Current Status and Trends of OTC in China

Social Science Academy in Sichuan Province
Zhou Yousu
Zhou Yousu

Professor and Research Fellow, Social Science Academy in Sichuan Province, Vice-President of China Commercial Law Society, Vice-President of China Securities Law Society, Committee Member of the People’s Government Legislative Advisory Board in Sichuan Province, Legal Advisor to the People’s Government of Chengdu City, Director of Listed Companies Association’s Independent Director Committee Board in Sichuan Province, Independent Directors of Yibin Wuliangye Company Limited, New Hope Liuhe Company Limited, etc.

1. Definition of OTC

OTC is a form of transaction different from securities exchange. In the latter a securities transaction happens within the exchange, whereas in the former a securities transaction happens outside the exchange.
China Stock Market

Exchange Market
Constituted by Shanghai Stock Exchange Main Board, Shenzhen Stock Exchange Main Board, Shenzhen Stock Exchange SME Board, and Shenzhen Stock Exchange GEB

OTC Market
A stock trading market independent from the Stock Exchange System with distinct characteristics of different zones
OTC has existed since the emergence of China’s securities market, or more precisely, China’s securities market evolved from the OTC market. However, it lacks of a clear definition currently.
OTC is an important component of multi-layer capital markets; OTC is a market contrasted with the Securities Exchange.
OTC market is connected to over-the-counter trading

OTC mainly trades stocks
China’s OTC can be roughly defined as a stock trading market which is independent from the securities exchange system and has distinct characteristics of different zones.
2. Current status of OTC

OTC structure:

- The Third Board (OTC Bulletin Board)
- Local Equity Exchange
The Third Board, known as the Stock Transfer Agent System, refers to a stock trading platform, which relies on technical systems of stock exchanges and registration and clearing companies, and where securities companies are entrusted to trade shares of non-listed companies.
The old Third Board includes companies traded in the STAQ and NET Systems originally and delisted companies, currently a total of 56. Amongst these, six of them are originally traded in STAQ and NET System (first three digits of their stock codes are 420) and 50 of them are delisted companies (first three digits of their stock codes are 400).
The New Third Board was born in 2006 when China’s State Council and Chinese Securities Regulatory Commission (CSRC) approved a pilot scheme that shares of non-listed companies in Zhongguancun Science and Technology Park would be traded in the Old Third Board.

Both the New Third Board and the Old Third Board take the Stock Transfer Agent System as their trading platforms. Their core businesses are trading stocks with securities companies’ brokerage services. They are primarily regulated by Securities Association of China. Their main differences are companies whose shares are traded on boards and the way to trade shares. The Old Third Board adopts centralized trading approach while the New Third Board uses transfer by quotation approach.
A Ceremony of Non-listed Companies in Zhongguancun Science and Technology Park Join in the Stock Transfer Agent System
In August 2012, the State Council approved that the first lot of New Third Board companies was expanded from Beijing Zhongguancun Science and Technology Park to Shanghai Zhangjiang, Wuhan Donhu and Tianjin Binhai high-tech zones. In September, the first lot of non-Zhongguancun companies were formally listed. Until the end of 2012, there are 256 companies listed on the old and new Third Boards, 200 of which are new Third Board companies (First three digits of their stock codes are 430).
<table>
<thead>
<tr>
<th></th>
<th>The New Third Board</th>
<th></th>
<th></th>
<th>SME</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Requirements of listed companies</strong></td>
<td>Compliant Operation and Comprehensive Corporate Governance</td>
<td>New business focus in innovation and growth</td>
<td>Stable Profit and High Market Shares</td>
<td></td>
</tr>
<tr>
<td><strong>Financial Status</strong></td>
<td>Will be delisted if loss in three consecutive years</td>
<td>Continuous growth of profit for last two years, accumulated net profit should not be less than 10 million. Or Profit gain for one year with a profit not less than five million, sales not less than 50 million, the growth of sales shall not less than 30% for last two years.</td>
<td>Continuous growth of profit for last three years, accumulated net profit should not be less than 30 million. It has no loss to cover in the latest period. Net cash flow value accumulated for last three years should be over 50 million. Or accumulated revenues should be over 300 million.</td>
<td></td>
</tr>
<tr>
<td><strong>Share Capital Status</strong></td>
<td>Not less than five million before issuing</td>
<td>Its net assets value is 20 million RMB or more. The total amount of capital stocks after offering is over 30 million RMB.</td>
<td>Not less than 30 million before issuing, total share capital not less than 50 million after issuing</td>
<td></td>
</tr>
<tr>
<td><strong>Way of Audit</strong></td>
<td>Disclosure-basis, reviewed by China Securities Association</td>
<td>Merit Reviewed by the CSRC</td>
<td>Merit Reviewed by the CSRC</td>
<td></td>
</tr>
<tr>
<td><strong>Financing Period</strong></td>
<td>No initial Financing in six months</td>
<td>1-2 years</td>
<td>2-3 years</td>
<td></td>
</tr>
</tbody>
</table>
Local Property Exchange Institute

Approved or directly established by provincial or municipal governments. There is no common name of the local property trading institute. It could be called as “Property Exchange”, “Property Trading Centre”, “State-Owned Property Exchange”, “Property Trading Company Limited”, etc. Statistically, there are over 300 local property trading institutes in China. Their business includes equity trading. Since equity trading involves the transaction of state-owned assets, the setting up of a local property trading institute is governed by the “Law on the State-Owned Assets of Enterprise”.

Article 54 promulgates that “Except the state-owned assets that may be directly transferred by agreement in accordance with the state provisions, the transfer of state-owned assets shall be openly conducted at a legally established property right exchange.”
Some local platforms for the trading of non-listed companies’ shares also use the words “equity exchange” in their names. The background to set up local equity trading institutes is directly related to national policies of district reforms. Several local equity trading institutes have been established in China, including Tianjin Equity Exchange, Chongqing Shares Transference Center, Shanghai Equity Deposit and Trading Center, and Shenzhen OTC for Non-Public Shares of SMEs.
The Tianjin Equity Exchange is the largest one. By the end of 2012, there are over 200 listing enterprises from 22 provinces.
Securities companies have begun centralize deposits of non-listed companies’ shares as early as 1990s when China was conducting the pilot of shareholding system. According to relevant guidelines of CSRC, many local professional equity depository institutes were established to take over the centralized deposit business of securities companies. The businesses of local equity depository institutes include alteration of equity registration, so they have an incomplete function of equity transference (trading).
Problems of OTC

- Uncertain legal status
- Lack of top-level design
- Limited capitalization scale
- Lack of unified trading rules and regulations
Although the 2005 amendments of Companies Law and Securities Law allow the existence of OTC, there is no direct rule dealing with it. It gives rise to uncertainties in terms of the OTC legal status, trading venues, trading methods, regulatory authorities, disclosure, and so on, which has become the primary obstacle to develop OTC in China.

When the legal status of OTC is ambiguous, it is said the OTC does not achieve a legitimate “birth certificate”. Therefore, the equity trading on the OTC lacks of certain expectation.
Lack of top-level design

Some significant issues: whether there are different tiers of the OTC market; how to divide these tiers; what main functions of the OTC are; how a great many of non-listed companies list in the OTC by category; what the model of unified regulation is; whether local government can involve into regulations; how they can involve; whether different trading methods are used in different tiers of the OTC; whether the market-maker institution can be introduced; whether it is necessary to set up the tier-switch institution between different tiers of the OTC; how to coordinate the OTC with the exchange; etc.
Companies, eligible to list in the New OTCBB, have been limited to those in Zhongguancun Science and Technology Park for years. Only institutional investors and individual shareholders of OTCBB companies are permitted to trade while retail investors are forbidden. The total market value of negotiable shares of those OTCBB companies is small. For example, the annual turnover of shares in 2011 was only 732 million RMB and the average turnover rate was 3.4%. In contrast, the average turnover rate in the exchange was over 230% in the same year. In 6 years after the pilot, listed companies in the OTCBB merely refinance 1.71 billion RMB in total by additional share issuances.
District equity trading markets are even worse, some of which do not yet operate businesses and some of which are incapable to obtain enough listed companies. Most district equity trading markets have shown features like limited listed companies, limited market depth, and low liquidity. The annual turnover of equity trading institutes in Tianjin, Shanghai and Chongqin is only 2 billion RMB. This figure plus the annual turnover of new Third Board take up less than 0.02% of the total capitalization of China’s A-share market. On the contrary, the annual turnover of US OTCBB is more than 10 trillion USD.
US Stock Market

NASDAQ: 2717 companies

Pink sheet market: 6199 companies

OTCBB: 2386 companies

Grey market: over 60,000 companies

The pyramid structure of American stock market
China Stock Market

The inverted pyramid structure of Chinese stock market

Main Board: 1438 companies
SME Board: 701 companies
GEM: 355 companies
The Third Board: 256 companies
District Equity Market: limited companies
Lack of unified trading rules and regulations

The Third Board is regulated by Securities Association of China. District equity trading market runs pursuant to its own rules and is regulated by a local governmental department which authorizes its establishment. In some places, this department is local State-Owned Assets Supervision and Administration Commission while in other places, this department is Governmental Financial Office. Market entrance criteria and trading rules have very obvious differences in different districts. The phenomena of non-regulation or insufficient regulation are very common.
Lack of unified trading rules and regulations

As a result, the State Council promulgated “Decision of the State Council on Straightening out and Rectifying Various Types of Trading Venues to Effectively Prevent Financial Risks” and “Implementation Opinions of the General Office of the State Council on Straightening out and Rectifying Various Types of Trading Venues” in the end of 2011. The State Council intended to make clean-up and rectification of district equity trading market.
3. Development of OTC

Functional target of OTC

Tier structure of OTC

Latest Development of OTC
OTC is supposed to be a market providing financing service and equity transfer server to non-listed companies. Currently, there are more than 100,000 companies limited by share in China. Only 2494 companies have been listed on the Main Board, SME Board or GEM, and a much smaller number of non-listed companies has accessed to the Third Board or district equity trading market. Less than 3% companies limited by share finance in stock market. Due to inadequate legitimate trading venues, it is more difficult to transfer shares of non-listed companies limited by share than that of companies limited by liability.
The Third Board Market
As a national equity trading market, it stands on the top of OTC and serves high-tech companies located in high-tech parks.

District Equity Trading Market
It locates the bottom of OTC and serves non-listed companies other than the Third Board companies. It can be further divided into several tiers.
China’s OTC is constituted by the Third Board market and district equity trading market together. The number of non-listed companies far exceeds the capacity of the Third Board, so the development of China’s OTC depends on the breakout of district equity trading market.
CSRC also divided China’s OTC into the Third Board market and district equity trading market. There have been substantive measures and remarkable progresses since 2012:

1. The promulgation of two important Regulations: “Guiding Opinions on Regulating Securities Companies' Participation in Regional Equity Trading Markets (for Trial Implementation)” and “Measures for the Supervision and Administration of Non-listed Public Companies”. They are meaningful to guide the next step of China’s OTC development because they cover delimitation of non-listed public company, stock transfer, private placement, information disclosure, corporate governance, regulation, conditions to establish district equity trading market, business scope, qualified investors and other issues.
Development Trends of OTC

National Stock Transfer System for SMEs started operation on 16 January 2013
Development Trends of OTC

2. National Stock Transfer System for SMEs started operation. National Stock Transfer System for SMEs is a national securities trading avenue, approved to set up by the State Council. It is managed by National Stock Transfer System for SME Company, Ltd. Its registered capital is 3 billion RMB and its domicile is Financial St., West City, Beijing. The Stock Transfer Agent System, which is the operational platform of the Third Board originally, will be replaced by the National Stock Transfer System for SMEs. The listing criteria and continuous regulations will be charged by Non-Listed Public Company Division of the CSRC. The small scope and district pilot of the Third Board is going forward to national operation.
3. The beginning of OTC trades
On 21 Dec 2012, The China Securities Association announced “Standard of Practice on OTC Trading”. Simultaneously, Haitong Securities, Guotai Junan International, Guosen Securities, Shenyin and Wanguo Securities, China Securities Company Limited, GF Securities, Industrial Securities, etc. have commenced OTC trading. OTC is trade of securities with a designated party outside the stock exchange or service provided outside the stock exchange to investors. OTC clearly sets on private equity markets and is a platform for issuing and assigning shares and transaction of private equity funds.
Thank you!