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Legal Updates

1. China to Allow Foreign Control of Securities Firms: Measures issued by CSRC for Administration of Foreign Investment in Securities Companies (Draft for Comment) (Authors: TieCheng YANG, Yin GE, Ting ZHENG, Michael KAN)

On 9 March 2018 the China Securities Regulatory Commission ("**CSRC**") issued the *Measures for Administration of Foreign Investment in Securities Companies (Draft for Comment)* (the "**Draft Measures**")[1], and requested public comments until 8 April 2018. The CSRC's issuance of the Draft Measures is widely considered a significant move to further open up China's domestic financial sector.

How will the Draft Measures affect foreign investment in securities companies in China? This newsletter begins with a background of the current foreign ownership limitations in China, interprets the key regulatory changes and impacts on foreign investment in securities companies as proposed in the Draft Measures, and briefly analyzes the regulatory trends for further implementing China's other commitments to ease restrictions on foreign investment in the financial sector.

Background

At present, there are 13 foreign-invested joint venture (JV) securities companies in China, including four JV securities companies approved under the Closer Economic Partnership Arrangement (CEPA). Global financial giants mainly operate in China through minority-owned JV securities companies, among which most are limited to investment banking services due to the current regulatory constraints.CSRC has issued the Draft Measures to replace the *Rules on the Establishment of Securities Companies with Foreign Equity Participation*[2], last amended by CSRC in 2012 (the "**Current Rules**"). Under the Current Rules, the total proportion of shares (or of the rights and interests held directly or indirectly) by foreign shareholders in a JV securities company cannot exceed 49%.

However, with the significant development and rapid changes in China's domestic securities markets, the existing 49% foreign ownership cap could no longer meet the need for the continuous development and opening up of the securities sector in China.

At the meeting between the Chinese President Xi Jinping and the U.S. President Donald Trump in

[1] 《外商投资证券公司管理办法（征求意见稿）》[Measures for Administration of Foreign Investment in Securities Companies (Draft for Comment)] (China Securities Reg. Comm.; issued 9 Mar. 2018, for public comment until 8 Apr. 2018), *available at:* http://www.csrc.gov.cn/pub/zjhpublic/zjh/201803/P020180309603189338426.pdf (Chinese).

[2] 《外资参股证券公司设立规则（2012 年修订）》[Rules on Establishment of Securities Companies with Foreign Equity Participation (Revised in 2012)] (China Securities Reg. Comm., Order No. 86; promulgated and effective 11 Oct. 2012), *available at:* http://www.csrc.gov.cn/pub/newsite/flb/flfg/bmgf/zjgs/gsslbg/201310/t20131021_236602.html (Chinese).

November 2017[3], China made the commitment to raise the cap on direct or indirect equity ownership by a single or multiple foreign investors in JV securities, fund management and futures companies to 51%, and there will be no equity cap limitation on such investments three years after the implementation of the proposed rules. Meanwhile, the strategic significance of further opening up the financial sector was also reiterated at other meetings, including the 19th National Party Congress and the National Finance Working Conference in 2017 as well as the most recent meetings of the National People's Congress ("**NPC**") and the Chinese People's Political Consultative Conference ("**CPPCC**").

In this context, the Draft Measures have been issued by CSRC as an effort to implement the strategic decision at the 19th National Party Congress to "significantly ease market access and further open the service sector"[4] and to deliver the commitment of further opening up China's securities markets at the high-level meeting between Xi Jinping and Donald Trump.

Key Proposed Changes in the Draft Measures

According to the *Statement of Drafting on the Measures for Administration of Foreign Investment in Securities Companies*[5], key proposed changes in the Draft Measures can be summarized in the five main areas as below:

a. Lifting shareholding cap for foreign shareholders

The first key regulatory change is to lift the cap on foreign shareholding in securities companies to 51% from the current 49%. According to the Draft Measures, the total proportion of the shares held directly and indirectly by foreign investors in a JV securities company shall not exceed the 51% cap according to China's commitment to open up its securities sector, and shall not be less than 25% in principle. JV securities companies converted from domestically-funded securities companies shall not be subject to the 25% minimum foreign investor shareholding requirement. It is further expected that the 51% ceiling on foreign shareholding in securities companies will be eventually scrapped three years after the proposed rules take effect.

b. Broadening business scope for JV securities companies

JV securities companies will be allowed to engage in a wider range of services in incremental steps.

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[3]《新闻办就中美元首北京会晤经济成果相关情况举行吹风会》[Information Office Holds Briefing Regarding the Economic Results of the Meeting between the heads of China and US in Beijing] (10 Nov. 2017), *available at*: http://www.gov.cn/xinwen/2017-11/10/content_5238617.htm#1 (Chinese).

[4]《决胜全面建成小康社会，奋力夺取新时代中国特色社会主义伟大胜利》[Secure a Decisive Victory in Building a Moderately Prosperous Society in All Respects and Strive for the Great Success of Socialism with Chinese Characteristics for the New Era] (delivered at the 19th National Congress of the Communist Party of China, 18 Oct. 2017), *available at:* http://www.xinhuanet.com/english/download/Xi_Jinping's_report_at_19th_CPC_National_Congress.pdf (English)

[5]《关于<外商投资证券公司管理办法>的起草说明》[Statement of Drafting on the Measures for Administration of Foreign Investment in Securities Companies] (China Securities Reg. Comm.; issued 9 Mar. 2018), *available at:* http://www.csrc.gov.cn/pub/zjhpublic/zjh/201803/P020180309603189492100.pdf (Chinese).

For example, a newly established JV securities company may apply to engage in four of the following services as provided in the *Securities Law of the People's Republic of China (Revised in 2014)*[6]*:*

i. securities brokerage business;

ii. securities investment advisory business;

iii. financial advisory business related to securities trading and securities investment activities;

iv. securities underwriting and sponsoring business;

v. securities business on its own account;

vi. securities asset management; and

vii. other securities business.

One year after regulatory approval and each year thereafter, the JV securities company may apply to engage in two additional services as indicated above.

c. Updating regulations on foreign holding of listed securities companies

CSRC has also proposed to raise the ceiling for both the total and single shareholding of foreign investors of listed securities companies in China.

According to the Draft Measures, the total proportion of shares held directly and indirectly by all foreign investors in a listed securities company shall not exceed the current cap of 51% according to China's commitment to open up its securities sector, which is consistent with the updated cap for foreign shareholding in unlisted securities companies.

With regard to the shareholding of a single foreign investor, the ceiling set by CSRC will be raised from 20% to 30%.

d. Clarifying regulations for a change of nationality by actual controllers of domestic shareholders

The Draft Measures address a new occurrence which has arisen in recent regulatory practice where the actual controller of a shareholder in a domestically-funded securities company changes his or her nationality from Chinese to that of a foreign country. This change of nationality leads to the issue of indirect shareholding by a foreign investor in a domestically funded securities company. The Draft Measures provide that if the controlling shareholder or actual controller of a domestically funded securities company is changed from a domestic investor to a foreign investor, the relevant foreign investor must comply with the relevant eligibility requirement for foreign shareholders, but their shareholding could be less than 25%.

[6]《中华人民共和国证券法（2014 年修订)》 [Securities Law of the People's Republic of China (Revised in 2014)], Art. 125 (*as revised and adopted by* Standing Comm. National People's Cong., Pres. Order No. 14; promulgated and effective 31 Aug. 2014) , *available at:* http://www.npc.gov.cn/npc/lfzt/rlyw/2015-04/23/content_1934291.htm (Chinese).

Where foreign investors do not meet the relevant criteria and requirements as specified in the Draft Measures, they are required to complete the relevant rectification and remediation measures within three months.

e. Improving criteria for foreign shareholders

CSRC has expressed the intention to raise the bar for foreign investors planning access to China's domestic securities markets, by updating the criteria for foreign shareholders in a JV securities company. According to the Draft Measures, the foreign shareholders in a JV securities company shall satisfy the following criteria:

i. their home country or region has a sound legal and regulatory system for securities business and has concluded a memorandum of understanding on securities regulatory cooperation with CSRC or any institution recognized by CSRC and maintains constructive relations of regulatory cooperation with CSRC or any institution recognized by CSRC;

ii. they are lawfully established financial institutions in their home countries or regions, and all of their financial ratios have, for the last three years, conformed to the legal requirements applicable in their respective home countries or regions and to the requirements of their respective securities regulator;

iii. they have been operating for no less than 5 years, and have not received any serious penalty from any securities regulator, or from an administrative or judicial organ in their respective home countries or regions within the last 3 years;

iv. they have sound internal control systems;

v. they have good international reputations and business performance records, with internationally leading track records in terms of business scale, revenue and profit, and high-level long-term credit within the last 3 years; and

vi. any other prudential criteria specified by CSRC.

As compared with the Current Rules, the Draft Measures set higher requirements on foreign investors, requiring that they must be financial institutions with a sound international reputation, and good business and credit records over the past three years. This change reflects a higher standard from CSRC to attract high-quality foreign investors with good international reputations and leading management experience.

Outlook

In the past, the key issue with regard to foreign investors establishing JV securities companies has been whether the investors could have control over the JV securities companies. There are some precedents where foreign investors have had control over JV securities companies, but those precedents are exceptional and cannot be followed by other international investors. International

investors will undoubtedly welcome China's move to permit foreign investors to take majority stakes in JV securities companies as contemplated by the Draft Measures. For foreign investors who have invested in JV securities companies as minority shareholders in China, they may consider increasing their current shareholding to become the controlling shareholders of the JV security companies.

Following the issuance of the Draft Measures, it is expected that China will further open up its other financial sectors, such as asset management, futures, etc., and relevant specific regulations will be released soon.

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2. The New Economy: A New Path Home (1) - A Brief Overview of CDRs (Authors: Shijia LI, Kaiying WU, Joseph LI)

Recently, there have been a number of reports that the China Securities Regulatory Commission (the "**CSRC**") will embrace "new economy" companies to return to China's capital markets, such those engaged in new technologies, new industries, and new business operations and models. The CSRC also plans to allow certain companies with offshore structures to achieve onshore listings through the issuance of Chinese Depositary Receipts ("**CDRs**"). This has caused CDRs, a once popular concept, to return to the spotlight and attract the widespread attention of market players. In this article, we will briefly analyze the CDR system based upon the basic principles of depositary receipts, relevant CDR legal systems and practices in China,[7] as well as widely reported circumstances surrounding new economy companies that may return to the domestic market.

Implications and transaction structure of depositary receipts

Depositary receipts are a type of negotiable certificate issued and traded on the securities markets of a country or region, with each depositary receipt representing a certain number of underlying shares of a foreign company, or the issuer. Depositary receipts have different names depending on where the depositary receipt is listed. There are two primary types of depositary receipts: one is dedicated for listing on a single securities market, such as American Depositary Receipts (ADRs), and the other is dedicated for listing on two or more securities markets, such as Global Depositary Receipts (GDRs).

The purpose of depositary receipts is to facilitate the listing and trading of an issuer's securities outside its home jurisdiction. The underlying shares represented by the depositary receipt are held by a depositary in its own name, and the holder of the depositary receipts has rights to theunderlying

[7] For purposes of convenience, in this article, references to "China" and "PRC" do not include the Hong Kong Special Administrative Region, Macau Special Administrative Region and Taiwan.

shares through the depositary. The basic transaction structure for depositary receipts is typically as follows:

a. The issuer will deposit its shares, which are listed or planned to be listed, with a custodian bank in the issuer's home jurisdiction.

b. After the shares are deposited, the depositary will issue depositary receipts in a host securities market based on the underlying shares.

c. Investors purchase and then trade the depositary receipts on the host securities market.

Matters related to the underlying shares, such as an increase or decrease in the ratio of number of underlying shares to that of depository receipts, shareholder rights and corporate governance, are required to be consistent with the laws and regulations of the place where the issuer is registered. However, matters in relation to the issuance, quotation, trading, settlement and dividend distributions of the depositary receipts are required to comply with the laws and regulations of the host market. Under this structure, the depositary and custodian bank are the two key intermediaries in the issuance and circulation of depositary receipts. The depositary is generally a commercial bank, which is also referred to as depositary bank. As a registered holder of the underlying shares, the depositary provides services for investors of depositary receipts, including assisting the issuer to complete the issuance, registration, transfer and cancellation of the depositary receipts, acting as a communications channel between the issuer and investor and receiving dividends and exercising voting rights on behalf of investors. The custodian bank is generally a commercial bank where the issuer is registered and is responsible for custody of the underlying shares represented by the depositary receipts.

Concept and background behind CDRs

a. Concept of CDRs

CDRs refer to negotiable depositary receipts issued and traded on China's domestic securities markets. Based on international practice, we presume the basic operating procedures for CDRs will be that: the depositary deposits the shares of the offshore company with the custodian bank of the place where the offshore company is registered, and then issues depositary receipts representing those shares within China. In this manner, the shares of the offshore company can be indirectly traded and circulated on the domestic securities markets (the PRC authorities may make some arrangements differing from international practice, however, based on factors such as China's domestic capital markets and foreign exchange regulatory environment).

b. CDR background

CDRs are certainly not a new concept. In the history of the development of CDRs, a few major steps have attracted widespread attention, including:

i. During the process of researching and discussing the opening of an international board on the Shanghai Stock Exchange which took place from 2009 to 2011, CDRs were considered as a path for the implementation of an international board;

ii. On June 21, 2016, the People's Bank of China released the *2015 Annual Report of the People's Bank of China*, which indicated that qualified foreign companies would be permitted to issue shares in China's domestic securities markets, and could consider recommending the issuance of depositary receipts (CDRs) that were convertible into shares;

iii. On December 5, 2016, the State Council issued the National Plan for Information Technology During the Period of the Thirteenth Five-year Plan. In the section *Developing Investment and Financing Channels and Inspiring Development Vitality*, the plan recommends "developing systems and policies related to the listing of offshore companies with special equity structures on the domestic market."

However, to the date this Article first published, CDRs remain only a concept which is discussed in internal studies or referenced in macro planning documents, and the relevant PRC authorities (including the CSRC) have not yet formally formulated or released any public substantive policies, systems, work plans or timetables related to CDRs.

c. Which offshore companies are allowed to issue CDRs

Based upon the general practice of depositary receipts, provided it is permitted by the laws of the host market, depositary receipts may be issued by companies already listed on other securities markets, or companies whose shares or other securities have never been listed on any securities market. At present, it is unclear whether the CSRC will allow unlisted offshore companies to directly issue CDRs within China. Judging from relevant news reports, the CSRC is currently taking a very cautious attitude towards this issue by only tentatively permitting a few well-known "China concept stocks" to issue CDRs in China (enterprises whose main operating entities and/or business relationships are located in China, but are listed outside China). However, in our understanding, if the pilot program works well, the PRC government may soften restrictions by extending the scope of entities eligible for the issuance of CDRs to other offshore listed companies (including both China concept stock companies and non-China concept stock companies) that meet certain conditions, and may even grant permission to non-listed companies that are registered overseas.

Key legal issues involving CDRs

CDR is a concept that arises from the depositary receipts that have long existed in international capital markets. In light of China's specific regulatory environment, the integration of CDRs into China's existing legal framework will inevitably involve a number of issues. Below, we discuss some of the key PRC legal issues related to introduction of CDRs.

a. Convertibility between CDRs and underlying shares

Convertibility between CDRs and the underlying shares refers to whether the CDRs and the underlying shares (the issuer's shares represented by the CDRs) can be converted to each other. This substantially influences whether a price difference exists between the CDRs and the issuer's shares and the size of such a difference. If the CDRs and the underlying shares are non-convertible (meaning the CDRs and other depositary receipts issued by the issuer in other securities markets corresponding to the underlying shares are not convertible), the price of the CDRs and the underlying shares, as well as of the other depositary receipts issued in other securities markets corresponding to the underlying shares, will depend upon the value determined by investors in each of those securities markets.

Based upon some reports currently circulating in the market, we assume the PRC regulators are inclined to adopt a policy to restrict convertibility between CDRs and the underlying shares (or to provide for conversion limits), in order to maintain the stability of financial markets and to promote reforms in a more prudent manner. The picture is different in the U.S. and Hong Kong stock markets, which allow for the holders of depositary receipts to convert their depositary receipts into underlying shares. We believe the PRC regulators will restrict (or temporarily restrict) convertibility between CDRs and underlying shares mainly for the following reasons: (i) given China's securities markets are dominated by retail investors and CDRs will be a scarce new type of investment, permitting convertibility of CDRs may result in price speculation, which could result in the price of CDRs to seriously deviate from reasonable values and it may lead to large-scale, unpredictable cross-border capital flows; (ii) in addition, if a domestic investor chooses to convert CDRs into shares of an offshore company, thus becoming the shareholder of that offshore company, matters such as overseas investment approval/filing and foreign exchange registration would be involved. However, long term, the lack of convertibility may lead to the price of the CDRs deviating from the price of the underlying shares.

b. CDR listing examination and approval standards and regulatory rules applicable to companies with listed CDRs

Since there are no valid policies, systems or standards for the issuance of CDRs at present, we will analyze the examination and approval standards applicable to the issuance of CDRs as well as the listing related regulatory requirements based upon the Securities Law of the People's Republic of China ("**Securities Law**"),[8] rules applicable to initial public offerings in the A-shares market ("**A-share IPOs**") and the regulatory rules applicable to listed companies in China.

i. <u>Listing conditions</u>

First, according to provisions of the Securities Law, the public issuance of securities must comply with the conditions stipulated by administrative regulations and be reported to the securities regulatory authority under the State Council or a department authorized by the State Council for

[8] [Securities Law of the People's Republic of China] (*as revised and adopted by* Standing Comm. Nat'l People's Cong., Pres. Order No. 14; promulgated and effective 31 Aug. 2014) [hereinafter "Securities Law"].

approval in accordance with the law. No entity or individual may publicly issue securities without obtaining regulatory approval. Therefore, we assume that the issuance of CDRs must meet certain regulatory conditions and be approved by the securities regulatory authorities in China.

According to the Securities Law, one of the conditions for companies to apply for public offerings of new shares is to be sustainably profitable. According to the *Measures for Administration of Initial Public Offerings and Listing of Shares*[9] and *Measures for Administration of Initial Public Offerings and Listing of Shares on the Growth Enterprise Board*,[10] promulgated by the CSRC, an important condition for a company to apply for an A-share IPO is to meet certain standards for net profit, operating income, etc. Specifically, such conditions include the following:

- In order to apply for an A-share IPO on the Main Board, the applicant's net profit for the previous three fiscal years is required to be positive and cumulatively exceed RMB 30,000,000. Net profit is calculated based on the lower net profit figure before or after deducting non-recurring gains and losses. Net cash flow generated from annual operating activities for the previous three fiscal years must cumulatively exceed RMB 30,000,000 in total, or the cumulative operating revenue for the previous three fiscal years must exceed RMB 300,000,000.
- In order to apply for an A-share IPO on the Growth Enterprise Board, the applicant must either (i) be profitable for the previous two consecutive years and the cumulative net profit generated for the previous two years cannot be less than RMB 10,000,000, or (ii) the applicant has been profitable for the most recent year and the operating income for the most recent year was no less than RMB 50,000,000. Net profit is calculated based on the lower net profit figure before or after deducting non-recurring gains and losses.

If the profitability requirements applicable to A-share IPOs as mentioned above are also applicable to CDR issuers, a large number of loss-making new economy companies will be deprived of the opportunity to participate.

ii. <u>Compliance reviews</u>

A-share IPO applicants are subject to rather high compliance standards, whereas the U.S. and Hong Kong markets only require disclosure filings. Therefore, the regulatory authorities need to clarify, for example, whether CDR issuers will be subject to the A-share IPO period examination and approval standards and procedures, or whether an exemption mechanism may apply. We understand offshore and offshore-listed company CDR issuances may involve certain issues that require examination and disclosure, such as (i) the use of funds raised from overseas listings/bond issuances, (ii) whether the distribution and overseas remittance of domestic company profits is compliant, (iii) enterprise income taxes paid by the CDR issuer on

[9] [Measures for Administration of Initial Public Offerings and Listing of Shares] (*as amended by* China Sec. Reg. Comm., Decree No. 122; promulgated 30 Dec. 2015, effective 1 Jan. 2016) 2016 ST. COUNCIL GAZ. 5.

[10] [Measures for Administration of Initial Public Offerings and Listing of Shares on the Growth Enterprise Board] (China Sec. Reg. Comm., Decree No. 99; promulgated and effective 5 May 2014) 2014 ST. COUNCIL GAZ. 21.

income generated in China, (iv) individual income taxes payable by the actual controller, (v) whether taxes have been paid with respect to employee stock incentive plans and indirect transfers of domestic equities among non-resident enterprises.

iii. Accounting standards used in the preparation of financial statements

The issuer, as an overseas company, generally adopts U.S. accounting standards or international accounting standards (IFRS). Although the accounting standards applicable in China are similar to IFRS in basic terms, there still exit some differences in between the standards. Therefore, with respect to the issuance of CDRs in China, the issuer will probably need to restate its financial statements in accordance with PRC accounting standards.

iv. Conflicts between the principles of "weighted voting rights" and "one share, one vote"

Some overseas jurisdictions, such as the Cayman Islands, a common place of registration for many overseas listed companies, permit companies to adopt a "weighted voting rights structure" (where a company may issue different classes of shares, and each class is entitled to a different number of voting rights). In addition, some overseas securities markets, such as in the United States, also accept share or ADR listings from companies with weighted voting rights structures.

In this case, if companies with weighted voting rights structures (including some U.S. listed companies) issue CDRs in China, the voting rights of CDR holders may be inferior to those of shareholders (or ADR holders) of other classes of shares in the issuer. Although the issuer is an offshore company and the CDRs issued for it are not regarded as shares of a PRC company, we cannot rule out the possibility that the regulatory authority will disapprove of the weighted voting rights structure of the CDR issuers versus the "one share, one vote" principle. It remains to be clarified whether the PRC regulators may reject CDR issuance applications if the underlying shares which the CDRs represent are subject to weighted voting rights structures, or whether any special mechanisms will be designed to address these conflicts.

v. Requirements for corporate governance structures and internal control systems

There may exist significant difference between the laws and regulations in China related to the "three boards" governance structures (the board of shareholders, board of directors, and board of supervisors) of A-share listed companies, the appointment of directors and senior management personnel (including independent directors and related requirements) and control rights (A-share listing related rules emphasize the concept of "actual controller") of A-share listed companies and relevant rules and regulations in the offshore company's place of registration or listing.

vi. Review of related-party transactions and horizontal competition

Related-party transactions and horizontal competition are two issues that are greatly emphasized in the A-share IPO review process and daily supervision of PRC listed companies.

- According to the *Measures for Administration of Disclosing Information by Listed Companies*[11] and the stock listing rules of domestic securities exchanges, related-party transactions refer to the transfer of resources or obligations between listed companies or their holding subsidiaries and affiliates of listed companies. From the perspective of A-share IPO reviews, the transaction values in related-party transactions should be fair, determined through due procedures, have no detriment to independence and are not obviously unfair. From the perspective of governance of PRC-listed companies, related party transactions between listed companies and its affiliates should (i) be consistent with the principle of equality, voluntariness and making compensation for equal value; (ii) the content of the transaction agreements must be clear and specific, the listed company is required to disclose the matters concerning the conclusion, modification, termination and performance of related-party transaction agreements in accordance with relevant rules; (iii) the listed company is required to take effective measures to prevent shareholders and their affiliates from misappropriating or transferring funds, assets and other resources of listed companies in any form; (iv) and listed companies may not provide guarantees for their shareholders or affiliates.
- There is no clear legal definition of horizontal competition. Generally, horizontal competition refers to circumstances in which the listed company and its controlling shareholders, actual controllers, and other companies controlled by it are engaged in the same or similar business. This results in a direct or indirect competitive relationship between the two parties. From the perspective of A-share IPO reviews, horizontal competition should be avoided between the listed company and its controlling shareholder, actual controller and other enterprises which the listed company controls. In terms of supervision, the listed company's business should be completely independent from the controlling shareholder. The controlling shareholder and any entities subordinate to it should not engage in business that is the same as or similar to the listed company. The controlling shareholder should take effective measures to avoid entering into horizontal competition with the listed company.

There are differences between domestic and offshore listing rules regarding the definition, determination criteria and treatment principles of related-party transactions and horizontal competition. In addition, PRC regulatory authorities shall have no precedent to follow in determining related-party transactions and horizontal competition in transactions involving VIE structures. This is an area which the regulatory authorities will need to further consider and clarify.

vii. <u>Information disclosures</u>

[11] [Measures for Administration of Disclosing Information by Listed Companies] (China Sec. Reg. Comm., Decree No. 40; promulgated and effective 30 Jan. 2007) 2007 ST. COUNCIL GAZ. 34.

After the issuance of CDRs, in addition to regulatory requirements of its place of listing, the offshore companies will also be required to comply with the relevant PRC regulatory rules to the extent required by the CDR system and the PRC securities regulatory authorities. Specifically, offshore companies should pay attention to differences in disclosure requirements applicable in the different listing markets.

However, we understand that there is a difference in nature between CDRs and corporate shares (particularly assuming that CDRs will not be convertible with the underlying shares). We have also noticed that many research articles suggest CDRs should be classified as "other securities … lawfully recognized by the State Council" under Article 2 of the Securities Law,[12] which distinguishes CDRs from publicly issued corporate shares. In this case, the relevant regulatory requirements applicable to A-share IPOs and companies listed in the PRC securities markets may not directly apply to the issuance and supervision of CDRs. However, the PRC regulators are still likely to formulate relevant rules related to the issuance and supervision of CDRs with reference to the rules applicable to A-share IPOs and the supervision of listed companies (it should be observed, for example, that certain public securities markets, such in the United States, rules applicable to public depositary receipt issuances are quite similar to rules applicable to the post-listing supervision of companies in China). If the State Council determines CDRs to be "other securities" pursuant to Article 2 of the Securities Law, we assume the relevant PRC supervisory authority may issue a separate regulatory rule applicable to CDRs, which, to a certain extent, will resolve the issues arising from developing relevant CDR rules with reference to corporate shares.

c. "VIE Structure" Compliance

A considerable number of the new economy companies engage in businesses that restrict or prohibit foreign investment (such as value-added telecommunications, network culture, etc.). In order to facilitate equity financings and listings of offshore companies, new economy companies engaged in industries that restrict or prohibit foreign investment will establish a protocol control structure (i.e., a variable interest entity "**VIE**" structure). Under a VIE structure, the offshore financing or listed entities do not directly hold interests in domestic operating entities of the relevant businesses that are in restricted or prohibited industries. Instead, the domestic operating entities are controlled through VIE agreements.

Regarding VIE structures, in *Relevant Questions and Answers on the Information Disclosure Requirements for the Removal of the VIE Structure of Target Assets in a Major Asset Restructuring,*[13] CSRC clarifies the requirement that, if a listed company plans to acquire target assets which remove a VIE structure, disclosure of information such as compliance during the creation and removal of the

[12] Securities Law, Art. 2. "[the Securities Law] is applicable to the issuing and trading in China of shares, corporate bonds and such other securities as are lawfully recognized by the State Council. Where their issuing and trading are not covered by this Law, the provisions of the Company Law and other laws and administrative regulations shall apply."

[13] [Relevant Questions and Answers on the Information Disclosure Requirements for the Removal of the VIE Structure of Target Assets in a Major Asset Restructuring] (China Sec. Reg. Comm., issued 18 Dec. 2015).

VIE structure should also be disclosed. In the review of A-share listing applications, CSRC holds the same attitude towards VIE-structured companies.

However, if a CDR issuer needs to adjust its VIE structure in order to be accepted to the A-share market, it would be hard for the issuer convert its VIE structure into a direct shareholding structure due to restrictions on foreign investment in certain industries and regulatory restrictions on related-party mergers and acquisitions, etc. In addition, according to our understanding, the regulatory authorities consider that the purpose of the CDR system is to enable offshore issuers to participate in China's securities market without changing the issuer's overseas company structure (even including its identity as an overseas listed company). Therefore, the relevant government authorities, including the securities regulatory authority, may coordinate to adopt appropriate and flexible regulatory policies and requirements if a VIE-structured company intends to list in China through the issuance of CDRs.

d. Foreign Exchange Administration

Once the CDR system is implemented, if capital raising is allowed domestically, foreign exchange supervision matters will also have to be considered, such as (i) how to coordinate foreign exchange administration for the funds involved; (ii) whether RMB may be converted into foreign currency and then remitted overseas, and whether such foreign currency is allowed to remitted back to China; (iii) how foreign exchange related to stock dividends is remitted into and out of China.

e. Other issues

In addition to the above issues, the PRC regulatory authorities may need to consider issues such as jurisdictional conflicts and choice of law between PRC law and the laws of place of registration and place of listing of the CDR issuer.

Conclusion

If relevant media reports prove to be true, introduction of the CDR system is certainly good news for new economy companies because they are provided with a new choice for completing listings in China's securities markets through the issuance of CDRs. However, as discussed above, in order to successfully implement the CDR system in China, the existing legal framework and implementing rules will still need to be adjusted, which will require close cooperation among different domestic regulatory authorities and cross-border securities regulatory authorities. However, we cannot not rule out the possibility that the pace of progress will exceed expectations. For market players, we expect CDRs to be successfully implemented in China and will become one of the cornerstones for the long-term development of the China's capital markets. Going forward, we will closely monitor developments regarding the CDR system and timely share our opinions with you.

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3. Overview of Cross-border E-mail Fraud and Asset Recovery in China (Authors: Andy LIAO | Shirley LIAO)

With the wide use of e-mail in the ordinary course of business, hackers increasingly enter e-mail systems to deceive users and defraud them of money or property. This kind of fraud is particularly prevalent in cross-border transactions which, including payment processing, are heavily reliant upon e-mails due to time zones and language barriers. These circumstances provide an opportune chance for hackers to plot their crimes. The most common e-mail fraud is a type of phishing scam, whereby hackers send out payment instructions by using e-mail addresses that are identical or nearly identical to those of staff working for trading companies or senior executives of multinationals. For this reason, it is also known as "trade fraud" or "CEO fraud." When a company discovers it has fallen victim to the fraud, it is often quite helpless because it is difficult for the judicial authorities or financial institutions to discover the fraud and immediately freeze the funds as the funds have been transferred to banks in different jurisdictions and the hackers usually use shell companies to receive funds.

Han Kun's commercial dispute resolution team has represented many multinationals to handle a significant number of cases relating to e-mail fraud and asset collection in recent years and we have accumulated a wealth of practical experience as a result. This article intends to provide an overview of the main types and methods of e-mail fraud, major remedies victims may seek, and the relevant legal and practical issues involved. Considering that the particularities of each individual case impact the selection of specific strategies, a successful asset recovery requires timely involvement and efficient handling from experienced counsel who are familiar with local judicial process.

E-mail Fraud

a. Main Types of E-mail Fraud

Main Types	Common Fraud Scenarios	Discovering the Fraud
Trade Fraud	Trading company A is negotiating sales of goods with its foreign client B, when the parties are close to a deal, the hacker impersonates A and sends an e-mail to B: (1) "The goods have been exported, our original bank account is under audit and cannot receive new funds, please pay to the following account of our Hong Kong subsidiary..."; (2) "We are negotiating and resolving tax issues with our bank, please make the payment to our affiliate company as follows… ".	Trading company A has still not yet received the payment after a long time and decides to send another e-mail or call B directly, both parties are shocked to discover the wrongful remittance.
CEO Fraud	The hacker impersonates senior executive A and	When the senior

	sends an e-mail with the subject "Urgent and Confidential M&A" to financial staff B: "I am currently on a business trip in China conducting a highly confidential M&A deal, please pay attorney fees/consulting fees to the following Chinese company immediately and do not to tell any other third person regarding the e-mail and purpose of the payment."	executive A appears in front of B or B goes through payment formalities with A, they are shocked to discover the fraud.

b. Carrying Out the E-mail Fraud

i. Confirming the Target

Hackers gather contact e-mails of trading companies or multinationals through their websites or foreign business forums. Free corporate e-mails with poor security protection or personal e-mails without unified corporate suffixes are more likely to be targeted. Hackers hack into the targeted e-mail accounts and intercept e-mail correspondence between the parties or steal the password of and log into the targeted e-mail account to learn of the transaction progress.

ii. Secret Observation

Instead of acting immediately, hackers usually take time to review all related e-mails to familiarize themselves with internal corporate structure, financial procedures, senior executives' agenda, transaction progress, and even to imitate writing styles of the parties, all of which lay the foundation for the contemplated phishing e-mail at the key point of payment.

iii. Phishing E-mails

At the key point of the wire transfer, hackers cut off e-mail communications between the parties and impersonate the trading company to request a change of bank account or impersonate the senior executive to request the financial staff to execute a wire transfer.

The phishing e-mail is rarely sent from the actual e-mail address being targeted, the prevalent form of the fraud is to use a forged e-mail address that merely resembles the actual e-mail address. To lower the suspicions of the victim, hackers usually use the forged e-mail address to intervene at an earlier stage before payment in normal communications between the parties, such as exchanging documents or checking on transaction progress. Below are examples of common means to forge e-mail addresses:

Methods	True e-mail address	Forged e-mail address
Character resemblance	apple@qq.com	app1e@qq.com
Increase or decrease in character count	sasaki@sahathai.com	sasaki@sahatthai.com
Suffix replacement	vicky@yahoo.com	vicky@ymail.com

iv. Money Laundering

Hackers often cash out immediately or after several transfers after the funds have been wired, but their whereabouts are at risk of being exposed. It is thus common at present for hackers to launder the funds through a second transaction. Specifically, before hackers send out the phishing e-mail to foreign clients requesting a change of bank account, they will negotiate with another trading company for a purchase of goods and request the trading company to provide their bank account and to export the goods upon receipt of the payment. The bank account provided by the trading company will be designated as the false account in the phishing e-mail. Thus, the hackers are not only able to resell the goods received, but also to launder the illegal funds and make the case harder to solve and the funds more difficult to trace.

Asset Tracing and Recovery Strategies and Methods

Upon discovering the e-mail fraud, it is a top priority for the victim to contact the banks involved and the police immediately to freeze the funds or to disclose the movement of the funds. For a foreign remitter, efforts should immediately be made to contact its bank to cancel the transfer. Even if the transfer has been executed, the remitting bank is in a more advantageous position than its client to find the proper persons in the receiving bank and to lobby them to restrict or delay further transfers, especially when the banks cooperate on the money laundering and so on.

It is noted that local police in China, when receiving a report from a foreign victim, are inclined to reject the case on the grounds that they lack the jurisdiction or the reporting documents are incomplete, and advise the foreign victim to report the crime to local law enforcement in their home country or to Interpol, which will result in missing the best opportunity to recover funds. The receiving bank faces a dilemma in these fraud cases; although it is sympathetic to the victim, due to the contractual duties of confidentiality to its clients and indeterminacy of the case, it usually states it has no right to take measures against the suspected account before receiving any instructions or orders from judicial authorities. Given this, it is vital for the victim to engage local counsel to provide practical assistance for case acceptance and asset freezing in preparing reporting materials, arranging and translating evidence, and providing explanatory documents to local police and the receiving bank to address the jurisdiction issue and bank regulatory provisions.

A successful fund freezing certainly buys sufficient time for the next step of asset recovery, the major options are set out as follows:

a. Local Criminal Investigation and Prosecution or International Police Cooperation

When the funds are successfully frozen or the hackers are located where the receiving bank is situated, a local police investigation is undoubtedly the most efficient way to apprehend the criminal suspects and recover the assets. Even if the funds have been transferred, an investigation will be helpful to trace the movement of the funds and take the next steps. We previously assisted a client to cause the local police to order the receiving bank to disclose information about where the funds were transferred, and our client used this fund transfer information to trace the funds to a bank

account held by a Hong Kong company. Through cooperation with Hong Kong counsel, we successfully caused the Hong Kong police to take investigative measures against that company and its senior executives.

For such kind of cross-border fraud, it is theoretically possible to resort to Interpol. The remitter may report the case to the National Central Bureau of Interpol located in its home country, which will then transfer the case to the receiving bank's National Central Bureau with a request to take action. However, Interpol tends to focus on high profile cases and does not publicize working procedures. It is difficult for the victims to maintain efficient contact with Interpol or predict the outcome of their cases. Therefore, fraud victims normally will not utilize the Interpol approach as the sole remedy and will also report the case to the local police concurrently.

b. Civil Litigation

The opportunity to apprehend hackers or to recover funds is not very optimistic due to the use of high technology and cross-border complications. Victims usually resort to civil litigation if they cannot recover the funds through the police. Generally, there are the following options in practice:

i. The Foreign Remitter Files Suit against the Recipient based on Unjust Enrichment

The recipient normally dares not to or cannot appear before the court if the recipient is a hacker or a hacker-controlled shell company. Unjust enrichment claims filed by the foreign remitter will basically be upheld by the courts as the recipient will fail to provide legitimate reasons for the receipt of funds.

Laundering of the funds, however, will complicate the case. The foreign remitter is at risk of losing the case if a trade relationship or a consignment collection is established between the recipient and the hackers. Unjust enrichment means profits are acquired without a legal basis by one party and cause losses to the other party. In this scenario, the recipient normally will respond proactively by arguing they have a contractual basis to receive the funds, such as sales of goods or consignment collection. According to our experience and observations, the result of a judgment will mainly depend on the evidence presented by both parties.

ii. The Foreign Remitter Files Suit against the Receiving Bank based on Property Damages

Filing suit against the recipient is unproductive if the receiving bank is controlled by the hacker and the funds have already been transferred. Considering that the hackers may use false identity documents to open the account, we note that some foreign remitters have filed suit against the receiving bank to request compensation based on the bank's negligence in reviewing and verifying the applicant's identity documents. According to our observations, the results of these judgments are inconsistent because courts hold different opinions as to whether the review should be substantial or not and how broad the scope of the review should be.

c. Diplomatic Channels

Most countries set up police liaison offices in their embassies abroad to promote information exchange and law enforcement between their countries and the local police relating to trans-national crimes. Consulates normally play a role in promoting and protecting their overseas trade and investment in China. Therefore, it may be productive for victims or their lawyers to seek protection from the embassy or consulates. The local police will be more receptive and may take proactive steps upon receiving a diplomatic note from an embassy or consulate.

Conclusion

E-mail fraud is on the rise in recent years with scams that are similar in design and implementation as those described in this article. Trading companies and multinationals should take precautionary measures by safeguarding their e-mail and network systems. If a case of e-mail fraud occurs, it is a top priority to take immediate measures to secure the funds and then to recover the funds through police, judicial, diplomatic and other routes.

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