Hong Kong Depositary Receipts

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Hong Kong Depositary Receipts defined

In July 2008, the Hong Kong Stock Exchange1, (“HKEx” or “the Exchange”) amended its regulations to permit foreign companies to list their shares, in the form of Hong Kong Depositary Receipts, on the Exchange. A depositary receipt (DR) listed on HKEx is known as an “HDR”.

HKEx’s listing requirements for foreign issuers

Issuers from any foreign jurisdiction can apply to have HDRs listed on the Exchange, as long as they meet certain requirements, specifically that the laws of its home jurisdiction or its articles of association (or other constituent documents) provide a level of shareholder protection equivalent to that required under the Listing Rules as amplified by the Joint Policy Statement issued by the Exchange and the Securities & Futures Commission dated March 7, 2007. In addition to companies incorporated in the jurisdictions of Hong Kong and the People’s Republic of China (listed under Chapter 18), companies incorporated in jurisdictions whose regulations have been considered acceptable by the Exchange include Australia, Bermuda, Canada (British Columbia and Ontario), Cayman Islands, Cyprus, Singapore and Luxembourg and United Kingdom. Another primary requirement for an issuer to list shares or HDRs in Hong Kong is financial statements prepared under either IFRS, or HKFRS. Financial statements drawn up in other accounting standards may also be acceptable to the Exchange for overseas companies (e.g. US GAAP).

Under the Exchange’s Main Board Rule 3A.02 (http://www.hkex.com.hk/rule/listrules/Chapter_3A.pdf), issuers must appoint a sponsor to assist with its listing application. Sponsors must be a corporation or an authorized financial institution licensed or registered under applicable laws to advise on corporate finance matters. The sponsor is responsible for organizing the issuer for listing on the Exchange, such as preparing the necessary listing documents and filing the formal listing application and all supporting documentation required by the exchange. In addition, the sponsor must conduct due diligence inquiries with the issuer to ensure compliance with the Listing Rules and that the listing document contains accurate and complete information about the issuer.

The amount of time needed to effect a listing in Hong Kong will depend on the issuer’s ability to fulfill the requirements of the Exchange. Typically, once a company’s financial statements have been prepared in accordance with IFRS, or HKFRS or other acceptable accounting standards, and evidence that issuer’s home market regulations provide equivalent investor protections has been submitted, a listing will become effective in approximately three months. Two of the three months will include the review process of the listing documents by the Hong Kong authorities.

An issuer meeting the requirements of the Main Board Listing Rules can submit an application to list HDRs, even if it is not already listed on another stock exchange. Additionally, the requirements for admission, the listing process, and the continuing obligations are the same irrespective of whether the issuer lists ordinary shares or HDRs.

¹SEHk is a wholly owned subsidiary of the Hong Kong Stock Exchange, HKEx.
Below is a summary of the Exchange’s other key listing requirements under Chapter 8 of the Main Board Listing Rules (http://www.hkex.com.hk/rule/listrules/Chapter_8.pdf). Issuers must meet any one of the following three financial tests:

1. **Profits Test**
   Aggregate Profits over three years equal to or greater than HKD50mm (USD6.4mm); and a market capitalization at time of listing equal to or greater than HKD200mm (USD26mm)¹.

2. **Market Cap/ Revenue Test**
   Market capitalization equal to or greater than HKD4bn (USD513mm) at the time of listing; and revenue in the most recent audited year equal to or greater than USD64mm (HKD500mm).

3. **Market Cap/ Revenue/ Cash flow Test**
   Market capitalization equal to or greater than USD256mm (HKD2bn) at the time of listing; and revenue in the most recent audited financial year equal to or greater than (HKD500mm) (USD64mm); and an aggregate positive cash flow for three preceding financial years equal to or greater than USD13mm (HKD100mm).
   - Three years operating history.²
   - Management continuity for at least the three preceding years - essentially, an adequate trading record under substantially the same management and ownership.²
   - Ownership continuity and control for at least the most recent audited fiscal year.
   - HDR issuers also have to comply with certain requirements set out in the new Chapter 19B (http://www.hkex.com.hk/rule/listrules/Chapter_19B.pdf) of the Main Board Listing Rules. This Chapter specifies matters such as content of the Deposit Agreement.

At least 25% of an issuer’s outstanding shares must be publicly held at all times (with some exceptions). In calculating public float, an HDR issuer can include the underlying shares provided they are the same class of security as those represented by HDRs and there are no restrictions on the conversion of those shares into HDRs. Therefore, the total number of publicly held ordinary shares outside of Hong Kong, plus the shares represented by HDRs held by the public via the Exchange will count towards the 25% public float requirement under the listing rules.

**Introduction versus public offering**

An issuer can list HDRs in one of two ways: as an “introduction”, which is a listing without an offering, or as an offering of shares. In the first instance, generally it would be more difficult to establish and maintain liquidity in the HDRs.

¹The Hong Kong dollar is pegged to the US dollar at a rate of US$1=HK$7.78.
²the Exchange may accept a shorter trading record and/or waive or vary the operating history and management requirement for material companies, project companies and companies applying under Market Cap/Revenue Test.
An issuer should seek HKEx listing approval for the total number of HDRs which are created and traded on the Exchange at any given time. Thus, it is advisable to consider seeking approval for more HDRs than are initially listed and traded to allow for additional HDRs to flow into the market. This is commonly known as “headroom.”

HKEx listing fees

HKEx listing fees for HDR issuers are generally the same as those paid by issuers that list ordinary shares. However, since the fee scale is commensurate with the number of securities seeking listing, there may be savings of initial and annual listing fees. For example, if an issuer does not apply for the listing of all HDRs representing the entire class of the underlying shares (see headroom above), the initial listing fees will be lower.

Current fee schedules can be found by using the following links to the Exchange’s web site:

Accepted currency for trading and clearing of HDRs

The HKEx accepts trading and clearing in both Hong Kong dollars and US dollars. The choice between these currencies is made by the HDR issuer.

Corporate announcements

Under current Listing Rules, issuers are required to publish corporate announcements on the HKEx’s web site as well as the issuer’s own web site as soon as practically possible as part of the disclosure process.

Dividend payments

Investors holding HDRs can receive dividends in Hong Kong dollars or US dollars as established in the depositary agreement at the time of listing. The Depositary Bank will receive from its custodian dividends in the issuer’s currency, convert these into the specified currency and remit the proceeds to holders of the HDRs, net of any applicable taxes and fees.

If an investor holds HDRs in CCASS (Hong Kong’s centralized securities depository), the dividend will be credited to the investor’s CCASS account (or to their broker’s or custodian’s CCASS account) net of CCASS’s cash distribution fee. CCASS fees are 0.12% of the aggregate cash amount of: dividend, distribution or bonus per security paid to a participant in one currency on the same day, subject to a maximum fee of HK$10,000 (or its equivalent in foreign currencies).

Stamp duty

A stamp duty tax applies to trades in HDRs at the rate of 0.2% (split between the buyer and seller), similar to the taxation of trades in ordinary shares. However, issuance or cancellation of HDRs will not result in the imposition of stamp duty.

The Hong Kong government does not levy a withholding tax or capital gains tax on the sale of HDRs.
Setting the HDR ratio

A foreign issuer is free to decide the ratio of HDRs to the number of home market shares that underlie them. Generally, an issuer would seek to list its HDRs at a price that approximates the per share (or per HDR) price of its sector peers that trade on the same stock exchange. It is thought that some individual investors perceive an issuer’s value in terms of its share or HDR price relative to its sector peers, which might have some bearing on their investment decisions regarding this issuer; other stakeholders, such as employees, might also be similarly influenced by the relative price.

This same mechanism is used for ADRs. For example, China Life Insurance which has a NYSE listed ADR program, trades on the Exchange at HK$24 (on 16.12.08), while on the NYSE it trades at US$45, under a 1 ADR-to-15 ordinary share ratio.

Trading and settlement procedures

Trading and settlement procedures for HDRs are the same as those for ordinary shares. All HKEx investors, both retail and institutional, are eligible to trade HDRs through their brokers. HDRs will be traded on the same HKEx trading platform on which ordinary shares exchange hands. HDR trades executed through HKEx’s trading system will be settled via CCASS on the second settlement day after trading (T+2). Upon settlement, investors’ HDR holdings will be credited to or debited from their accounts with CCASS, or from the CCASS accounts of their designated custodians or stock exchange participants.

An issuer’s continuing obligations

Chapter 13 of the Rules governing the listing of securities on HKEx details an issuer’s continuing obligations. In common with the other stock exchanges, HKEx requires that listed issuers provide investors with accurate and timely information to ensure the maintenance of a fair and orderly market and that all users of the market have simultaneous access to the same information. A few of the ongoing listing obligations for HDR issuers include:

- Disclosure of price sensitive information (Chapter 13 of the Main Board Rules) as soon as possible.  

- Notifiable and connected transactions must be disclosed and in some instances, shareholder approval must be sought (Chapters 14 and 14A of the Main Board Rules).  
  (http://www.hkex.com.hk/rule/listrules/vol1_2.htm)

- At least three independent non-executive directors, one of whom must possess an appropriate professional qualification or have accounting or related financial expertise (Chapter 3 of the Main Board Rules).  

- Compliance with the Code on Corporate Governance Practices (Appendix 14 of the Main Board Rules) or an explanation of why the issuer did not comply with this Code.  

- Annual reports must be sent to the HKEx and shareholders not less than 21 days before the Annual General Meeting of shareholders and no later than four months after financial year-end. A Chinese language version must be available upon request.

- An interim report or a summary interim report must be sent to the HKEx and shareholders not later than three months after the sixth month of the fiscal year. A Chinese language version must be available upon request.

Under Exchange listing rules, a foreign issuer must appoint “a person in Hong Kong authorized to accept service of process and notices on its behalf in Hong Kong.” However, there is no requirement that the designated person be a member of the issuer’s management.

**Language Requirement**

Under Chapter 11.14 of the Listing Rules, every listing document is required to be in both English and Chinese (http://www.hkex.com.hk/rule/listrules/Chapter_11.pdf). In the event the company is required to send out circulars, these too must be in English and Chinese, per Chapter 13.55. (http://www.hkex.com.hk/rule/listrules/Chapter_13.pdf)

With respect to the Annual Report and Accounts, Chapter 13.46, HDRs issuers can mail an English language version of either (i) its directors’ report, auditors’ report and annual accounts or (ii) its summary financial report if these documents contain a prominent statement in both English and Chinese to the effect that a Chinese translation is available from the issuer on request. (http://www.hkex.com.hk/rule/listrules/Chapter_13.pdf)

**The case for Hong Kong Depositary Receipts**

An HDR listing can give foreign issuers an additional channel to access Hong Kong and Mainland Chinese institutional and retail investors, as well as regional institutional investors and the Asia divisions of global investment houses. Regarding the latter, emerging market funds are increasingly being managed outside of Hong Kong.

Currently, China regulation limits access to foreign equity markets to Qualified Domestic Institutional Investors (QDIIs), which have a growing capital base. Consequently, QDII funds are the only current means that Chinese retail investors have at their disposal to invest internationally. Mainland Chinese institutional investors require government approval to invest internationally but are not required to do so using QDIIs.

With respect to Hong Kong-based investors, the Hong Kong Securities and Futures Commission (“HKSFC”) calculated that as of December 2007, there was over $1 trillion of assets under management, up from $300 million at the end of 2000. Further, HKSFC estimated that at the end of December 2006, nearly 75% of these assets were invested in overseas markets.

As with DRs listed in London and New York, some institutions and other well-resourced investors may prefer to trade directly in a foreign issuer’s overseas shares. Generally, retail investors and many small institutional investors prefer otherwise, as trading in overseas equity markets often entails share registration procedures, tax reclaims, currency conversion, foreign custody arrangements and, in some cases, registration of the investor with local market regulators. With HDRs, such procedures are handled by a Depositary Bank, allowing investors to trade within a relatively familiar trading and settlement environment: their home market.
Given the advantages that HDRs can afford investors in China, as well as those in other parts of Asia, foreign issuers that list on the HKEx can expect to derive the benefits that these instruments can offer, such as a more diversified shareholder base, a local acquisition currency, a more visible presence abroad, and easier access to capital outside the home market.

**Qualified Domestic Institutional Investors**

QDIIs form part of a Chinese government system that gives certain financial institutions the ability to invest in overseas markets in assets such as equities and bonds. These funds provide opportunities for domestic investors to access foreign markets at a stage where China’s currency and capital are not tradable or floating freely.

The China Banking Regulatory Commission, China Insurance Regulatory Commission and China Securities Regulatory Commission oversee respective QDII operators. In May 2007, the China Banking Regulatory Commission stated that QDIIs operated by banks could invest in the stock-related products. Meanwhile, securities companies were allowed to issue QDII products. The net investment value of a QDII product invested in stocks must not exceed 50 percent, with the net value represented by any single stock capped at 5 percent. The total amount approved for international investment by QDIIs was US$64.5 billion at the end of 2007, when China’s government last reported a threshold.

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