



Analysis of financing risks for the issuance of CDR by red-chip enterprises

-Take Company Nine as an example

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Abstract. With the launch of the Science and Technology Innovation Board, China has, for the first time, allowed red-chip enterprises with VIE structure and AB shares to land in China's capital market by issuing Chinese Depositary vouchers. Based on the perspective of financing, from the perspective of financing risk, comprehensively considering the CDR issuance and trading process and the VIE structure, we found two key risk points: the VIE risk, the depository risk, and liquidity risk in the trading process, the two key risk points run through the financing process. Due to the particularity of the VIE architecture, investors should be fully alert to its possible legal loopholes. Finally, this paper puts forward relevant suggestions from the perspective of relevant regulators, issuers, and investors.

Keywords: Chinese depository receipts; financing risk; VIE architecture

1 Introduction

Depository receipts (DR) originated in the United States and can be traced back to 1927, when the United Kingdom implemented a stricter capital control system. To avoid domestic controls, British companies issued American Depositary Receipts (ADR) to achieve financing in overseas markets. Iedge acted as the issuer to sell an ADR to a US citizen through J.P. Morgan Bank, in which J.P. Morgan acted as a trust intermediary. At the same time, the agent investor purchases 100 shares of common stock from Selfridge in the United Kingdom and deposits the corresponding shares in the branch of J.P. Morgan Bank in the UK, and JPMorgan Bank manages the shares on behalf of the investor by collecting commissions. The birth of ADR marks the birth of DR, which meets the needs of cross-border financing and enriches investment channels. Since the 80s of the 20th centuries, financial regulation has been gradually liberalized, and the emergence of the new economy has led to a large increase in the number of depository receipts, and ADR has become an important financing tool in the US market.

Li ^[1] found that the relationship between DR premium and investor sentiment variables changed structurally before 1997, and DR premium was more sensitive to

non-QFII holdings after 1997. The DR premium is more sensitive to company size and less sensitive to non-QFII holdings after 1997. Elena ^[2] found businesses with less access to sound capital in the domestic market are more likely to issue depository receipts, and these companies also achieve a higher market value, as measured by Tobin's value. Hamad ^[3] emphasizes pair trading as the main price correction mechanism that maintains equity-ADR parity through arbitrage. Oksana ^[4] showed that the benefits of information risk reduction on ADR and GDR were comparable. The two approaches (disclosure and analyst) to address information asymmetries after cross-listing are substitutes that make equally important contributions to reducing information risk, ultimately leading to similar capital reduction costs for ADR and GDR. Qinjin ^[5] found that the sentiment corresponding to the local stock market of the US market and the ADR is positively correlated with the price deviation between the ADR and its local stocks, and the characteristic risk is the main factor of pricing error, and the local stock market sentiment will have a positive effect on it. However, high sentiment in global equity markets will have a negative weakening effect. Wang ^[6] manages VIE structure risks from the company's own level and market level, on the one hand, the company should improve its governance structure; On the other hand, the government should strengthen the supervision of the VIE structure and reform the capital market to reduce the risks brought by the VIE structure to the company from a macro perspective.

Fan ^[7] discusses why Internet companies adopt VIE architecture and what risks this structure brings to enterprises from the perspective of Hato Interactive's listing in Hong Kong. Cai ^[8] believes that the steps to dismantle the VIE architecture are complex, and it is necessary to assess whether it is feasible and carefully designed to prevent possible risks. Wang Zhengang^[9] compares the different paths of VIE architecture enterprises to regress, obtains the common points and differences of their return, and puts forward corresponding suggestions from the perspective of regulators and investors. Wu ^[10] believes that the control of the agreement is stipulated from the legal level, the "control" is clearly defined, and a new path for enterprises to return to China's capital market is opened.

The issuance method of depository receipts can be divided into the issuance of existing shares and the issuance of new shares. The issuance of existing shares is different from the issuance of new shares in that the source of shares is different. The issuance of existing shares is based on the company's existing shares as the underlying securities to issue depository receipts, while the issuance of new shares is to issue depository receipts using the company's newly issued shares as the underlying securities. When the capital market is not yet perfect, allowing the issuance of new shares is more in line with market demand, so China adopts the method of issuing new shares.

China Depository Receipts (CDR) refer to depository receipts issued by depository institutions in China (excluding Hong Kong) for trading by domestic investors, settled in RMB, and issued for listing. The issuer entrusts the depository bank to act as the depository bank by signing a depository agreement with a domestic bank, and the domestic bank signs a custody agreement with the overseas branch to entrust the overseas branch to act as the custodian bank, and the agreement stipulates that the

underlying shares are deposited with the custodian bank and the depository bank issues depository receipts. During this issuance transaction, four participating entities were involved: the overseas issuer, the overseas custodian bank, the inbound depository bank, and the domestic investor.

2 Financing risks of issuing CDR by red-chip enterprises

The development of Chinese depository receipts is closely related to the return of red-chip enterprises. In the 90s of the 20th century, China's enterprises developed rapidly, but due to the imperfect securities market system, enterprises did not meet the requirements for domestic listing, resulting in many high-quality enterprises going to foreign listings. These enterprises with their domicile overseas are called red-chip enterprises, and their overseas listed shares are called red-chip enterprises. At the beginning of the 21st century, affected by the Asian financial crisis, the value of these red-chip stock markets listed overseas was seriously underestimated, and they hoped to return to the A-share market to enhance the influence of the company. So, what are the financing risks of issuing CDR with red chips?

2.1 Liquidity risk

CDR listing and trading are like stock trading, so the liquidity of CDR trading is like the liquidity of stocks, mainly including four aspects, namely the timeliness of the transaction, the cost of the transaction, the number of tradable transactions, and the degree of low price. Higher liquidity means that transactions are instantaneous and costly, the number of transactions is large, and the price is low. The liquidity risk of CDR trading refers to the risk of large fluctuations in the price of CDR trading. CDR similar stocks can be listed and traded on the Science and Technology Innovation Board, so there are certain liquidity risks in the trading process, such as CDR's turnover rate and trading volume, which can reflect its liquidity strength. Liquidity risk is not only affected by factors such as market environment, trading system design, regulatory policies, etc., but also by the company's own equity structure and operating conditions. Especially when the market is not yet mature, the company itself has a strong impact on liquidity. China launched the Science and Technology Innovation Board in 2019 to encourage emerging high-tech companies to go public and raise funds. Companies listed on the STAR Board have a low market capitalization, and a small number of shares issued relative to the Main Board, and a low market capitalization, so liquidity risk is more important for companies listed on the STAR Board.

2.2 Depository risk

Depository receipts are issued by depositaries and represent overseas underlying shares, which means that the holder of the depository receipt does not directly own the shares, so he does not directly exercise the rights related to the shares. The exercise of

shareholders' rights by a depositary is solely based on the provisions of the depositary agreement, unlike the direct exercise of stock rights by direct holders under the articles of association. The depositary agreement stipulates that if you want to exercise your rights in shares, such as voting rights, dividends, and other income rights, and the right to know, etc., you need to convey them on your behalf. In this process, the depositary may act untruthfully based on its interests, and the true will of the holder cannot be communicated to the issuer.

Depositary receipt holders enjoy the same rights and interests as Class A common shareholders, not only in the exercise of the right to income from the shares but also in participating in corporate governance decisions. In the payment of dividends, the depositary pays dividends to the holders of the depositary receipts by the depositary agreement, and the transfer of funds involved in this process is exercised by the depositary. If the funds are not transferred enough, the interests of the holders will be depleted. In addition, there is some uncertainty as to whether the depositary can fully reflect the views of the holders of the depositary receipts by exercising voting rights on behalf of the company and participating in corporate governance. If the depositary fails to faithfully perform the contents of the depositary agreement, it will bring certain losses to the holders, and such losses are closely related to the interests of the holders.

In the process of CDR issuance, the parties establish relationships through the signing of agreements, mainly depositary agreements and custody agreements. The depositary agreement is the most critical, mainly because the depositary builds a bridge between the issuer and the investor. Depositary risk exists in the relationship between the three parties. In this process, the issuer forms a principal-agent relationship by entering into a depositary agreement with the depositary, and the depositary exercises its rights and performs its obligations based on the depositary agreement signed. As an intermediary between investors and issuers, depositaries assume the responsibility for the issuance of CDR on the one hand and exercise the rights of interest subjects on behalf of investors on the other. At the same time, it plays a key role in the issuance of depositary receipts, with the depositary finding a custodian.

2.3 Custody risk

In a CDR issuance transaction, the depositary seeks a custodian, and the issuer deposits the shares with the custodian. It is also important for issuers to faithfully perform the escrow agreement. The custodian obligation of an overseas custodian is mainly embodied in the purpose of isolating the underlying securities from its property, managing them separately, and at the same time having separate accounts for the basic securities, not encroaching on the underlying securities using depositary receipts, and assisting in handling dividends, voting, and other related matters by the custody agreement, and providing the depositary with market information on the underlying securities. The custodian is responsible for the custody of the underlying securities, so in this process, the custodian's faithful performance of duties is related

to the normal trading of depositary receipts. If there is a problem with the underlying security, then the depositary receipt will lose the ground for existence.

3 Analysis of financing risks of the issuance of China Depositary Receipts by Company Nine

China Depositary Receipts (CDR) have been widely discussed since 2000 but have been unable to be promoted due to inadequate institutional systems and inadequate capital market development. To get rid of financing restrictions, many high-tech companies rushed to list overseas, and with the launch of the Science and Technology Innovation Board, China allows high-tech enterprises to raise funds in the mainland by issuing CDR. As the first red-chip enterprise listed in China with a VIE structure and AB share structure, Company Nine reflects China's regulatory attitude towards Chinese depositary receipts and the corresponding legal system protection. Given the company's VIE structure and AB-share structure, what are its financing risks? This article will explore the financing risks of Company Nine from this issue.

Since the 90s of last century, there has been a discussion about Chinese depositary receipts in China. At the beginning of this century, China Mobile, a red-chip stock listed in Hong Kong, considered issuing CDR to return to the A-share market, but due to regulations and China's imperfect capital market system, CDR issuance has been suspended. It was not until March 2018 that the CSRC established the legal status of CDRs. In the document "Notice on Several Opinions on Carrying out the Pilot of Domestic Issuance of Shares or Depositary Receipts by Innovative Enterprises," it is stipulated that pilot enterprises in the new economy can issue stocks or depositary receipts in China, and it is also stipulated that red-chip enterprises can also return to the A-share market by issuing stocks or depositary receipts, but there are relatively strict requirements for the industry and financial indicators in which the enterprises are located. In June 2018, the China Securities Regulatory Commission (CSRC) issued the Administrative Measures for the Issuance and Trading of Depositary Receipts (for Trial Implementation), which provides detailed explanations on the specific issuance and transaction process of CDR and how enterprises can disclose information to protect investors' rights and interests.

Company Nine is more special in the VIE structure. From the perspective of the composition of the VIE architecture, there are architecture subjects and protocol control. Among the main structural entities, there are mainly overseas listed companies (Cayman companies), wholly domestic enterprises (WFOE), and domestic operating entities. In addition, there are BVI commercial companies and Hong Kong shell companies. In terms of agreement control, it is mainly the agreement signed between WFOE and domestic operating entities, so this paper analyzes the risks of transaction entities and transaction process risks.

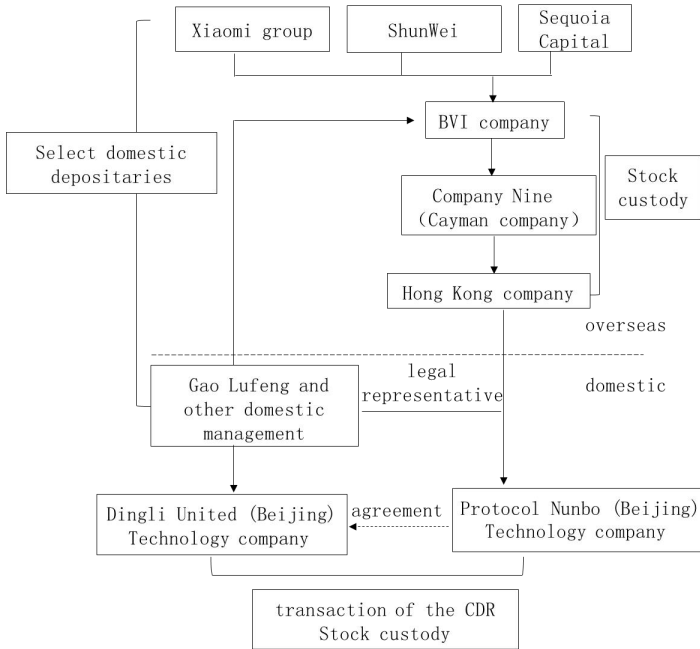


Fig. 1. Relevant issuance and transaction links involved in the VIE structure.

3.1 Equity subject risk

Gao Lufeng, the founder of the domestic operating entity, and other joint private equity, venture capital, and other investment institutions set up overseas enterprises in areas where overseas companies are easy to register and regard this overseas enterprise as the main body of listing, namely Company Nine (Cayman Company). On the one hand, when establishing Company Nine (Cayman Company), the listing qualification issue should be fully considered, and the Cayman entity of Company Nine is a pure holding business entity, which must meet the economic substance test standards required by Cayman companies; On the other hand, the establishment of a Caymanian entity in Hong Kong involves different policies between Cayman and Hong Kong, and the Caymanian entity must ensure that it can achieve control over the Hong Kong shell company. As for the Hong Kong shell company, it does not carry out substantive operations, and the purpose of setting up the company is to take advantage of the mainland's tax incentives for Hong Kong. Company Nine set up Company Nine Hong Kong not only because the Hong Kong shell company became a channel for profit transfer, but more importantly, the tax incentives between the mainland and Hong Kong. For shell companies, any problems in the company's qualification review and tax payment may lead to certain compliance risks. Therefore, when setting up a Hong Kong shell company, it is necessary to pay attention to the control of the shareholding structure, be vigilant against illegal fund transfer

activities, and avoid compliance and legality problems in qualification review and tax payment.

A sole proprietorship (WFOE) achieves control of a domestic operating entity by entering into a package agreement. Company Nine established Ninebo as a wholly owned domestic enterprise through a Hong Kong shell company. Company Nine indirectly controls the sole proprietorship through layers of equity control. Although China has granted certain tax incentives to foreign-invested enterprises, under the unstable international environment, they should be vigilant against the foreign exchange control risks they may face when transferring profits to Hong Kong shell companies.

The domestic operating entity is the company where Company Nine conducts business. From the perspective of the operation of domestic operating entities, it mainly relies on the customized products of Xiaomi Group, which has greater risks for enterprises. Once triggered, this risk will have a critical impact on onshore operating entities. Therefore, domestic operating entities should expand their customers as much as possible and reduce their dependence on Xiaomi Group. The main domestic stakeholders are WFOE and domestic operating entities, and WFOE and domestic operating entities have signed a series of agreements. When a domestic operating entity transfers profits to WFOE, it mainly involves corporate income tax, and in the relevant provisions of enterprise income tax, independent business transactions are the key to confirming enterprise income tax. If business transactions with affiliated enterprises are involved, the tax authorities will examine whether there is a possibility of tax evasion and tax evasion and may impose enterprise income tax on them as independent business transactions. To a certain extent, this standardizes the related business of enterprises and narrows the operational space for tax evasion. Therefore, when WFOE and domestic operating entities engage in profit transfers, they may be identified as related party transactions, and there is a risk that their transactions will be included in taxable income.

3.2 Protocol control risks

Company Nine established Ninebo (Beijing) Technology Co., Ltd. as a wholly foreign-owned enterprise, namely WFOE. Ninebo (Beijing) Technology Co., Ltd. has achieved control of Dingli United (Beijing) Technology Co., Ltd., and its subsidiaries by entering into a series of agreements with Dingli United (Beijing) Technology Co., Ltd. The agreements signed mainly include the Exclusive Advisory and Service Agreement, the Exclusive Purchase Option Agreement, the Share Pledge Agreement, the Shareholders' Voting Rights Proxy Agreement, and the Spouse Consent Letter. As shown in the figure below, the contracting parties involved are shareholders such as WFOE, VIE, and GaoLufeng, and the spouses of shareholders.

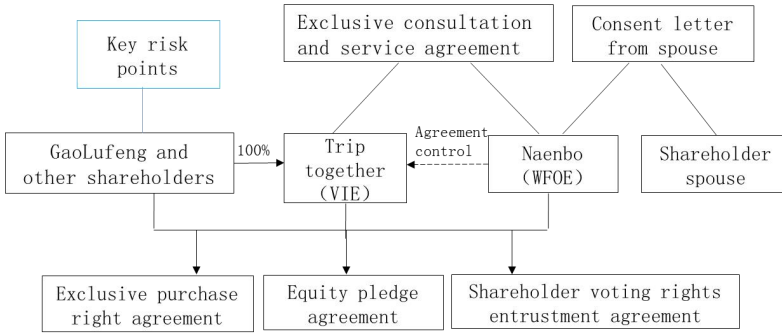


Fig. 2. VIE protocol composition.

Exclusive advisory and service agreements are designed to achieve profit shifting and meet the requirements of consolidated financial statements. The agreement stipulates that VIE Company appoints WFOE as its exclusive consulting and service provider, WFOE agrees to accept such appointment, and WFOE provides software and other information technology consulting and services for VIE Company, which is embodied in the agreement that Ninebo jointly provides exclusive consulting and service to Dingli. Syndication pays a fee equivalent to the entire net income for the year. It can be seen that the purpose of the agreement is to realize the profit transfer from VIE to WFOE.

Exclusive purchase agreements include conversion options and asset purchase options. FOE has the right to require shareholders of VIE Company to transfer option equity to WFOE or its designated entities or individuals and has the right to require VIE Company to transfer assets, and neither of them shall refuse. The agreement provides absolute control over the equity and assets of VIE.

The equity pledge agreement refers to the pledge of equity to WFOE by shareholders such as Gao Lufeng. The agreement guarantees the loan provided by WFOE to VIE shareholders and protects WFOE's creditor's interests. The equity pledge is not to protect the interests of creditors, but a means for WFOE to achieve control over the shareholders of VIE company, and to achieve control over VIE shareholders through equity pledge. At the same time, the shareholder voting proxy agreement means that the WFOE appoints personnel to exercise the shareholders' voting rights on behalf of the VIE shareholders. These two agreements impose significant restrictions on the rights of shareholders, and WFOE effectively controls the equity of VIE.

The spousal consent letter controls the equity owned by the shareholder's spouse, and the agreement stipulates that the WFOE has the right to exercise relevant decisions over the shareholding of the shareholder's spouse, and the shareholder has no right to interfere with the shareholding of the spouse. On the one hand, the agreement effectively avoids the possibility of the husband and wife jointly controlling the equity manipulation, and, on the other hand, strengthens the equity control of the VIE company.

Under the VIE framework, foreign shareholders only enjoy the equity of overseas listed entities and cannot control the ownership of domestic entities. The control of the domestic operating entity has not been transferred, and the foreign shareholders have transferred the operating profits of the domestic operating entity to the overseas listed entity through a series of agreements. However, China's laws and regulations allow the court to make free decisions on uncertain matters, which is very random, and if the issuer conducts relevant business in China through the agreement control structure and is determined by China to be non-compliant with the law, that is, it "conceals the illegal purpose in a legal form," the VIE agreement may be found invalid. In addition, if the state tightens restrictions on foreign investment so that issuers cannot control domestic operating entities through the VIE structure, they will face VIE adjustments in the case of the schema. The instability of the agreement is not only reflected in the influence of national policies but also in the agreement itself. The agreement arises voluntarily between the parties and is not protected by law. Even if one party does not comply with the provisions of the agreement, the other party cannot obtain the corresponding rights and interests. Therefore, the key to the risk point lies in the credibility of both parties. The domestic operating entity has a strong independence in the agreement between the two parties. If the domestic operating entity does not comply with the provisions of the agreement, it will have a significant impact on the issuer's operations.

The VIE entity of Company Nine is Dingli United, which is controlled by the company's founders, Gao Lufeng and Wang Ye. In terms of consistency of interests, the founder of the company will make decisions based on the interests of the whole company No.9, and the WFOE is also controlled by the founder of the company, so the agreement control relationship is formed under the operation of the founder of the company, which has a certain stability. From the perspective of the operation of WFOE and VIE entities, WFOE, or Naenbo, is responsible for the research and development of the entire company and is jointly responsible for part of the research and development and production of the main body of VIE company. From the business relationship, Dingli United required WFOE to provide technical support and services for it, and, at the same time, paid its operating profits to Naenbo in the form of expenses. Although the above VIE agreement involves the four-party contracting entity since Gao Lufeng and other shareholders control the equity of VIE company, it is an agreement between WFOE and VIE shareholders, that is, an agreement signed between Naenbo and Gao Lufeng and other shareholders.

In addition, for the high-tech industry, R&D is crucial for the growth and development of the company. The number of patents owned by the domestic operating entities of Company Nine accounted for 18.37% of the total number of the company, the number of R&D personnel accounted for 32.07% of the total R&D personnel of the issuer, and the total assets accounted for 61.74% of the total assets of the company. From the perspective of these three indicators, VIE company plays an important role in the company's R&D and production. If Company Nine loses effective control over VIE and its subsidiaries, it may not be able to continue to use some of the technology and assets under the control of VIE to operate part or all of its business, and its related R&D work may also be affected.

3.3 Trading process risks

The company's VIE structure risk will have a greater impact on the issuance and trading of CDR, which is mainly reflected in the selection of the trustee of the CDR, the custody of shares in the issuance process, and the listing and trading of CDR. The company's VIE structure consists of the VIE architecture body and the VIE protocol. The company's management has B-share voting rights and controls the company, which determines what financing plan No.9 adopts and how CDR financing is conducted.

On June 15, 2018, the China Securities Regulatory Commission (CSRC) and the China Banking and Insurance Regulatory Commission (CBIRC) issued the Provisions on Matters Related to Commercial Banks Acting as Depository Receipts on a Pilot Basis, establishing the role of commercial banks as depositories.

The CDR of Company Nine was issued with ICBC as the depository bank and ICBC Asia as the custodian bank. The incremental issuance of depository receipts by Company Nine accounted for 10% of the total amount after issuance, which was the minimum proportion stipulated in the issuance regulations, which reduced the depository risk of Company Nine to a certain extent for inexperienced state-owned banks. However, banks are not only concerned with the issuance of CDR and the custody of shares but also involve the exercise of investors' rights, so depository risks include not only the risk of issuing depository receipts but also the subsequent exercise of investors' rights. The depository receipts are kept by the Industrial and Commercial Bank of China, and investors are required to pay a certain handling fee every year. During this process, the information disclosure of Company Nine is passed on to investors by the Industrial and Commercial Bank of China.

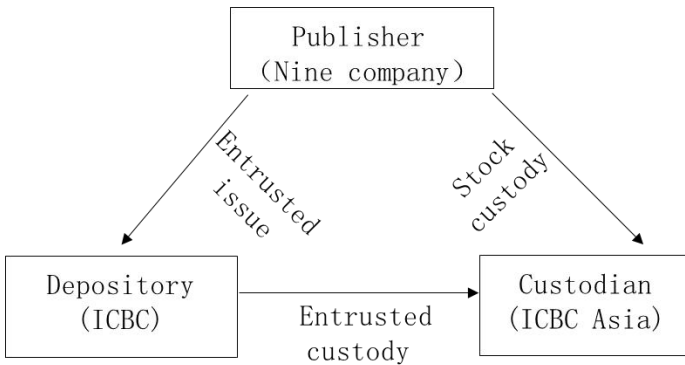


Fig. 3. Depository relationship

As a listed entity, Company Nine (Cayman entity) deposits its shares with a custodian during the issuance of CDR, and the compliance of the legal entity of Company Nine (Cayman entity) is crucial in this process. In connection with the offering, ICBC selected its Hong Kong-based subsidiary, ICBC Asia, as custodian. In Hong Kong's legal system, VIE structures and shareholding structures with different

rights to the same shares are recognized, and Hong Kong has also become a listing place for many high-tech enterprises. ICBC Asia is located in Hong Kong. On the one hand, Hong Kong's legal system is recognized by VIE entities, and ICBC Asia's role as the custodian bank has reduced the custody risk of Company Nine to a certain extent. On the other hand, the capital markets of Hong Kong and the mainland are relatively closely linked, and the information exchange between the two places is relatively smooth, which reduces the risk of cross-border conversion to a certain extent, which is undoubtedly beneficial to issuers.

From the perspective of the VIE structure of Company No.9, although the BVI Commercial Company exercises equity control over Company No.9 and introduces certain venture investors in the process, its actual controller is the founder of the company. The listed entity status of Company Nine will not be affected by venture investors, and the actual operating entity and depository bank of the Company are both in China, which to a certain extent strengthens the confidence of the custodian bank in Company Nine, and from another perspective, reduces the custody risk of the issuer.

3.4 The moral hazard of the actual controller

Moral hazard mainly refers to the possibility that company controllers and decision-makers will harm the interests of minority shareholders to achieve their interests. The moral hazard of the superior company is mainly reflected in the moral hazard in the financing and investment process. Moral hazard in the financing process refers to the phenomenon that major shareholders use shell companies to raise equity without paying high financing costs, thereby harming external investors. Moral hazard in the investment process refers to the phenomenon that the controller of a listed company arbitrarily changes the use of the raised funds for its profit. Company Nine adopts a VIE structure, and the actual controllers of the company, Gao Lufeng and Wang Ye, are both shareholders and managers of the company, which may have the moral hazard of benefiting themselves and harming the interests of minority shareholders. Due to the particularity of the shareholding structure of Company Nine, the moral hazard of the actual controller is not only reflected in the risks in the financing and investment process but also the risks of the founder's termination of the VIE agreement.

Given the moral hazard in the financing and investment process, the shareholding structure of Company Nine is expressed as AB shares, which are set to protect the founders. In the governance structure of a company, the actual controller serves as the director and executive of the company and has absolute control. The proportion of depository receipts issued by Company Nine to the total share capital after issuance is 10%, and the proportion of voting rights held is 4.92%. The issuance of CDR did not significantly impact the company's shareholding structure, and the company's two founders still hold absolute control of the company.

Given the moral hazard of the founder's termination of the VIE agreement, the legality of the VIE structure can be considered for analysis. At present, China's law does not explicitly recognize the legality of the VIE structure. According to the

Foreign Investment Law of the People's Republic of China, basic telecommunications services belong to the negative list for foreign investment access and should be controlled by the Chinese party. The newly revised Foreign Investment Law came into effect on January 1, 2020. The current Foreign Investment Law, supporting laws and regulations and the provisions of the State Council do not specify the form of "foreign investment", including contractual arrangements under the control framework of agreements. Once the state determines that the VIE structure is unreasonable, the regulatory authorities may impose penalties on the VIE company, which will have a great impact on the normal operation of the VIE company. At the same time, as a shareholder of a domestic operating entity, the founder may not consider the interests of the foreign investor and violate the VIE agreement when its interests are involved. Especially when there are different opinions, the moral hazard is greater, and there may be a situation where the founders and domestic enterprises obtain business income separately, which is a huge risk for foreign investors. Once the founder does not comply with the agreement, the entire VIE architecture will be disintegrated.

Company Nine brought in several venture capitalists. PeopleBeter holds 10.91% of the equity of Company Nine and 5.08% of the voting rights; Sequoia Capital holds 16.8% of equity and 7.83% of voting rights in Company Nine. In particular, as an ecological chain enterprise of Xiaomi, Xiaomi Group owns 10.91% of the equity and 5.08% of the voting rights of Company Nine through its controlled PeopleBetter. Xiaomi Group is its main customer, and VIE shareholders should consider the interests of their customers when making relevant decisions, which to a certain extent restricts the founder shareholders of Company Nine, reduces the moral hazard of the founders, and further protects the interests of foreign investors.

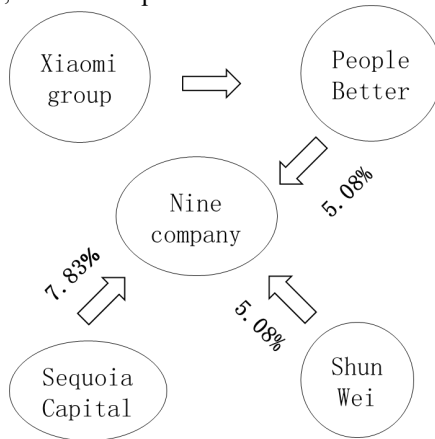


Fig. 4. Venture capitalists

4 Enlightenment and Recommendations

4.1 For the regulatory layer

Since CDR has just been introduced into the capital market, there are still many shortcomings at the institutional level. The link between issuers, investors, and depositories is depository agreements, so there are certain agency risks, and regulators should strengthen the standardized supervision of depository agreements to prevent possible depository risks. In addition, drawing on the management mechanism of ADR, CDR should be supervised at different levels, and different CDR issuance standards should be formulated for different enterprises, to gradually enrich and improve the types of CDR. Given the two market problems, a gradual transition approach should be adopted, that is, a certain time and amount limit should be imposed on the conversion of CDR and underlying securities, and gradually deregulated after the capital market matures. For CDR, it is necessary not only to give play to its financing function, but also to give full play to the function of capital flow, guide foreign enterprises to list in China's capital market through a sound mechanism, expand investment channels for Chinese investors, enhance the competitiveness of China's capital market, and encourage China's market to participate in the global competition of high-quality capital.

4.2 To Company Nine

Company Nine, which adopts the issuance of CDR for financing, should be vigilant against financing risks, and fully pay attention to the risks brought by its own VIE structure, under which a series of VIE agreements control operating entities, which itself has greater instability. Once a moral hazard occurs, that is, if the founders do not follow the VIE agreement, it will have a greater adverse impact on the company's operations. Companies should pay attention to the role of venture capital and dual controller systems to reduce the possibility of moral hazard.

4.3 To Investors

Due to the complex shareholding structure of Company Nine and the adoption of the VIE structure model, investors should not only be wary of macro risks such as the non-convertibility of CDR and underlying securities, and RMB account control, but also the risks of VIE structure. In the event of a default on the VIE agreement, Company Nine becomes a shell company, adversely affecting investors. In addition, CDR is still in the trial issuance stage in China, and investors should be fully vigilant against the situation that the media is waiting for the opportunity to speculate and cause the stock price to fluctuate greatly and harm the interests of investors.

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