HKEx Guidance on the Pre-release and Pre-cancellation of Hong Kong Depositary Receipts

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On July 3, 2012, The Stock Exchange of Hong Kong Limited (the “HKEx”) issued “HKEx Guidance Letter HKEx-GL39-12” (“GL39-12”) regarding the pre-release and pre-cancellation of Hong Kong depositary receipts (“HDRs”). This client alert summarizes the HKEx’s views set out in GL39-12 on the pre-release and pre-cancellation of HDRs in the context of overseas issuers.

Paul Hastings has advised on all HDR listings on the HKEx to date, and is one of the few international firms operating in Hong Kong experienced in the listing of HDRs. Paul Hastings has also advised issuers, investment banks, and other parties with respect to numerous landmark, capital-raising transactions in Hong Kong.

INTRODUCTION

HDRs are instruments issued by a depositary bank as agent for a company (the issuer) which evidence an interest in shares in that issuer.

Conceptually, they are similar to the much traded ADRs (American Depositary Receipts), listed on stock exchanges in the United States, and GDRs (Global Depositary Receipts), listed on other stock exchanges such as the Frankfurt and Luxembourg exchanges. An issuer is free to determine the ratio of HDRs to the number of underlying shares. Generally, an issuer would seek to list its HDRs at a price per HDR that is similar to the price per listed security (share or HDR) of its sector peers. HDRs may help resolve certain regulatory and operational challenges associated with listing ordinary shares in Hong Kong.

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

PRE-RELEASE: The early creation and release of HDRs by the depositary before it has taken delivery of the underlying shares

HDRs are created by the depositary against delivery to the depositary’s custodian of the issuer’s underlying shares in its domestic market. Pre-release enables the parties concerned to bridge the time gap between the need to settle HDRs (in secondary market transactions or new subscriptions) and the availability of the issuer’s shares for delivery to the custodian. A time gap may arise because of the logistics and communications between the depositary, the broker and the
custodian, or differences in the settlement cycles between Hong Kong and an overseas issuer’s domestic market.

PRE-CANCELLATION: The early cancellation of HDRs by the depositary and release of the underlying shares before the HDRs have been submitted to the depositary

This may be helpful where a person holding HDRs has 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 HDRs are made available to the depositary for cancellation, the seller may request pre-cancellation of the HDRs and consequent release of the shares in the domestic market. This will facilitate timely settlement in the issuer’s domestic market.

ADVANTAGES OF PRE-RELEASE AND PRE-CANCELLATION

With the operation of pre-release and pre-cancellation, the transfer time between ordinary shares in one market and HDRs in Hong Kong can be greatly reduced, lessening investors’ exposure to price discrepancies and currency fluctuations and increasing the liquidity of the HDRs. This operational advantage may be relevant to issuers seeking a dual listing in Hong Kong (both primary and secondary) even if the issuers’ domestic regulations do not present an obstacle to listing ordinary shares in Hong Kong.

OPERATION OF PRE-RELEASE

Deposit agreement must contain enabling provisions

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

Procedure and pre-release agreement

The HKEx expects a pre-release transaction to be carried out as follows:

A pre-release agreement is 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.

Additionally, the depositary will often provide a credit facility to cover any related market exposure versus the collateral levels.

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

Brokers will “book” a pre-release before engaging in the trade to ensure that they can settle the trade as needed. The depositary will have an automated system that monitors and calculates various parameters to assess the broker’s credit standing and availability of shares for a “spot transaction” before providing a quote. If the terms quoted are acceptable, the broker will book the pre-release and then execute the pre-release on or before the settlement date or the day prior to settlement to ensure that the shares are in place in time for settlement.
**Safeguards to be adopted by depositary**

To ensure an orderly market for the trading of HDRs, the HKEx expects the depositary to ensure that every pre-release transaction it carries out contains the following safeguards:

- there is an open market for the underlying shares;
- the underlying shares should be free from encumbrances;
- there is a fixed settlement schedule in the market where the underlying shares trade;
- where the broker belongs to the same group of companies as the depositary, ensure that there are measures to deal with conflicts of interest such that the broker is subject to equally stringent requirements as an independent broker;
- the pre-release agreement must 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 before it accepts delivery of pre-released HDRs for further disposition;
- the custodian/depositary has the right to buy-in the underlying shares or HDRs from the market in the event the shares are not delivered on the settlement/due date;
- the depositary or its custodian is provided with sufficient collateral by the broker; and
- 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.

Where the depositary does not use reasonable endeavours to put in place the above safeguards, the HKEx may consider that the depositary has not performed its role with the competence that is expected of a depositary. Where appropriate, the HKEx may review the depositary’s eligibility to continue to act as a depositary under the Listing Rules.

**PRE-RELEASE AND PRE-CANCELLATION DO NOT BREACH ANY EXISTING HONG KONG REGULATIONS**

The HKEx allows pre-release and pre-cancellation under the current HDR regime, although these practices are not specifically mentioned in the Listing Rules. Further, the HKEx considers that pre-release and pre-cancellation do not breach any existing Hong Kong regulations.

**PERSONS INVOLVED IN A PRE-RELEASE TRANSACTION NEED TO CONSIDER COMPLIANCE WITH THE SHORT-SELLING AND DISCLOSURE OF INTERESTS PROVISIONS UNDER THE SFO**

In a typical pre-release transaction, the depositary issues HDRs 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.

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 “naked” short sale, which is prohibited under the SFO.¹

Persons involved in a pre-release transaction also need to consider compliance with the disclosure of interests requirements in Part XV of the SFO.
The full text of GL39-12 is available at this link:

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Hong Kong lawyers:

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1 Generally, a short sale is the sale of securities at or through the Exchange that the seller does not own. 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 does not believe or has reasonable grounds to believe that he has such a right.