

HKEx GUIDANCE LETTER
HKEx-GL39-12 (July 2012)

Subject	Hong Kong Depositary Receipts (“DR”) -Pre-release and Pre-cancellation
Listing Rules and Regulations	Chapter 19B
Related Publications	Frequently Asked Questions on HKEx’s Framework For Depositary Receipts released on 9 May 2008 and updated on 10 September 2008 and 1 December 2010 (“FAQ on DR”)
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Important note: This letter does not override the Listing Rules and is not a substitute for advice from qualified professional advisers. If there is any conflict or inconsistency between this letter and the Listing Rules, the Listing Rules prevail. You may consult the Listing Division on a confidential basis for an interpretation of the Listing Rules, or this letter.

I. Purpose

1. This Guidance describes the market practice of pre-release of DRs and the reverse process, pre-cancellation. We also explain our rationale for allowing pre-release and pre-cancellation (**Section IV**) and the regulatory basis associated with the operation of a pre-release and pre-cancellation transaction (**Section V**).
2. This Guidance supplements the [FAQ on DR](#).

II. Nature of DR Regime

3. The DR framework is a facility for issuers to list in the form of DRs which are simply a convenient “wrapper” around the shares. There are no changes to the listing regime. DR issuers have to comply with the same rules on admission, continuing obligations, etc, as issuers in the form of shares. There is no policy change and the interests of existing market users are not affected. For most purposes shares and DRs are equivalent.

III. Benefit of DRs to Overseas Issuers and Investors

4. DRs may help resolve certain regulatory and operational challenges associated with listing international ordinary shares in Hong Kong. Given that DRs are by nature fungible with the shares they represent, the Exchange believes that DRs may provide liquidity advantages for global trading of securities.

5. **For issuers**, listing in DR form may provide the following advantages depending on the issuer's circumstances:

- (a) DRs may be the only practical method for overseas issuers to list overseas (such as in Hong Kong) if there are regulations or policies in their domestic¹ jurisdictions that:
 - (i) prevent them from listing overseas in the form of ordinary shares;
 - (ii) prevent the holding of ordinary shares overseas;
 - (iii) prohibit the establishment of a branch register overseas, or splitting of the share register; or
 - (iv) require direct holders of the issuer's shares to be licensed as foreign investors;
- (b) where the issuer's shares are of a very different price per board lot from that customarily used in Hong Kong, the DR form may provide a convenient means to "resize" the issue.

For example, in the US market blue chip stocks are commonly priced between US\$20 and US\$50; in the Hong Kong market, blue chips stocks may be priced at a few US dollars-equivalent. The DR mechanism enables the issuer to fit all price ranges by selecting an appropriate DR ratio for each market. The DR ratio can also be adjusted from time to time.

- (c) reduced time for transfer: with the operation of pre-release, the transfer time between ordinary shares in one market and DRs in Hong Kong can be greatly reduced, leaving investors less exposed to price discrepancies and currency fluctuations and increasing the liquidity of the DRs.

This operational advantage may be relevant to companies seeking a dual-listing in Hong Kong (both primary and secondary issuers) even if the issuer's domestic regulations do not present an obstacle to listing ordinary shares in Hong Kong;

- (d) reduce any potential legal risks as the company can issue dematerialised shares in their home market and then issue DRs on those shares in Hong Kong; and
- (e) a DR issuer may decide the amount of DRs in respect of which listing is sought to reflect actual trading needs². This flexibility allows a saving in listing fees (initial and annual listing fees) compared to a share issuer who must apply for listing of all the shares of that class.

¹ The reference to "domestic" in this document refers to the principal market of the issuer's underlying shares.

² See Rule 19B.07 and FAQ B10.

6. **For investors**, while they enjoy substantially the same protection as shareholders³, a DR programme can bring significant benefits, although these benefits come at a cost, in terms of the depositary's fees. The advantages, depending on the investor's circumstances, may include:
- (a) delegation of foreign tax administration to the depositary;
 - (b) dividend payments in the investor's local currency; and
 - (c) better information flow from issuer in the investor's language (with the assistance of depositary).

IV. The Nature of Pre-Release and Pre-Cancellation

7. Pre-release and pre-cancellation are a means of bridging settlement timing differences and facilitating other transactions. They are established features of DR markets overseas. Pre-release can improve the price formation process and can help improve liquidity.

What are pre-release and pre-cancellation?

8. DRs are created by the depositary against delivery to the depositary's custodian of the issuer's underlying shares in its domestic market. **Pre-release** is the early creation and release of DRs by the depositary before it has taken delivery of the underlying shares. Pre-release enables the parties concerned to bridge the time gap between the need to settle DRs and the availability of the issuer's shares for delivery to the custodian in the issuer's domestic market. A time gap may arise because of the logistics of communication between the depositary, the broker and the custodian, or differences in the settlement cycles between Hong Kong and the issuer's domestic market.
9. In the primary market, pre-release supports the arrangement of over-allotment option which enables the issuer to issue more DRs for price stabilisation purposes; in the secondary market, pre-release accommodates differences in settlement cycles between markets.
10. **Pre-cancellation** is the exact opposite transaction of pre-release, i.e. early cancellation of DRs by the depositary and release of the underlying shares before the DRs have been submitted to the depositary. In this case, the broker has bought DRs and sold the underlying shares in the issuer's domestic market. If the shares in the issuer's domestic market are required to be settled before the DRs are available for cancellation, the broker may request pre-cancellation of the DRs and consequent release of the shares in the domestic market. This will facilitate timely settlement in the issuer's domestic market.

³ The rights of DR holders arise from the deposit agreement entered between the DR issuer and the depositary (the financial institution authorised to create and cancel DRs) which are contractual in nature; whereas the rights of a shareholder are reinforced by the issuer's domestic statute.

Operation of Pre-release

Enabling provisions in the deposit agreement

11. The deposit agreement must take into account pre-release if this is intended, and the provisions should at least set out the broad parameters. The deposit agreement will often set the upper limit for number of DRs and shares involved in pre-release at any one time, e.g. 20% to 30% of the issued DRs (not including those DRs for which shares have not been received).

Pre-release agreement

12. Paragraphs 13 to 17 describe how a pre-release transaction is carried out, as we understand it.
13. A pre-release agreement signed between each counterparty broker and the depositary will set out the rights and responsibilities of the parties concerned. The depositary then opens a pre-release account for the broker, and records the broker's pre-release transactions in that account.
14. Additionally, the depositary will often provide a credit facility to cover any related market exposure versus the collateral levels.

In a pre-release transaction, DRs are pre-released (i.e. delivered) to the broker upon receipt of the broker's collateral, which is normally in cash. The depositary holds cash collateral equal to the value of the position, and may charge a number of basis points of interest on the value of the DRs. If a dividend is paid during the pre-release period the depositary will make the necessary claims and payments to the brokers. The depositary must obtain collateral.

15. Brokers will "book" a pre-release before engaging in the trade to ensure that they can settle the trade as needed. First, the broker will contact the depositary for a pre-release quote. The depositary will check the broker's credit standing and the availability of shares for a "spot" transaction. The depositary will have an automated system that monitors and calculates the various parameters. If the terms quoted are acceptable, the broker will book the pre-release. The broker will then execute the pre-release on the settlement date or the day prior to settlement to ensure that the shares are in place in time for settlement.
16. The flowchart in the **Appendix** illustrates the process.

Safeguards when depositary pre-releases DRs to broker

17. Based on our understanding of how a pre-release is carried out, to ensure an orderly market for the trading and HDRs, we expect the depositary to ensure that every pre-release transaction it carries out contains the following safeguards:
 - (a) there is an open market for the underlying shares;

- (b) the underlying shares can be freely deposited with the depositary, i.e. they should be free from encumbrances;
 - (c) there is a fixed settlement schedule in the market where the underlying shares trade;
 - (d) where the depositary enters into a pre-release transaction with a broker which belongs to the same group of companies as the depositary, the depositary must ensure that there are measures to deal with conflicts of interest between the depositary and the related broker such that it is subject to equally stringent requirements to those the depositary imposes on an independent broker;
 - (e) the depositary must ensure that the pre-release agreement contains a provision to require the broker to have first acquired the underlying shares or have entered into an enforceable agreement to enable it to acquire the underlying shares at a future date before it accepts delivery of pre-released HDRs issued by the depositary for further disposition;
 - (f) the custodian/depositary has the right to buy-in the underlying shares or DRs from the market in the event the shares are not delivered on the settlement/due date;
 - (g) the depositary or its custodian is provided with sufficient collateral by the broker; and
 - (h) the depositary must keep the collateral in a segregated account pending the settlement of the underlying shares to close out the pre-released HDR accounts.
18. Where the depositary does not use reasonable endeavours to put in place the above safeguards, the Exchange may consider that the depositary has not performed its role with the competence that is expected of a depositary. Where appropriate, the Exchange may review the depositary's eligibility to continue to act as a depositary under the Listing Rules.

V. Pre-release and the Hong Kong Regulatory Framework

Listing Rules

19. We allow pre-release and pre-cancellation under the current DR regime although these practices are not specifically mentioned in the Listing Rules. Pre-release and pre-cancellation do not breach any existing Hong Kong regulations.
20. Rule 19B.06 states that, " Depositary receipts may be issued in respect of newly issued shares and/or in respect of shares placed with a depositary..." (*underlining added*). Rule 19B.16(b) states that the deposit agreement must provide for, "the status of the depositary receipts as instruments representing ownership interests in shares of an issuer that have been deposited with the depositary" (*underlining added*).
21. Our interpretation is that these rules do not imply that there must have been a physical act of placing shares with the depositary in respect of each and every DR issued. The

words “have been deposited” is not intended to bar pre-release or pre-cancellation of DRs.

Impact of pre-release on short selling regime and disclosure of interests under SFO

22. In a typical pre-release transaction, the depositary issues DRs against the broker’s commitment (backed by collateral) that the broker is presently entitled to the shares and will subsequently deliver the shares to the depositary.
23. Under the Securities and Futures Ordinance (“SFO”), a broker conveying a sale of securities must have a presently exercisable and unconditional right to vest the securities in the purchaser of them, or believes and has reasonable grounds to believe that he has such a right when he sells the securities. Where these conditions are not satisfied, this will constitute a short sale⁴ which is prohibited under the SFO. Any persons conveying a “short selling order” must therefore ensure compliance with the requirements in sections 171 and 172 of the SFO and in the Eleventh Schedule to the Trading Rules⁵.

⁴ Generally, a short sale is the sale of securities at or through the Exchange that the seller does not own. To cover settlement the seller borrows the securities, and subsequently buys the securities in the market and at that time returns the loaned securities to the lender.

Section 170(1) of the SFO prohibits “naked” or “uncovered” short selling, i.e. a sale of securities where the seller does not have a presently exercisable and unconditional right to vest the securities in the purchaser of them or he believes and has reasonable grounds to believe that he has such right.

⁵ Such short selling order is a “covered” short sale and is not prohibited under section 170(1) of the SFO. A “short selling order” is defined in Schedule 1 of the SFO as an order to sell securities where the seller’s presently exercisable and unconditional right to vest the securities in the purchaser of them by virtue of (a) the seller having borrowed the securities before the sale of them or (b) the seller having title to other securities which are convertible or exchangeable into the securities being sold.

Sections 171 and 172 of the SFO set out requirements to ensure that a “short selling order” executed at or through the Exchange are properly reported and backed up by an adequate amount of securities at the time of the sale.







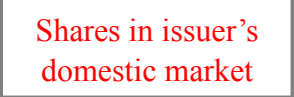

The Eleventh Schedule of the Trading Rules sets out how a “covered” short sale may be effected. One requirement is that a covered short sale may only be effected in designated securities which are posted on the HKEx website from time to time.

SFC published a Guidance Note for Short Selling Reporting and Stock Lending Record Keeping Requirements in 2003 at: <http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H202>

This Guidance Note sets out, among other things, the circumstances where SFC will not consider the short selling rules have been breached; the exemptions available; the reporting requirements for covered short selling and the stock lending record keeping requirements.

24. Any persons involved in a pre-release transaction need to consider compliance with the disclosure of interests requirements in Part XV of the SFO.

DRs – ANTICIPATED PROCESS FLOW FOR PRE-RELEASE

	Broker	Depository
T + 0	(1) Seeks pre-release quote (3) Books pre-release transaction (6) Buys shares in issuer's domestic market (via affiliate) (7) Sells DRs to investors (8) Posts collateral with depository 	(2) Provides pre-release quote (4) Checks broker's credit and other factors (5) Opens pre-release transaction and conveys availability of pre-release to broker  (9) Accepts collateral ⁶
T + 1	<i>(shares not available in issuer's domestic mark)</i>  (11) Accepts delivery of pre-released DRs (12) Delivers DRs to the purchaser 	(10) Pre-releases DRs
T + X	<i>(shares now available in issuer's domestic market)</i> (13) Submits shares to depository (via issuer's custodian in its domestic market)  (16) Accepts returned collateral 	(14) Accepts shares  (15) Releases collateral  (17) Closes pre-release transaction

⁶ Late delivery of the collateral (underlying shares) (i.e. before T+3) to replenish the pre-released DRs will invoke consequences under the General Rules of CCASS. See, for example, Chapters 35 (Latest Delivery of Securities – CNS System) and Chapter 36 (Risk Management Measures – CNS System) of the General Rules of CCASS available at:

<http://www.hkex.com.hk/eng/rulesreg/clearrules/ccassgr/ccassrule.htm>