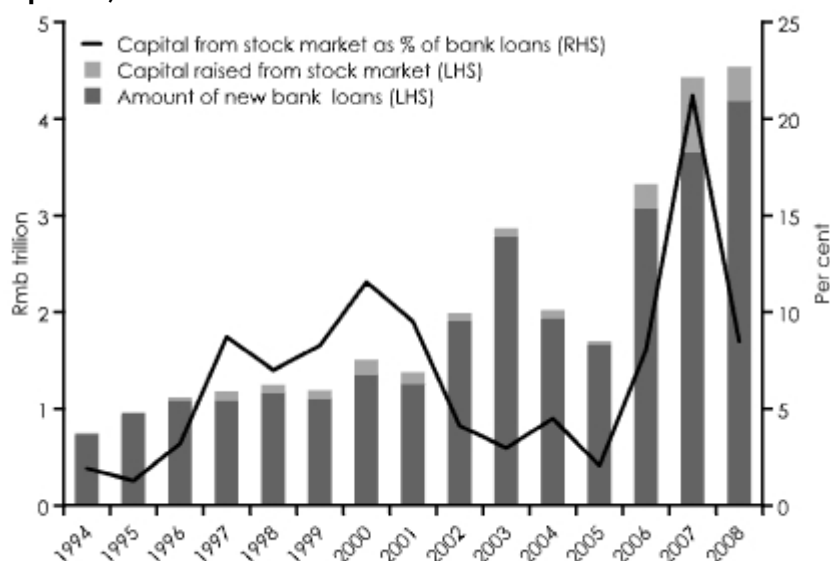
**Chart 1: Financial market comparisons, 2008 (% of GDP)**



Sources: IBS, IMF, Bloomberg.

Another result of China's dependence on direct controls is that its capital markets are dominated by banks. Chinese companies are heavily reliant on bank financing and other internal financing channels such as retained earnings; direct capital raising on the stock and bond markets represents just a small portion of total fund-raising activities, as can be seen in Chart 2.

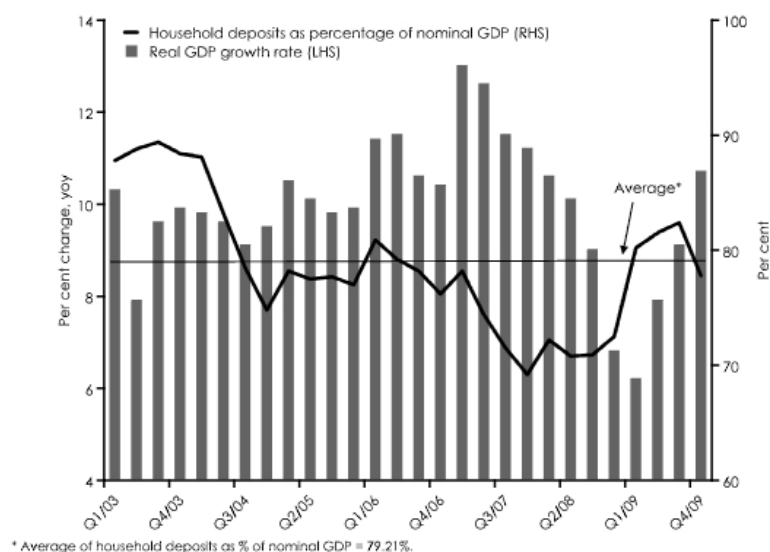
**Chart 2: Annual capital raised from domestic stock market vs bank loans to enterprises, 1994-2008**



Sources: China Securities and Futures Statistical Yearbook 2009.

The absence of a free domestic capital market has also discouraged the development of new financial instruments to intermediate China's high level of domestic savings to borrowers. China's household savings rates have been high throughout the reform era; total deposits from individuals have been growing rapidly, with the 2009 figure approaching RMB26 trillion or 77 per cent of GDP. But these huge savings have earned their holders low returns because interest rates on bank deposits have typically been fixed at low levels. Savers face a narrow choice of investment vehicles in terms of risk profile, time horizon and liquidity.

**Chart 3: Household deposits as percentage of nominal GDP vs real GDP growth, 2003-09**



Source: CEIC.

The government's approach to financial sector reform has been and will continue to be a cautious step-by-step process. **The initiative to list overseas companies on China's stock market, which is a step towards realising China's design for a more advanced financial sector**, is one example of this, which will support economic growth and integration with global capital markets by:

- Attracting financial professionals and international financial intermediaries, thereby creating a critical mass of talent to spur the development of relevant financial sector infrastructure;
- Widening investment options for local investors, who today cannot access foreign markets, by allowing domestic share issuance in RMB by international companies. Expanding investment options available to Chinese households will transform some of the excess domestic liquidity tied up in bank deposits into equity investment in world-class enterprises. It will turn the wealth accumulated via China's rapid economic growth into non-substitutable factors of production such as ownership of natural resources, technology and brands;
- Inviting high-quality multinational companies to list in Shanghai, which will increase the usage of the RMB by non-Chinese firms, thus facilitating the internationalisation of the currency.

Last but not least, permitting RMB funds raised on the Shanghai stock market to be transferred abroad will at the margin reduce the PBoC's foreign exchange reserves, as these RMB are converted into other currencies. This would lessen pressure for revaluation and thus be welcomed by the US and other countries seeking to support global financial adjustment. Allowing foreign companies to list on China's stock market will also bring more foreign investment into China but, because the investment vehicle will be RMB rather than foreign capital, the business activities of international companies could expand without adding to the PBoC's foreign exchange reserves.

## Chapter 3: Background on China's Capital Markets

### Overview

The Shanghai International Board ("the Board") would mark a major step forward in the development of China's capital markets. China ("China" for the purposes of this chapter comprises the Mainland and Hong Kong) currently has three stock exchanges, in Hong Kong, Shenzhen and Shanghai. As well as hosting Main Boards, Hong Kong and Shenzhen have additional stock markets that enable small and fast-growing firms to access capital.

**Table 1: China's stock exchanges**

City	Stock exchanges	Market cap, March 2010
Hong Kong	<ul style="list-style-type: none"><li>• Main Board</li><li>• Growth Enterprise Market (GEM)</li></ul>	HK\$18 trillion (£1.54 trillion) in total
Shanghai	<ul style="list-style-type: none"><li>• Main Board</li><li>• <i>Potentially the Shanghai International Board</i></li></ul>	RMB18 trillion (£1.75 trillion) in total
Shenzhen	<ul style="list-style-type: none"><li>• Main Board</li><li>• Small &amp; Medium Enterprise (SME) Board</li><li>• ChiNext (Growth Enterprise Market)</li></ul>	RMB6.54 trillion (£634.5 billion) in total

Hong Kong, an offshore market for Mainland firms and investors, is the pre-eminent venue for large (and often state-owned) Chinese firms to raise international capital. Shanghai and Shenzhen (in contrast) are the home to several boards which provide opportunities for domestic firms to tap into domestic savings to raise funds.

The Board, when implemented, will be the first Mainland venue for international firms to issue shares and the only one to allow Chinese Mainland investors to freely buy and trade stocks in these firms. It is therefore widely expected to have a major impact on existing capital markets in China, particularly the Main Board in Hong Kong.

### Hong Kong

As the most developed and internationalised of China's financial centres, Hong Kong possesses two principal capital markets: a securities market hosted by the Hong Kong Stock Exchange and a derivatives market at the Hong Kong Futures Exchange, both of which are under the holding company of Hong Kong Exchanges and Clearing (HKEx). The Hong Kong Stock Exchange hosts the Main Board and the GEM. As of March 2010 1,326 companies were listed on the Main Board and the GEM with a combined market cap of HK\$18 trillion (£1.54 trillion), making the HKEx the seventh-largest stock exchange globally by market capitalisation.

### Hong Kong's interplay with the Mainland economy

Hong Kong has benefited from not only its strategic political connections and geographic proximity to the Mainland but also from the relative immaturity of the

Mainland's financial sector (particularly its closed capital account regime). Its advantages include the following:

### **1) The main international platform for China-related investments (minus many of the risks associated with the Mainland)**

Strict capital controls as well as administrative controls on foreign direct investment (FDI) and portfolio investment mean that international investors face considerable obstacles when attempting to invest in Shenzhen and Shanghai.

- **The non-convertibility of the RMB** means there are no arbitrage opportunities for investors and liquidity is trapped domestically on the Mainland. The result is that Mainland markets are relatively unconnected to the rest of the world.
- **Foreigners have limited access to the stock exchanges.** Currently the differentiation between A- and B-shares (for domestic and foreign purchase) means that only a sliver of the equity listed is freely available for foreign investors. Although the Qualified Foreign Institutional Investor (QFII) scheme allows licensed foreign investors to buy and sell A-shares in Shanghai and Shenzhen, access remains limited to fewer than 90 foreign institutional investors and the combined quota for investment under the scheme is a diminutive US\$30 billion (though at the end of March 2010 only US\$17 billion of this, or 0.6 per cent of total domestic stock market capitalisation, had been approved).
- **Significant market volatility is** created by high turnover by retail investors, the heavy weight of state-owned enterprises in the market and limited tools for traders.
- **China's securities regulatory framework is relatively weak,** offering less protection for minority shareholders.
- **Considerable obstacles to international financial services firms** include restrictions and administrative licensing of financial products or services they can provide in China.

In contrast, Hong Kong is widely perceived to possess more transparent, accessible and sophisticated markets – although recent events have thrown light on several shortcomings in regulatory standards in the markets, specifically the lack of disclosure and insufficient due diligence on companies carrying out IPOs.

### **2) IPOs of top Chinese companies**

Many large Mainland firms have carried out their IPOs on Hong Kong's Main Board because the Mainland's stock exchanges in Shanghai and Shenzhen offer only limited amounts of shares to foreign investors (B-shares) and are much smaller than the HKEx. Such firms include both "red chips" (companies registered and listed in Hong Kong but whose principal shareholders are from Mainland China) and "H-share companies" (which are incorporated on the Mainland but are traded in Hong Kong).

Beijing strongly encouraged state-owned firms to list on the HKEx not only as a means to access large amounts of capital and raise their international brands and profile, but also to enforce better corporate governance and impose higher standards of discipline. There were 97 red chip and 156 H-share companies listed on

the Main Board and GEM in Hong Kong as of 28 February 2010. In recent years, the number of dual-listings in Hong Kong and on one of the Mainland exchanges has increased.

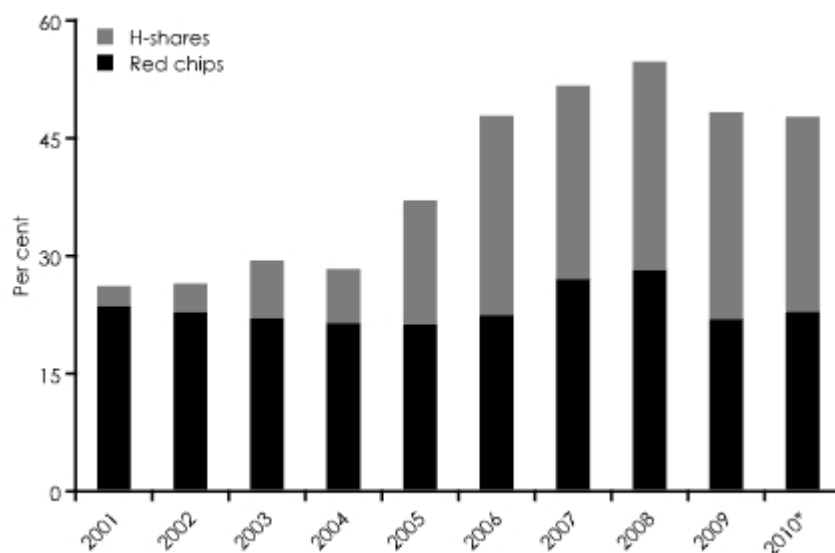
### 3) Attracting Chinese capital

Various regulatory changes have recently paved the way for Chinese capital to invest on the HKEx. Since 2007, Mainland commercial banks have been able to invest on the exchange if carrying out overseas investment management business under the QDII umbrella. The “Qualified Domestic Institutional Investor” scheme allows licensed Mainland financial institutions to invest in offshore markets, and has been widened to include fund management companies. These changes have created a potential source of demand for Hong Kong fund management and support services but outflows from the Mainland have so far been modest because of both expectations that the RMB will soon be revalued against the Hong Kong dollar and the poor performance of QDII funds that have already been launched.

#### Hong Kong capital markets depend on the Mainland

Hong Kong does not have a large non-financial domestic economy to service. It has instead become heavily dependent on the Mainland for business, with the majority of its work focusing on financial intermediation between international investors and Chinese companies. As Charts 4 and 5 illustrate, Hong Kong's capital markets have become increasingly focused on China-related companies.

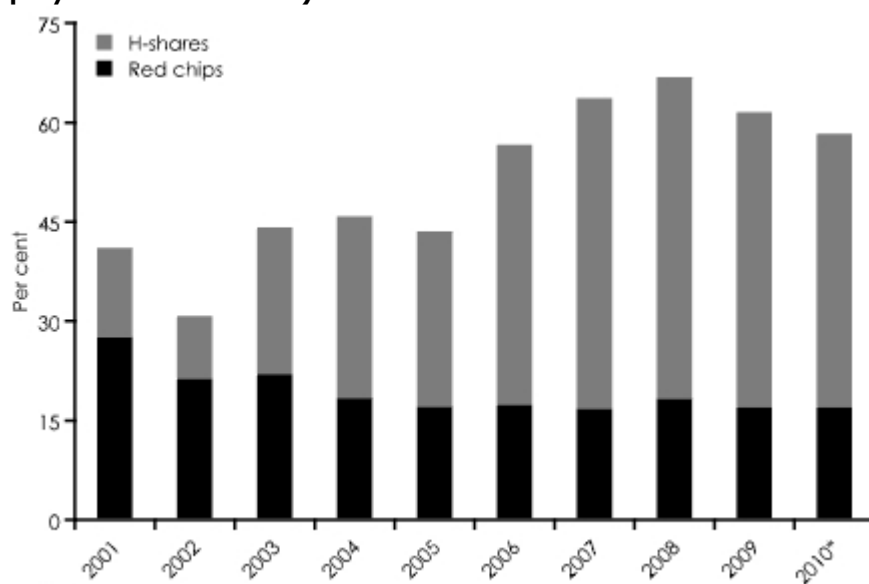
**Chart 4: Hong Kong Main Board market capitalisation of China-related stocks, 2001-10 (% of total market capitalisation)**



\* To date.

Source: HKEx.

**Chart 5: Hong Kong Main Board turnover of China-related stocks, 2001-10 (% of total equity market turnover)**



\* To date.

Source: HKEx.

Hong Kong has attempted to further integrate itself with Mainland China since the handover in 1997. For example, the Closer Economic Partnership Agreement (CEPA) signed in 2003 liberalised trade in goods and services and facilitated investment, thereby providing enhanced access to the Mainland for Hong Kong companies. As mentioned earlier, there are also a few exceptions to the Mainland's strict controls on capital outflows that have benefited the HKEx and fund management services in Hong Kong.

Furthermore, Hong Kong has tried to tap into the Mainland's vast pools of capital, as well as position itself for internationalisation of the RMB, by liberalising trading and exchange of the RMB in the region. As outlined, Hong Kong banks were given the go-ahead in February 2004 to begin taking deposits in the Chinese currency. After several years of pilot programmes, Hong Kong issued RMB-denominated sovereign bonds in 2009, marking the first major advance towards Hong Kong becoming an offshore RMB trading centre. In HKEx's strategic plan for 2010-12, a key goal is to offer a wide array of RMB-denominated investment products to attract greater capital flows into Hong Kong's markets. This would position Hong Kong to benefit if/when Beijing moves ahead in its long-term strategy to internationalise the RMB.

The proposed Board presents competitive challenges to Hong Kong, however, because of signs that red chip and H-share companies intend to return to Mainland markets for listing. According to some analysts and reports in the state-run media, this is in fact a prerequisite to the formation of the Board as the regulatory authority seeks to ensure that a critical mass of companies are involved in the new exchange. Because Hong Kong depends heavily on such firms for its liquidity, as illustrated, the establishment of the Board would unleash fierce competition between Shanghai and Hong Kong, both of which will attempt to attract large Chinese firms to list and related financial services firms to carry out their business.

It is not necessarily all bad news for Hong Kong, however. Competition with Shanghai should drive down costs for market participants – Hong Kong will have

lower profit margins but hopefully more volume. Moreover, further liberalisation of Chinese markets will provide additional benefits for Hong Kong. In particular, when the RMB becomes convertible, A- and H-shares will become fungible. We expect this to double or treble the market capitalisation, liquidity and turnover of the Hong Kong Stock Exchange as domestic Chinese and international investors pour into the markets.

### **Mainland capital markets: Shanghai and Shenzhen**

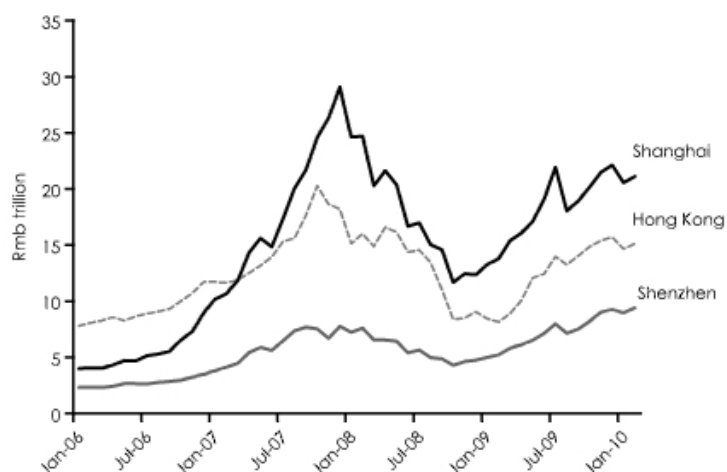
The Shanghai International Board will be a new stock market hosted by the Shanghai Stock Exchange (SSE), which was set up in November 1990 – though Shanghai has had a long history of securities markets dating back to the 1860s. Currently 874 firms are listed on the Main Board with a combined market capitalisation of RMB18 trillion (£1.75 trillion), making it the sixth-largest market in the world by market capitalisation (ahead of Hong Kong and Shenzhen).

The Shenzhen Stock Exchange was established in 1995 and is the smaller of the two Mainland exchanges. As well as hosting a Main Board, it also features the SME Board and the new Growth Enterprise Market (known as ChiNext) which was set up in October 2009. The Shenzhen boards have a total of 901 listed companies with a combined market capitalisation of RMB6.54 trillion (£634.5 billion), making it the 15<sup>th</sup> largest global stock exchange.

Like the SME Board, ChiNext is part of the government's plan to turn Shenzhen into a NASDAQ-style exchange aimed primarily at private and technology-oriented firms operating in the Pearl River Delta region. Although plans for ChiNext were discussed as early as 1999, they were postponed after the dot-com bubble burst and only reconsidered at the beginning of the global financial crisis when the capital needs of smaller companies were even higher than normal. ChiNext will likely become an important source of funding for small private companies that are in high-growth periods and need access to smaller amounts of capital. Firms carrying out IPOs on ChiNext, for example, typically raise around RMB300-500 million (£29-49 million) compared to the RMB40 billion (£3.9 billion) that companies have recently raised on the Main Board.

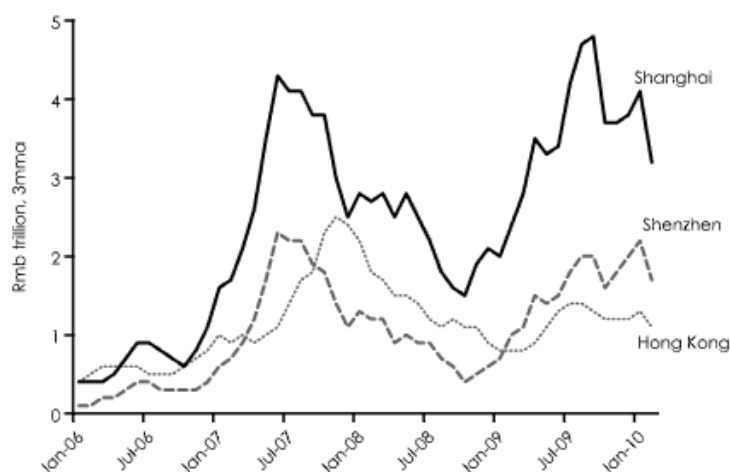
By market capitalisation, Shanghai is the largest stock exchange in China, followed by Hong Kong and then Shenzhen – although Shenzhen is currently ahead of Hong Kong in respect of market turnover. Currently China's A-share market (comprising those in both Shanghai and Shenzhen) is the second largest in the world by market capitalisation, behind the US.

**Chart 6: Market capitalisation of Shanghai, Shenzhen and Hong Kong stock exchanges, January 2006 – January 2010 (RMB trillion)**



Source: CEIC.

**Chart 7: Market turnover of Shanghai, Shenzhen and Hong Kong stock exchanges, January 2006 – January 2010 (RMB trillion, 3mma)**



Source: CEIC.

Both the Shanghai and Shenzhen exchanges currently offer two types of share: A-share (denominated in RMB) and B-share (denominated in foreign currency: US dollars in Shanghai; HK dollars in Shenzhen), which was initially created exclusively for foreign investors. While international investors can purchase B-shares with relative ease, capital controls restrict the amount of A-shares that can be purchased to the quotas under the QFII scheme.

B-shares, a marginal product category, are insignificant compared with A-shares in terms of both volume and value. Foreign investors have tended to shun B-shares as they consider them to be very high risk, especially compared with shares of Chinese companies listed on HKEx and other overseas boards. This perceived risk stems from the lack of transparency of Chinese firms and occasional government intervention in the markets as well as high price volatility. Cycles of extreme booms and busts are seen to stem not only from the high numbers of inexperienced retail investors

involved in the markets but also from the limited tools for institutional investors to hedge their portfolio risks.

So far the government's attempts to revive B-shares have not had much success. Since February 2001, Chinese Mainland households have been able to trade B-shares (they previously had access only to A-shares), but both transaction volume and turnover has remained small. More generally, the authorities have introduced new tools and products for investors, which will improve the investment environment for both A- and B-shares. The SSE started a pilot programme on short selling and margin trading on 31 March 2010, while the China Financial Futures Exchange launched trading of stock index futures on 16 April 2010, enabling investors to bet on downturns in the market. Although margin trading and short selling are restricted to six Chinese brokerages at present, this marks a major milestone and will likely eventually be rolled out across all the markets, potentially reducing volatility and enabling investors to hedge their risks.

Unlike the proposed Board, foreign firms are currently unable to issue shares on the Mainland. The Board would therefore mark an end to the Mainland markets' role of providing a venue for only Mainland Chinese companies to access capital from predominantly domestic investors. It is unclear whether the Board would have an impact on existing B-shares. Some commentators speculate that the authorities will merge A- and B-shares when they announce the Board's implementation. However, we found no evidence during our interviews in support of this. Moreover, the Board is unlikely to replace B-shares: it will rather comprise A-shares denominated in RMB issued by foreign companies, which we explore in the next chapter.

## **Chapter 4: The Shanghai International Board**

### **Background**

The proposal to establish the Board first emerged in 2007 but then faded away before reappearing recently at the centre of the government's strategic agenda to build the city into an international financial centre. Interest has intensified over the past six months since the city government announced in September 2009 that it would launch the Board in early to mid-2010.

A number of multinational companies and international financial services providers are awaiting implementation of the Board because of its potentially significant implications for their operations and investments in China. If successfully implemented, the Board could:

- Mark a major step forward in the development of China's financial sector and attract companies to move their headquarters to a new regional business cluster;
- Provide new opportunities for multinational firms to carry out multiple listings and tap into China's huge pool of domestic savings;
- Create significant business opportunities for financial services firms – including securities companies, accountancy firms and law firms – to support listings of foreign companies;
- Make Shanghai a regional financial hub in Asia and a credible competitor to London and New York over the long term, particularly with regard to mergers and acquisitions and as a venue for future listings of Asian companies.

### **What is the Shanghai International Board?**

The Board would be a venue for shares of foreign companies ("foreign companies" means companies incorporated overseas, including red chips, rather than those with foreign ownership). Although the initiative is called an international board, it is not necessarily completely separate from the SSE Main Board. It could be a component of the Main Board subject to the same trading rules but with independent supervision and its own share codes and indexes. This would be in accordance with the commitment by the CSRC and SSE to the principle of equal treatment for foreign and domestic firms. It could also augment the visibility of foreign shares listed and traded alongside domestic shares and therefore enhance the Board's position.

In terms of listing vehicles, there are two possible paths: through IPOs and in the form of Chinese Depositary Receipts (CDR). According to SSE Chairman Geng Liang, only IPOs of new shares denominated in RMB are being considered. We believe IPOs are preferred to CDRs because the latter involve additional issues that are difficult to address, such as whether and how CDRs should be made convertible with original shares of foreign companies if such demand arises. Moreover, the regulators are concerned that as a new product on China's securities market CDRs would create confusion among investors. Furthermore, a RMB-denominated negotiable certificate issued in China by a depositary bank would place higher technical demands on China's settlement and clearing system for coordination with its overseas counterpart.

The SSE also plans to roll out cross-border exchange-traded funds (ETFs) this year, allowing Chinese investors to buy a basket of overseas-traded shares using the local currency. Geng Liang told the media at the National People's Congress (NPC) in March 2010 that technical rules had been completed for cross-border ETFs. Twelve overseas stock exchanges and index providers have authorised the SSE to include their indices in the ETF, including the Dow Jones Industrial Average, the Nikkei 225 Stock Average and the Hang Seng China Enterprise Index.

The ETF product could be introduced before foreign companies are allowed to make public offerings on the Board. But, for the purposes of this special interest paper, we analyse the Board initiative as referring to non-ETF listings of foreign firms on the SSE.

### **The story so far**

As the following timeline illustrates, plans to establish the Board were first drawn up in 2007 but did not pick up speed until mid-2009, when the State Council publicly announced it would promote Shanghai as an international financial centre and the CSRC and SSE set up working groups to evolve mechanisms for the programme.

Although senior officials in Shanghai have previously announced that the first companies would be listed on the Board in 2010, we expect the formation of the Board to take significantly longer. By way of comparison, it took 10 years for the Shenzhen ChiNext to progress from initial discussion to its first day of operation in October 2009. Timing therefore remains the first major question mark with regard to the Board; many market participants we interviewed believe the initiative will be announced by Beijing between 2011 and 2015, depending on several factors related to the external and domestic environment.

## TIMELINE

**April 2007:** The Shanghai Stock Exchange Innovative Research Centre published a report, available to the public, calling for the establishment of an international board in Shanghai. Although lacking in details, this included a broad commitment to set this up in the “medium term”.

**May 2007:** The CSRC followed up with a policy paper sent to securities companies for consultation on draft listing requirements and trading rules of the potential board. This was not made public.

**June 2008:** At the China-US Strategic Economic Dialogue, Vice Premier Wang Qishan, on behalf of President Hu Jintao, agreed to allow qualified foreign companies to list on stock exchanges through issuing shares or depository receipts in accordance with suitable regulations. \*\*\*

**March 2009:** The PBoC wrote in its International Financial Market Report that China should explore ways to list red chip companies and foreign-incorporated firms on its domestic stock exchanges. This would strengthen and increase the influence of China's securities markets and improve the international competitiveness of China's capital markets, as well as assisting in internationalising the RMB. The Shanghai International Board was not specifically mentioned. \*\*\*

**March 2009:** The State Council issued an Opinion to “*Promote Shanghai Becoming an International Financial and Shipping Centre by 2020*”. This proposed that Shanghai should develop a multi-functional and highly internationalised financial market including a board on which foreign companies could issue RMB-denominated shares that could be traded by Chinese investors. \*\*\*

**Mid-2009:** The CSRC set up a special working group, led by its Vice President Yao Gang, to oversee the development of the Board, as well as to draft and revise laws relating to IPOs.

**Mid-2009:** The SSE set up a similar group led by its General Manager, Zhang Yujun, to draft and revise rules for listing and trading. The group is under the supervision of the CSRC and is supported by the municipal government.

**September 2009:** Tu Guangshao, Shanghai's Deputy Mayor in charge of financial affairs, announced to the Chinese media that overseas firms would be able to float shares on the SSE in 2010.

**September 2009:** During a conference in London, Director Fang Xinghai of the Finance Office for the SMG stated that one or two foreign companies are expected to list in Shanghai in early to mid- 2010.

**January 2010:** At the National Working Conference on Securities and Futures Regulation (a cross-departmental conference held in Beijing), CSRC President Shang Fulin announced that his agency would enhance communication and coordination with other departments to explore institutional arrangements for an international board.

Note: \*\*\* These announcements gave broad support to the idea of the Shanghai International Board, but no specific approval of its implementation at that time.

## **Main features of the Shanghai International Board**

### **Initial size**

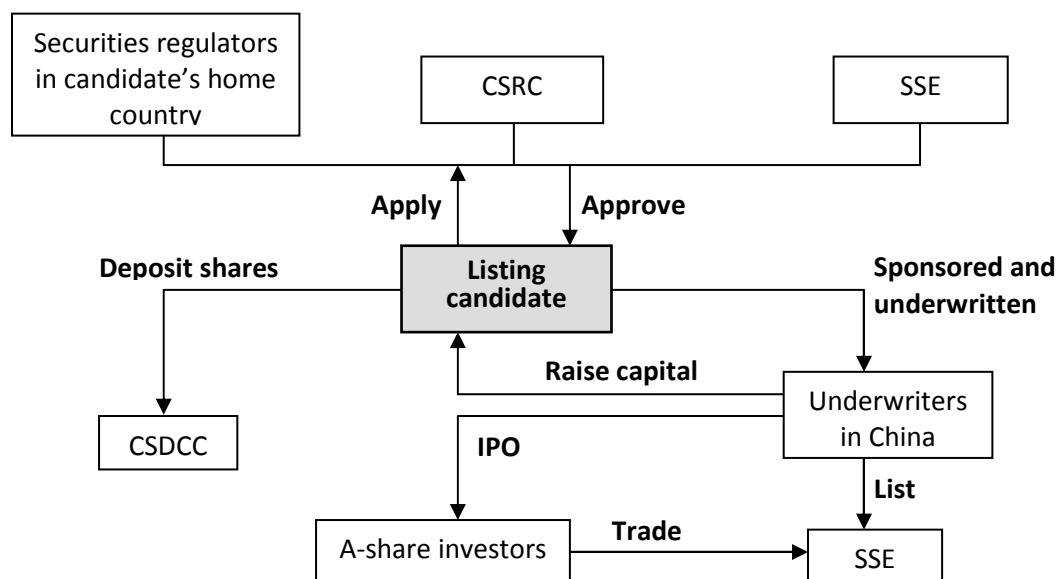
We expect the Board to start as a small pilot programme before expanding over time. The current Chinese leadership has followed the pragmatic approach embodied in Deng Xiaoping's famous phrase "crossing the river by feeling the stones" and will remain fairly prudent in its reform efforts. Given the potentially far-reaching implications for longer-term development of China's financial sector outlined in Chapter 2, it is understandable that the authorities in charge of the Board will embark on the path of internationalising China's securities market with a great deal of care. This caution is compounded by concerns that inviting many foreign companies to issue large IPOs will divert investors' capital from secondary markets and result in an overall deterioration in the performance of existing A-shares. Therefore, the speed of opening up the Board to foreign companies will be strictly controlled, at least at the beginning.

Based on interviews conducted in Shanghai, we believe that no more than three companies will list on the Board in the first year of the initial pilot phase, and that the capacity will expand to 20-30 companies over the subsequent five years, conditional on success of the pilot programme.

### **IPO procedure**

Deviating from the widely adopted registration system used by other stock exchanges in the world, China currently imposes an approval system for IPOs by domestic companies. This is unlikely to change for foreign companies on the Board. As laid out in Diagram 1, the current system requires each IPO candidate to secure a qualified securities firm as its sponsor (or two sponsors if the IPO exceeds a certain size). The sponsor(s) must conduct proper due diligence to ensure that the candidate's corporate structure and financial position satisfy all the criteria set out in the Securities Law, help the company to restructure and reorganise if necessary and provide sufficient training to company directors before and after its IPO (up to two financial years) to make sure all obligations are understood and fulfilled. The sponsor securities firm, which is also the underwriter or the main underwriter of a syndicate, also assists the candidate company in preparing and submitting its applications to the CSRC, where a stock issuance approval committee investigates the candidate and votes on its application. Once the issuance is approved by the CSRC, the underwriter(s) start marketing, organise pricing (details on which will be provided later in this paper) and share allocation, apply for a listing at the SSE and deposit shares as well as registering share ownership with the China Securities Depository and Clearing Corporation (CSDCC).

**Diagram 1: Detailed IPO procedures in China**



This system will be convenient for controlling the speed of the Board's development as the CSRC will have the final say on the number, diversity and sequence of foreign companies listed. However, we believe that it could be an impediment to long-term advancement of the Board. Transparency and open access to information are crucial preconditions if Shanghai wishes to compete with the world's more established stock exchanges. At present, it is an open secret that apart from a company's financial health and corporate governance, the CSRC decision is also heavily influenced by government industrial policies and its efforts to balance IPO supply with the liquidity in the market. Therefore, issuers in China face much more uncertainty and higher issuance costs than elsewhere. It could take anywhere between three months and three years to obtain final approval for IPO.

The authorities appear to be aware of this problem. At the Financial Development Forum attended by regulators and high-profile practitioners in the financial sector in April 2010, the CSRC stated its intention of looking into the possibility of adopting a registration system for IPOs, rather than the present procedure, though without commitment to a timeline. Since studies are yet to be undertaken and discussions will follow, it is probable that nothing will materialise for several years.

## Potential listing candidates

### a. Foreign companies (excluding red chips)

Most media attention to date has focused on the handful of international firms that are eager to list on the Board. Among these are HSBC, Bank of East Asia (BEA) and Standard Chartered Bank. HSBC has already expressed its intention of becoming the first foreign firm to list, reportedly planning a £5 billion share offer, with China Citic Bank and China International Capital Corporation (CICC) as advisers. The CEO of BEA, Sir David Li Kwok-po, and the CEO of Standard Chartered, Peter Sands, have both publicly announced their intention to list. Other candidates that have expressed potential interest include NYSE Euronext, Coca-Cola, Wal-Mart, General Electric, Vale SA, Unilever and Carrefour.

According to our interviews, the authorities are looking for the following types of foreign firms:

- 1) Those already listed on a market in their home country that has arrangements with the CSRC for mutual assistance and information exchange (see Appendix 1 for a list of such markets);
- 2) Those that are mature, international and record steady growth – preferably Fortune 500 companies;
- 3) Only those seeking to issue new shares, not sell old shares;
- 4) No shell, start-up or offshore companies.

Foreign firms are attracted to the Board by several key benefits. For a start, share valuations tend to be higher on Mainland exchanges than in other markets and RMB fundraising provides capital for subsidiary expansions in China. Moreover, listing enables firms to increase visibility in China significantly, boosting sales and marketing efforts. At least in the early stages, signing up to the Board would in addition be well-received by Chinese government officials, with whom such companies are keen to maintain good relations.

**A big swing factor for foreign companies is how the authorities will approach the issue of repatriation of funds.** Because the Board will be RMB-denominated, there are concerns over whether capital raised could be converted and taken out of China – or whether current constraints on converting the RMB into foreign currencies will be maintained, preventing this.

Strictly controlled and limited convertibility of the RMB will remain government policy, its attractions underlined for Beijing by the global financial crisis. However, we do not anticipate this being a major problem. Conversations we had with the Chinese authorities led us to believe that they are aware of the negative effects which blocking repatriation of funds would have on the Board's success by limiting the number of companies wishing to pursue a listing in China.

Moreover, China's new regulations on foreign exchange, promulgated in 2008, provide room for foreign firms to carry out FX transactions with capital raised on Mainland stock exchanges. Although regulations on the exact procedures for executing this have not yet been released, it demonstrates that the State Council and State Administration of Foreign Exchange (SAFE) will not completely block foreign exchange transactions related to the Board under the capital account. It is likely that once the CSRC has approved the listing of each foreign firm, it would have to issue a notice to SAFE with an estimated range of total capital to be raised by the company's IPO. This would act as the cap for cross-border capital transactions by that company in the future.

The by-product of non-convertibility of the RMB is that there will be few arbitrage opportunities for either domestic Chinese investors (most of whom are unable to invest in foreign stock markets) or international investors who have limited access to domestic stocks. This trapped equity pool will be unable to leak from the domestic market. Combined with enormous liquidity available in China, in the case of multiple listings this will result in China-listed shares trading at a premium to those shares listed on other markets. The absence of such currency restrictions is a big reason (among

others we will explore later) why listing in Tokyo eventually fell out of favour in the late 1990s.

The only caveat to our otherwise sanguine view on the repatriation of funds is that the authorities, particularly the CSRC and the State Council, might face considerable political pressure not to allow foreign firms to have this freedom. The Chinese public are worried that stock market liquidity and, indirectly, domestic household savings will be turned into what Chinese media have termed “an ATM machine” for foreign companies. Professor Yu Yunhui, a well-respected commentator who worked in the securities industry in China for more than 15 years, speculated in his blog during the NPC meetings in 2010 that listed foreign companies could issue A-shares in China at higher valuations and convert the capital into US dollars or other currency to buy back floating shares on other markets at a lower price.

In addition, SAFE may become hostile to the process as over time it is likely to face high administrative and time costs when inspecting and approving all FX transactions relating to ever-increasing numbers of foreign firms.

#### **b. Red chip firms**

The Board would be a good opportunity for red chips currently listed in Hong Kong to go back to the Mainland for secondary listings. Indeed, the main reason for the SSE's initial proposal to establish an international board in 2007 was “to meet the demands of red-chip companies which want to undertake secondary listings on the mainland to tap into extensive liquidity in the Chinese A-share market”. Red chips would also be able to broaden their investor bases with compatriots more familiar with their business. Their participation would ensure the critical mass of listings the Board needs to succeed.

Among the red chips that seem keen to list on the Board, the most enthusiastic and well prepared are China Mobile and China National Offshore Oil Corporation (CNOOC). China Mobile Chairman Wang Jianzhou has stated on several occasions that the firm has already started preparations for listing; rumours are that it has appointed the CICC as its adviser. Similarly, in August 2009 Fu Chengyu, Chairman and CEO of CNOOC, disclosed the company's intention to list – though, as an aside, it must be noted that it tried to issue shares on the SSE in 2007 but failed due to unresolved legal and technical difficulties.

#### **Pricing mechanism**

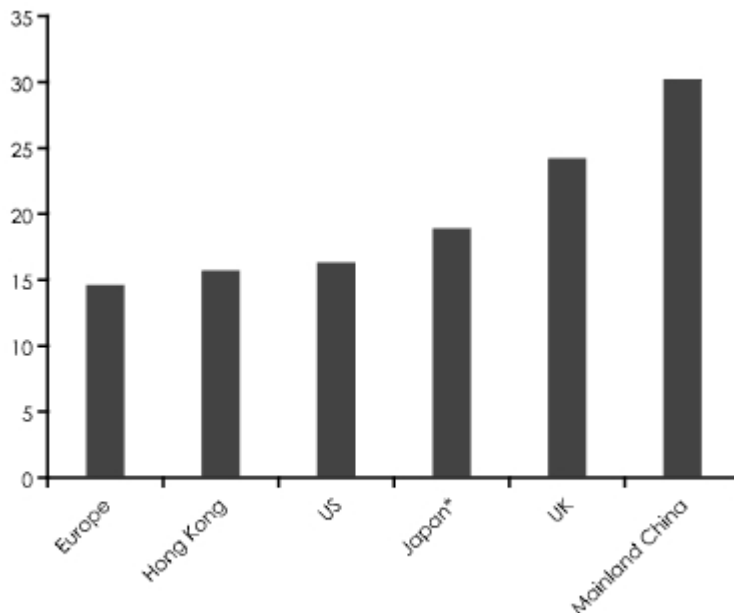
China operates a two-stage pricing inquiry process for IPOs on its Shanghai and Shenzhen Main Boards. First, underwriters conduct an initial price enquiry with qualified institutional investors including fund management, securities and insurance companies as well as QFIs to determine a price range for the offering. This is followed by a round of bookbuilding within that range to decide on the final offer price. Shares are then placed offline to the investors who participated in the initial enquiry stage and made a valid quotation (i.e. above the final offer price), and sold online via the electronic systems of stock exchanges to retail investors.

We expect the authorities to adjust this method of pricing IPOs for the Board. This is because the current system would set the price too high for domestic investors and result in their paying a much higher price premium than international investors.

When investors place valuations on cross-listed equity shares, they often use the first-issued share prices of that company on other exchanges as the anchoring point and make directional adjustments on the basis of valuations of similar companies listed on the same exchange or the overall valuation level of that market. This would create two problems for the Chinese stock market, although there are ways to overcome these:

- 1) International blue chip companies have high absolute prices on overseas stock exchanges. For example, Coca-Cola's share price on NYSE Euronext was US\$54.20 on 22 April 2010, equivalent to RMB368.6, which was about 34 times the average share price on the SSE on the same day. Such price levels would have a negative impact on affordability for Chinese retail investors and would have to be adjusted as fractional shares.
- 2) IPO valuations are on average much higher in Mainland China than in developed economies. According to Wind Information System, a Chinese financial database provider, the average IPO price-to-earnings (P/E) ratio on China's main boards rose steadily to 66.87 in January 2010 after a reform in June 2009 that attempted to impose a more market-oriented pricing regime and end the previous practice of the CSRC guiding shares to start trading at 20-30 times forward earnings. The existing pricing mechanism would therefore likely result in domestic investors paying a higher price than international investors for identical ownership rights. Due to a lack of consolidated data on P/E ratios in primary markets, data for secondary markets are used as a proxy in Chart 8 for comparison between main boards in Mainland China and other stock markets.

**Chart 8: Average P/E ratio on selected main boards, 1 January 2007 – 31 December 2009\***



\* Note: data for Japan is 01/01/2007-30/03/2009.

Source: Bloomberg.

A potential solution to this problem is for the CSRC to cap the issuing prices at an appropriate level through administrative measures, and for investors to start making offers and placing orders below this. The cap could be anchored at the overseas trading prices of the same stocks, and shares issued in China could be sold as fractions of offshore shares after the prices are converted to RMB.

## **Market participants**

### **a. Investors**

Only domestic investors and others under the QFII scheme are expected to have access to the Board – though since 2003 fewer than 90 foreign institutions and US\$17 billion of investment capital have been approved under the programme (although the full quota under the programme is US\$30 billion). Domestic investors will therefore constitute the great majority unless the QFII scheme is dramatically widened.

The reason for such discrimination against foreign portfolio investors stems from the authorities' fears of "hot money" inflows. This is already a major problem – such inflows are estimated to have amounted to US\$500 billion in 2006-09, peaking in H2/08. These were caused by foreign investors wishing to cash in on rising stock and property markets prices and RMB appreciation, which they have been anticipating. The government wants to avoid further inflows for several reasons: if the costs of sterilising foreign currency inflows rise to unmanageable levels, the dollar peg will eventually collapse; in the shorter term, capital inflows could destabilise the domestic financial market by creating a bubble, the bursting of which would provoke capital flight.

### **b. Sponsors/underwriters**

All IPOs in China need to be sponsored and underwritten by securities companies. Foreign securities firms can only operate in China through joint ventures (JV) or holding shares in listed Chinese securities firms. Except for the CICC, the first JV securities firm, domestic companies currently dominate IPO underwriting on the A-share market. JVs fare better in assisting Mainland companies to list in Hong Kong or overseas. Because of their familiarity and closer business links with foreign companies' overseas operations, the Board provides JVs with significant growth potential in underwriting more IPOs on the Mainland. However, competition for this lucrative business will be fierce. In the initial phase, industry leaders such as the CICC and China Citic Bank are likely to be the biggest deal winners.

Eight foreign-invested securities companies have been awarded the sponsorship qualification (see Table 2 in the Appendix) and therefore can engage in underwriting and sponsoring the issuance of shares (including ordinary RMB-denominated common shares and B-shares) and bonds in China. CSRC Chairman Shang Fulin said last July that the agency would resume processing applications by foreign brokerages for JVs in 2010, ending a four-year moratorium. Restrictions to ensure Chinese control of the JVs and protect domestic players require that the percentage of shares or the interest held by foreign investors does not exceed one-third.

## **CASE STUDY**

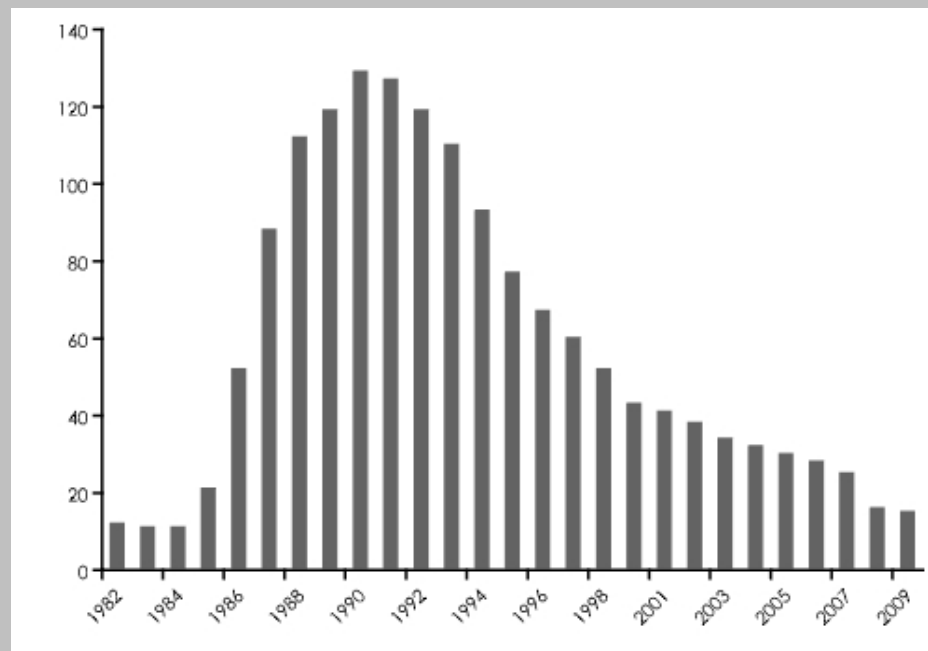
### **Lessons to be learned from Japan**

By examining the problems encountered by the Foreign Section of the Tokyo Stock Exchange (TSE) – the equivalent of the Shanghai International Board for the SSE – it is possible to understand the main preconditions of success for new international boards, including the planned Board. Put simply, there must be demand for foreign stocks from local investors and a ready supply of new companies willing to list on the exchange.

The TSE opened up to IPOs of foreign stocks in December 1973 in line with the process of capital account liberalisation taking place in Japan. Listings targeted mainly blue chip firms in the US and Europe, were denominated in yen and required financial reports to be released in Japanese. Many foreign firms listed on the TSE in the late 1980s as a means of boosting their reputation in Japan, raising capital to expand in the country and creating shares to attract local staff.

The number of listings grew rapidly in the 1980s, reaching a peak of 127 firms in 1991. At this time the TSE's aggregate market value was the world's largest. Since then, however, the number of foreign listings has continued to fall sharply to just 15 firms by the end of 2009, ranking it only 21st in the world. The majority of the de-listings that took place during this period were voluntarily made by foreign companies. For example, between 1973 and 2007, 76 US firms de-listed from the TSE, of which only 15 were due to a merger or takeover in the home country, while one firm also de-listed from the NYSE around the same time as its TSE withdrawal.

**Chart 9: The number of foreign companies listed on the Tokyo Stock Exchange, 1982-2009**



**Source: TSE.**

Increased de-listings and declines in new listings by foreign companies took place for multiple interlocking reasons:

- 1) In general, companies list on an overseas stock exchange to broaden their investor base. Japanese investors have, however, shown limited interest in foreign stocks (the share turnover rate is a useful proxy for measuring this). Research shows that the daily volume for a typical firm on the TSE Foreign Section never reached 10 per cent of that on the TSE domestic section, and exceeded 10 per cent of that on the home market only in four out of the 31 years between 1974 and 2005.

This is because Japanese institutional investors had free access to overseas markets for investment and therefore engaged very little in the Foreign Section, while retail investors had a serious “home bias” problem, which became a major feature in stock selection in Japan after the stock market bubble burst in the early 1990s and high numbers of individual households rapidly left the market. The TSE's effort in 2004 to rectify the problem by merging the Foreign Section and main sections in order to increase visibility of the foreign firms listing alongside domestic blue chips did not seem fruitful either. Many companies – such as Apple Computer, Daimler Chrysler and Deutsche Bank – de-listed their shares in the face of economic stagnation, declining market size and inactive trading in Japan.

- 2) Some potential listing candidates were also deterred by the cumbersome and costly regulatory procedures as well as stringent disclosure requirements imposed by the TSE and therefore chose public offering without listing or funds from Japanese institutional investors (again without publicly listing), which lowered issuing costs. Unlike publicly listed stocks, the transactions for these issues are made in local currencies, not in yen.

### **Lessons for Shanghai**

On the supply side, the authorities behind the Shanghai International Board project should be aware of the deterrent dangers of excessive regulation and of loading on administrative costs. On the demand side, the reaction of Chinese retail investors will be conditioned primarily by price. With limited channels for investing in foreign companies, and the currency blockage, Chinese institutional investors are likely to welcome the Board.

### **Regulatory and institutional arrangements**

The authorities face major obstacles in converging China's regulatory and institutional arrangements with international standards, as will be necessary before the Board is launched.

#### **a) Legal framework**

Chinese law currently does not accommodate foreign firms listing on domestic exchanges. Several commentators have suggested that the absence of provisions relating to foreign firms in China's Securities Law (revised in 2005) and Company Law (revised in 2005) means that they are restricted from such activities. Under this

scenario, major amendments to both laws would be necessary before the Board could be launched, and these have to be discussed and approved at annual NPC meetings.

But we see sufficient room to interpret the Securities Law, which takes precedence over the Company Law in these circumstances, to allow foreign firms to list and issue shares on domestic stock markets. New provisions must be introduced, however, to accommodate additional requirements for foreign firms, particularly as regards the scope and terms of entry and corporate governance (the latter will require that different standards be applied to international companies).

So the CSRC needs to create new regulations pertaining to foreign companies, all of which must be approved by the State Council. This could be a lengthy process – though according to our interviewees, it is currently under way.

## **b) Regulatory issues**

Many of China's regulations do not conform to international standards and are frequently costly and cumbersome to follow. According to people we interviewed, the SSE is looking to provide supplementary rules to the present system rather than creating a whole new set of rules, but the following areas in particular could discourage potential listing candidates.

- **Corporate governance**

The structure of corporate governance prescribed in the Company Law of the PRC, Securities Law and Code of Corporate Governance for Listed Companies is significantly distinct from international norms. How to reconcile such differences to make Chinese rules simple to follow yet rigorous enough to protect the interests of investors is a critical problem the CSRC has to address. For example, Chinese companies listed domestically are compelled to set up not only a Board of Directors but also a Board of Supervisors, whose functions are normally carried out by independent directors in more developed markets such as the US or UK. If overseas companies listing in China were required to adopt the same corporate structure, they would face substantially higher costs or even a change of power distribution within their corporations, which is not likely to be accepted.

- **Information disclosure**

China has onerous standards relating to information disclosure, currently demanding that listed companies publish annual, interim and quarterly reports. This could potentially be costly for foreign firms that are unused to such requirements because most other exchanges only require annual reports. Moreover, China stipulates that the interim report must be compiled and published within two months of the end of mid-year, compared to three months for the HKEx and the London Stock Exchange. Again, the Chinese authorities must decide whether to be more lenient with foreign firms and, if so, create suitable new legislation in support of this.

- **Accounting standards**

This is potentially the most challenging stumbling block for the Board if not properly resolved. Since 1 January 2007, listed companies in China have been required to adopt the new Chinese accounting standards – Chinese Generally Accepted Accounting Principles (GAAP). In spite of the move to converge

Chinese accounting standards with the International Financial Reporting Standards (IFRS), there are still specific and noteworthy differences, particularly on the points of related-party transactions and disclosure and reversal of impairment on depreciable assets.

Because different accounting standards have different rules for calculating profit and loss, the same company may exhibit divergent financial performance if reported according to more than one standard. This would significantly confuse investors and impact on their decisions. Moreover, it would be very expensive for companies that already comply with the IFRS to prepare a separate set of financial reports according to Chinese GAAP. It would be prohibitively expensive for sophisticated multinational firms with complex corporate structures and numerous business operations. Several companies we talked to made it clear that they would not be willing to prepare a new set of financial reports to comply with this listing requirement.

While the practices of more established stock exchanges show different ways of overcoming the problem, the operating-level feasibility of these solutions needs to be evaluated against the ability of Chinese investors, accounting and auditing professionals and the relevant regulatory bodies. We believe that China may follow the pre-2008 practices of the US Securities and Exchange Commission (SEC) when it allowed overseas companies listed on the NYSE to prepare financial reports based on the accounting standards of their home countries but requested that they also submit line-item reconciliation of earnings according to the US GAAP. A supplementary reconciliation document under the two sets of accounting standards would be a good opportunity for local Chinese accountants to gradually familiarise themselves with international practices, and could be more easily supervised by regulators.

#### **Accounting requirements for listing foreign companies on the NYSE**

The US SEC used to require that financial statements of foreign private issuers be prepared using US GAAP, IFRS or local GAAP. If IFRS or local GAAP were used, the consolidated financial statements (both annual and interim) could include a footnote reconciliation to US GAAP. In practice, most European companies followed IFRS for primary consolidated financial statements as required by their home regulations. By contrast, Chinese and Indian issuers typically compiled their primary financial statements under US GAAP.

However, the SEC eliminated the reconciliation requirement in late 2007, so that issuers that file financial statements using IFRS no longer needed to provide footnote reconciliation for years ending after 15 November 2007.

This will still increase the costs for listing candidates of raising capital in China, so companies (particularly those from the EU) are hoping their home governments can reach reciprocal recognition of equality of accounting standards with the Chinese authorities. On 6 December 2007, China's Ministry of Finance (MoF) and the Hong Kong Institute of Certified Public Accountants signed a joint declaration recognising the convergence of Chinese Accounting Standards for Business Enterprises and Hong Kong Financial Reporting Standards. On 12 December 2008,

the EU recognised the equivalence between China's accounting standards and the EU's IFRS; since the beginning of 2009 Chinese enterprises listed on European markets are allowed to prepare financial statements according to Chinese accounting standards without adjustment to the IFRS.

China, however, does not yet have reciprocal agreements with the EU, US or any other jurisdiction. It is unclear when the MoF – the government body responsible for regulating accounting – will make further progress on this front. We believe it may be concerned that information supplied to Chinese investors would make it difficult for them to compare the performance of foreign and domestic enterprises.

We understand from our interviews that negotiations on this front are ongoing, and that the CSRC is soliciting support from the MoF for a mutually beneficial agreement. It is still too early to draw a conclusion on how the matter will be resolved, but the companies looking to get involved in the Board should pay close attention to the final decision.

## CONCLUSIONS

### Implications for UK based firms

Given the uncertainties surrounding some of the key decisions to be made about the Board, the opportunities and challenges it may present to international firms cannot yet be predicted. However, we foresee the Board changing the business environment of several financial services sub-sectors in the following ways:

- International securities firms, including joint ventures – such as UBS-Beijing Securities, Goldman Gaohua and China Euro Securities – as well as domestic companies that seek closer relationships with the US and European firms looking to list in China will vigorously compete for the listing of global companies on the Board.
- We expect the first few listed companies in the financial sector to have opportunities to advise other foreign companies on carrying out IPOs on the Board, even though they might not be able to qualify for participation in the underwriting syndicates.
- The Board will not have a material impact on the operations of City Law firms operating in China. These firms do not practise Chinese law in general: their main areas of business are to assist Chinese companies in complying with English or American laws when pursuing a listing abroad. Their involvement with the Board may be narrower than that of joint venture securities companies. But they might derive some additional business from advising companies to coordinate new obligations on the Board with existing obligations.
- Accountancy firms are eagerly waiting for the authorities to reveal their decisions on the accounting standards to be adopted by listed companies. If reciprocal recognition is accepted by China and the EU, and if the IFRS is adopted, City accountancy firms, particularly the big four, will see a significant increase in business thanks to their strong business networks and experience in handling assignments connected with activities in the securities market.
- It is possible that the government might want to protect and support the development of local accountancy firms however, subject to China's commitments to the World Trade Organization. If this is the case, the big four firms will likely feel increased competitive pressure, though other City firms which are in partnership with local Chinese firms in the form of resource sharing will benefit more.

## Appendix

**Table 1: Entities that have signed memoranda of understanding with the Shanghai Stock Exchange**

	<b>Stock exchanges</b>	<b>Year of signing</b>
1	London Stock Exchange	1994
2	NASD	1995
3	Pacific Exchange	1995
4	Hong Kong Exchange	2002
5	Australian Stock Exchange	2002
6	Tokyo Stock Exchange	2002
7	Korea Stock Exchange	2002
8	New York Stock Exchange	2003
9	Singapore Exchange	2004
10	Osaka Securities Exchange	2004
11	Vienna Stock Exchange	2004
12	Toronto Stock Exchange	2004
13	Moscow Interbank Currency Exchange	2004
14	Deutsche Boerse AG	2004
15	BOVESPA	2005
16	Chicago Mercantile Exchange	2005
17	Chicago Board Options Exchange	2005
18	Jakarta Stock Exchange	2005
19	Borsa Italiana	2005
20	Mexico Stock Exchange	2005
21	MTS S.p.A	2005
22	OMX	2005
23	Luxembourg Stock Exchange	2006
24	Bourse de Montreal	2006
25	Euronext N.V.	2006
26	NASDAQ	2006
27	Karachi Stock Exchange	2007
28	Cairo & Alexandria Stock Exchange	2007
29	Istanbul Stock Exchange	2007
30	Ho Chi Minh City Stock Exchange	2007
31	Tel-Aviv Stock Exchange	2008
32	Malta Stock Exchange	2008
33	Abu Dhabi Securities Exchange	2009
34	New Zealand Exchange Limited	2009
35	Colombo Stock Exchange	2009
36	Stock Exchange of Thailand	2010
37	The Egyptian Exchange (formerly Cairo & Alexandria Stock Exchange)	2010

**Table 2: Joint venture securities firms with sponsorship qualification in China**

<b>Joint venture company</b>	<b>Date of establishment</b>	<b>Shareholders</b>
China International Capital Corporation (CICC)	August 1995	<ul style="list-style-type: none"> <li>• China Jianyin Investment Limited (43.35%)</li> <li>• Morgan Stanley International (34.3%)</li> <li>• China National Investment &amp; Guaranty Company (7.65%)</li> <li>• The Government of Singapore Investment Corporation (7.35%)</li> <li>• Mingly Corporation (7.35%)</li> </ul>
Everbright Securities	1996	<ul style="list-style-type: none"> <li>• Everbright Group (33.92%)</li> <li>• Temasek Holdings (33.33%)</li> <li>• Others (32.75%)</li> </ul>
China Euro Securities Limited (CESL)	April 2003	<ul style="list-style-type: none"> <li>• CLSA Asia-Pacific Markets (33%)</li> <li>• Xiangcai Securities (67%)</li> </ul>
Daiwa SSC Securities (DSSC)	June 2004	<ul style="list-style-type: none"> <li>• Shanghai Securities (67%)</li> <li>• Daiwa Securities Capital Markets (33%)</li> </ul>
Goldman Sachs Gao Hua Securities (GSGH)	November 2004	<ul style="list-style-type: none"> <li>• Beijing Gaohua Securities (67%)</li> <li>• Goldman Sachs (33%)</li> </ul>
UBS Securities	September 2005	<ul style="list-style-type: none"> <li>• Beijing Guo Xiang Asset Management (33%)</li> <li>• UBS AG (20%)</li> <li>• China Jianyin Investment Securities (14.01%)</li> <li>• State Development &amp; Investment Corporation (14%)</li> <li>• COFCO (14%)</li> <li>• International Financial Corporation (4.99%)</li> </ul>
Credit Suisse Founder Securities (CSFS)	October 2008	<ul style="list-style-type: none"> <li>• Founder Securities (66.6%)</li> <li>• Credit Suisse (33.3%)</li> </ul>
Zhong De Securities	January 2009	<ul style="list-style-type: none"> <li>• Shanxi Securities (66.7%)</li> <li>• Deutsche Bank AG (33.3%)</li> </ul>

## List of Abbreviations

### General

CDR	Chinese Depository Receipt
ETF	Exchange-traded funds
FDI	Foreign direct investment
FX	Foreign exchange
GBP	Pound sterling
GDP	Gross Domestic Product
H2	Second-half of year
HK\$	Hong Kong Dollar
IPO	Initial public offering
JV	Joint venture
MOU	Memorandum of understanding
P/E ratio	Price-to-earnings ratio
RMB	Renminbi
US\$	US Dollar

### Capital markets

ChiNext	Growth Enterprise Market (Shenzhen)
GEM	Growth Enterprise Market (Hong Kong)
HKEx	Hong Kong Exchanges and Clearing
LSE	London Stock Exchange
SME Board	Small and Medium Enterprise Board (Shenzhen)
SSE	Shanghai Stock Exchange
TSE	Tokyo Stock Exchange
NYSE	New York Stock Exchange

### Chinese government authorities

CBRC	China Banking Regulatory Commission
CIRC	China Insurance Regulatory Commission
CSDCC	China Securities Depository and Clearing Corporation
CSRC	China Securities Regulatory Commission
MoF	Ministry of Finance
NPC	National People's Congress
PBoC	People's Bank of China
SAFE	State Administration of Foreign Exchange
SEC	Securities and Exchange Commission
SFC	Hong Kong Securities and Futures Commission
SMG	Shanghai Municipal Government

### Legislation/agreements

CEPA	Closer Economic Partnership Agreement
GAAP	Generally Accepted Accounting Principles
IFRS	International Financial Reporting Standards
QFII	Qualified Foreign Institutional Investor
QDII	Qualified Domestic Institutional Investor

## **Organisations**

BEA	Bank of East Asia
CICC	China International Capital Corporation
CNOOC	China National Offshore Oil Corporation