

**CANADIAN FINANCING OPPORTUNITIES
FOR
ASIAN ENTERPRISES**

by

Albert J. Hudec

Securities & Corporate Finance Group

Davis & Company

Barristers & Solicitors

Vancouver, Canada

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The Canadian equity market presents unique capital raising opportunities for enterprises from the Peoples Republic of China (the "PRC"), Hong Kong, Taiwan and other Asia Pacific countries. Foreign investment in the PRC is expected to exceed U.S. \$30 billion in 1994 (almost equal to the U.S. \$32 billion foreign investment in the United States), presenting Canadian investors with significant investment opportunities.

This paper provides a brief, practical introduction to the legal aspects applicable to PRC enterprises interested in accessing Canadian capital markets through public offerings, private placements and joint ventures with Canadian investors.

I. INTRODUCTION

A. BACKGROUND

The Canadian financial community has demonstrated a significant appetite to participate in Chinese financing opportunities, both directly and through Hong Kong. Canada's equity market is the sixth largest in the world. In 1993, the Canadian dollar volume of trading on Canada's four stock exchanges exceeded CAN \$170 billion (CAN \$1.38 = U.S. \$1.00). Last year, public equity offerings in Canada raised in excess of CAN \$22 billion, including over 67 initial public offerings which raised CAN \$3.4 billion. Canadian financial markets are well regulated and internationally respected and a Canadian listing can be used as a basis to raise equity capital in global markets.

B. RECENT ASIAN OFFERINGS

Recent successful Asian offerings in Canada include a CAN \$100 million public offering by South China Industries (Canada) Inc., with proceeds used to acquire an interest in the Guilin Tire Co. located in the Guangxi Zhuang Autonomous Region of the PRC and a CAN \$70 million offering by Noble China Inc., used to purchase a brewery producing Pabst

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Blue Ribbon beer under a licensing agreement and located in the City of Zhaoqing in Guangdong Province.

One Asian enterprise, Belcarra Motors Corp., has just obtained a conditional listing on the Vancouver Stock Exchange (the "VSE") and is currently marketing a U.S. \$15 million offering in Canada to finance an investment in the Baoding Automobile factory in Hebei Province in northeastern PRC. Another dozen or more Asian companies are at various stages of the VSE listing process and seven Asian companies already listed on the VSE's venture board are expected to be future candidates for graduation to the Asian Board.

As well, Canadian investors are investing in "B" Shares listed on the Shenzhen and Shanghai exchanges, in "H" Shares listed on the Hong Kong Exchange and in American Depository Receipts listed on the New York Exchange, both directly and through mutual funds which are dedicated to PRC and Asian investment opportunities.

Top Canadian mutual funds investing in listed Asian securities include CIBC Far East Property Fund, AGF Asian Growth Fund Ltd. and Hypersion Asian Trust. The Wardley China Investment Trust is a Canadian mutual fund which invests in unlisted securities of companies having significant assets, production activities, investments, trading or other business interests in the PRC or deriving a significant portion of their revenue from the PRC.

Last year, thirteen very large state-owned Chinese companies listed on foreign exchanges, most of them on the Hong Kong Exchange. Following the initial successful listing of Qingdao Brewery on the Hong Kong Exchange in July, 1993, a total of eleven Chinese state-owned enterprises successfully listed on the Hong Kong Exchange. Two Chinese firms chose to list on the New York Exchange, including the Shandory Huaneng Power Company Limited, which raised a total of U.S. \$333 million in its initial public offering.

II. CANADA'S EQUITY MARKETS

A. INTRODUCTION

Canada has four stock exchanges located in Toronto, Montreal, Vancouver and Calgary. The Toronto Stock Exchange, Canada's largest exchange, accounts for approximately CAN \$420 billion of market capitalization and 75% of all Canadian trading.

B. THE VANCOUVER STOCK EXCHANGE

The Vancouver Stock Exchange (the "VSE"), Canada's third largest exchange and North America's most prominent public venture capital market, has recently established an Asian board (the "Asian Board") to facilitate the listing in Canada of substantial companies which have their primary operations or assets in Asia. The VSE, which is a world leader in the implementation of sophisticated computerized trading, is currently considering extension

of its trading hours to accommodate direct trading on the Asian Board by its member brokers in Hong Kong.

C. THE VSE ASIAN BOARD

To qualify for a listing on the Asian Board, an Asian enterprise must satisfy listing criteria essentially equivalent to those applicable to the senior or national markets board on NASDAQ in the United States. For an issuer with an operating history, the listing criteria can be satisfied with at least CAN \$5 million of net tangible assets, together with pre-tax profitability in at least two of the three preceding years and pre-tax income of at least CAN \$400,000 in the most recently completed fiscal year. Alternatively, an issuer may qualify for listing solely on the basis of a balance sheet test if it has CAN \$12 million of net tangible assets.

In special cases, a listing may be granted to smaller issuers where the founders have contributed tangible assets of at least CAN \$5 million and can provide a comprehensive technical and market study demonstrating the feasibility of the undertaking; provided that the VSE is satisfied with the management capabilities and technical expertise available of the company.

In addition, in all cases, the enterprise must be sponsored by a member broker of the VSE and must have a public float of at least CAN \$2.5 million. At least 25% of its issued capital or such lower percentage as may be permitted by the VSE must be held by at least 300 shareholders (each holding a purchase lot of at least 1,000 freely trading shares) who are not insiders of the company.

At the present time, one Asian company is conditionally listed on the VSE Asian Board and nine other issuers have engaged professional advisors to assist in obtaining a listing. Nineteen other issuers have made enquiries and 12 other issuers are sufficiently interested to have engaged professional advisors to provide legal and accounting advice respecting a listing. Approximately twenty other small Asian companies are considering a listing on the VSE's regular venture board.

In comparison to the Asian Board, the Hong Kong Stock Exchange and the New York Stock Exchange listing criteria put greater emphasis on factors such as total market capitalization and the distribution and value of the securities held by the public. Generally, for example, the Hong Kong Stock Exchange requires a market capitalization of at least HK \$100,000,000 (approximately CAN \$17,700,000) held by the public. The New York Stock Exchange requires a total capitalization of not less than US \$18,000,000 (CAN \$24,800,000) and at least 3,000 shareholders and has net tangible asset and pre-tax income criteria that are substantially greater than those of the Asian Board. The VSE Asian Board is an excellent alternative to issuers seeking financing to participate in a sino-foreign equity joint venture and to Asian companies seeking foreign investment which are not large enough to qualify for

a listing on the other exchanges. The Asian Board's target market is such medium-sized companies.

D. THE UNIQUE ADVANTAGES OF CANADIAN CAPITAL MARKETS

1. Introduction

There are several very significant advantages to Asian business ventures choosing to source new equity financing in the Canadian capital market. In many cases, the VSE Asian Board will provide a very viable alternative for an Asian issuer wishing to access North American capital markets, broaden its investor base and reduce its cost of capital.

2. Sophisticated Participants

A high concentration of wealthy and well educated Chinese have relocated to Canada in recent years, primarily to Vancouver and to a lesser extent to Toronto. These Chinese Canadians generally have a high degree of financial sophistication and a good understanding of the risks and opportunities of investing in China. They constitute a solid base of retail interest to support PRC and other Asian public offerings in Canada.

This retail market is coupled with demand from a large contingent of institutional investors who account for 75% of equity trading in Canada. These institutional investors are attracted to the VSE by high return, albeit high risk, opportunities to invest in emerging markets and by the desire to add an element of international diversification to their portfolios. Many of these Canadian investors strongly prefer to trade on a domestic exchange where the rules and trading practices are familiar to them and transaction costs are lower.

3. Gateway to U.S. and International Markets

In recent years, Canadian equity markets have become increasingly integrated with the United States and North American markets such that it is now relatively routine to use a Canadian offering as a gateway to the U.S. market. For example, a very effective means of entering the U.S. market is to combine a Canadian public offering with a private placement under Regulation D to qualified institutional buyers in a transaction designed to preclude the applicability of the registration requirements of the *U.S. Securities Act of 1933*. Such qualified institutional buyers can then resell in reliance on Rule 144A.

Canadian investment dealers, and their professional legal and accounting advisors, are among the most sophisticated in the world. Nevertheless, in comparison to an American offering, the time, cost and regulatory delay involved in completing a Canadian public offering and achieving a listing on a Canadian exchange are considerably less. Ongoing compliance costs are similarly lower.

III. CANADIAN FINANCING ALTERNATIVES

The two principal equity financing alternatives available to Chinese, Hong Kong or other Asian enterprises seeking capital in Canada include a public offering or a private placement, generally with the proceeds of the financing being invested in either sino-foreign equity joint venture or a cooperative joint venture constituted under Chinese law.

A public offering involves a distribution of securities to public investors using a prospectus which has been pre-cleared by applicable securities commissions. A private placement involves a limited distribution to qualified investors pursuant to prospectus exemptions, often pursuant to an offering memorandum. Pre-clearance of the offering memorandum is not required but the securities issued are subject to statutory "hold periods" which restrict their tradeability.

A. *PUBLIC OFFERING AND A VSE OR TSE LISTING*

1. *Canadian Securities Laws*

An Asian issuer making a public offering in Canada must, like a Canadian issuer, comply with Canadian securities laws and the rules and the listing policies of the applicable stock exchange. Canadian securities markets are regulated by provincial securities commissions with a mandate to enforce securities laws to maintain the integrity of Canadian securities markets and to protect investors.

As a result of the efforts of the Canadian Securities Administrators Association, there is a high degree of national uniformity in securities regulation, including a comprehensive set of national policy statements. In fact, the establishment of a national securities commission is currently under consideration. Unlike the U.S., there are no customized forms in Canada applicable to foreign issuers and foreign issuers are, in general, subjected to the same rules as are applicable to Canadian issuers.

2. *The Canadian Public Offering Process*

The Canadian public offering process involves an initial and thorough due diligence investigation process, after which the working group, usually led by the issuer's legal advisor, will proceed with the preparation and filing of a comprehensive disclosure document (a preliminary prospectus) in accordance with applicable securities regulations and policy statements.

The preliminary prospectus sets out all material information about the business and financial condition of the issuer and about the securities being offered and is certified as constituting full, plain and true disclosure by both the issuer and its underwriters. Materially misleading statements and omissions can result in liability accruing to the issuer, its

underwriter or their professional advisors and, as a result, great care is taken to ensure the accuracy and completeness of the prospectus documents.

Once filed with the appropriate provincial securities commissions, the preliminary prospectus is reviewed by them, both with respect to formal compliance with the specific legislative requirements and also as to both the adequacy of disclosure and the substantive merits of the offering. Typically it takes 4 to 8 weeks for the securities regulatory authorities to clear a preliminary prospectus. Once a final prospectus has been receipted, sales of the offered securities can be confirmed and the offering completed.

3. Ongoing Compliance Obligations

Once publicly-listed in Canada, Asian enterprises will be required to comply with the ongoing continuous disclosure obligations applicable to Canadian issuers generally. This includes the timely disclosure of material events in their affairs and the filing of annual audited financial statements, unaudited quarterly statements and material change reports, as well as adherence to standardized procedures to ensure that beneficial owners of shares held by depositaries and other intermediaries receive proxy materials for shareholder meetings.

Consent of the applicable exchange will generally be required before proceeding with securities issues, dealing with insiders or amending the issuer's corporate charter. Insiders of the issuer will be subject to insider trading reporting requirements and to restrictions prohibiting trading on the basis of material non-public information.

In addition, the Canadian investment community demands complete, accurate and timely disclosure of all material information about an issuer. Unfortunately, recent successful PRC offerings in Canada have not performed in secondary trading as might have been expected based on the underlying economic performance of the business enterprises. For example, shares of South China Industries, which were issued at CAN \$6.25 per share, have fallen to as low as CAN \$2.55 notwithstanding that the Company's earnings have been steady and that its 1994 price/earnings ratio is four. Noble China shares, which were issued at CAN \$7.50, are now trading at about CAN \$6.50 notwithstanding that revenue forecasts have been achieved and that the company has recently announced the purchase of a 60% interest in a second brewery located in the province of Hebei near Beijing. In part, this lack of market performance can be attributed to the failure of these issuers to understand how essential it is, in the context of North American capital markets, to provide a constant flow of financial and other information in accordance with North American standards.

B. PRIVATE PLACEMENTS TO INSTITUTIONS AND SOPHISTICATED INVESTORS

Private placements of securities in Canada are permitted in limited circumstances pursuant to exemptions from compliance with the prospectus requirements of provincial securities laws. Securities distributed under such exemptions are subject to resale or "hold

period" restrictions and may not be resold except under further exemptions until the expiry of a prescribed period (e.g. 12 months in the case of an issuer listed on the VSE).

In British Columbia, for example, four exemptions as described below are commonly used to conduct private placements.

1. *The CAN \$97,000 Exemption*

An issuer may issue securities to an unlimited number of investors if each purchaser is purchasing as principal and the trade is a trade in securities aggregating over CAN \$97,000 in price. If the securities are publicly advertised, an offering memorandum is required. We anticipate that the minimum required purchase will be raised to CAN \$150,000 in the near future to conform with the requirement in other Canadian jurisdictions such as Alberta, Ontario and Quebec.

2. *The CAN \$25,000 Sophisticated Purchaser Exemption*

If an offering memorandum containing detailed disclosure about the issuer is used, securities can be sold to an unlimited number of "sophisticated purchasers", resident in British Columbia so long as each purchaser is purchasing securities costing in aggregate over CAN \$25,000. "Sophisticated purchasers" are purchasers who, by virtue of their net worth or investment experience or their consultation with or advice from a registered broker or advisor are able to evaluate the prospective investment on the basis of information respecting the investment provided by the issuer. Recently, the British Columbia Securities Commission tabled for discussion proposed amendments to the applicable regulations which would require that, to be considered as a "sophisticated purchaser", an investor must have either a net worth (or joint net worth with a spouse) of CAN \$100,000 (excluding the value of the investor's principal residence), or CAN \$400,000 net worth (if the individual does not own a principal residence), or gross annual income of CAN \$100,000 in the past two years and anticipated for the current year.

3. *The Less than 50 Sophisticated Purchasers Exemption*

Securities costing less than CAN \$25,000 per purchaser may be sold to "sophisticated purchasers" provided that each such purchaser receives an offering memorandum. The offer and sale of the securities may not be accompanied by an advertisement and no selling or promotional expenses may be paid to any person except for professional services or for services performed by a registered dealer. This exemption is available to an issuer only once in each 12-month period.

4. *The Relatives and Close Friends Exemption*

Securities of an exchange issuer may currently be sold to a spouse, parent, brother, sister, child or close personal friend of a senior officer or director of an issuer subject to

limited regulatory requirements. If a disclosure document is given to the purchaser, it must be in the required form applicable to an offering memorandum. The offer and sale of the securities must not be accompanied by an advertisement and no selling or promotional expenses may be paid to any person. During the 12 months preceding the trade, sales under this exemption must have been limited to not more than 24 different purchasers and to an aggregate of CAN \$250,000. The British Columbia Securities Commission has announced that it is currently considering the elimination of this exemption.

IV. THREE STEPS TO A SUCCESSFUL CANADIAN FINANCING

Three critical ingredients are necessary pre-requisites to a successful Canadian financing. The first step is to educate a suitable Canadian investment dealer as to the business activities and prospects of the Chinese entity and to convince the Canadian brokerage community of the merits of the proposed financing. This includes the implementation of various measures to reduce the risk and uncertainty associated with the investment for a Canadian investor.

The second stage often involves a corporate restructuring to conform with the capital structure and organizational features typical for listed North American corporate entities seeking international financing and to achieve optimal tax treatment across applicable jurisdictions.

Finally, the third, and often the most difficult task, is to restate the Asian company's financial statements in accordance with Canadian accounting and auditing standards.

A. *INCREASING THE ATTRACTIVENESS OF THE INVESTMENT*

The first task will be to convince the Canadian investment dealers, and their legal and accounting advisors, as to the merits of the proposed investment and to inform them fully as to the details of the issuer's business and prospects. All efforts should be focused initially on facilitating an intensive and extensive due diligence investigation by Canadian investment bankers, lawyers and accountants so that they become familiar with the significant differences between Chinese and Canadian corporate structures, accounting principles, fiscal environment and regulatory situations.

From the viewpoint of a Canadian investor, there are significant risks associated with an investment in a PRC enterprise. These include uncertainties relating to government approvals required in order to conduct business in the PRC; the fact that PRC government policies and changes in these policies can have significant impact on underlying economic conditions; the impact of rising inflation, possible currency export controls and exchange rate risks; and the lack, in the PRC, of a comprehensive set of laws regarding economic matters.

Responding in detail to their many due diligence questions is an essential task for the issuer and its professional advisors. The due diligence investigation process will include

interviews with the issuer's executive and operating personnel, a review of operations and business plans; a review of financial condition, accounting standards and accounting controls with the issuer's chief financial officer and independent auditors and meetings with the issuer's lawyers to review material contracts and any outstanding litigation.

2. *Concurrent Hong Kong Financing*

Obviously, if there is a significant Chinese capital investment in the business or project, this will increase the comfort level of the Canadian brokerage community in the investment. In particular, an attractive feature is to couple a proposed Canadian public offering with a significant private placement, arranged by the issuer, in the Hong Kong market.

To qualify as a private placement under the Hong Kong *Companies Ordinance*, it is necessary to either limit sales to "professional investors" whose ordinary business is to buy or sell shares or debentures and who, generally, agree to hold their shares for at least six months or to qualify the offering as a "private offering" by limiting the solicitation to 50 persons purchasing for investment purposes only and agreeing to hold their shares for six months. A confidential offering memorandum may be used, but no publicity is permitted and definitive registered certificates must be issued.

If the issuer establishes a place of business in Hong Kong, including, for example, a share transfer registry office, a manufacturing location or a warehousing facility, registration in Hong Kong as an "offshore company" will be required under the *Companies Ordinance*. Whether a Canadian or Bermuda-incorporated entity is employed, neither dividends paid by the issuer nor capital gains on a disposition of its shares will be subject to tax in Hong Kong. So long as a share register is not maintained in Hong Kong, no stamp taxes or estate duties will be imposed.

3. *International Joint Venture Partner*

Another feature which will be attractive to a Canadian investment dealer will be the participation in the business of the Asian issuer of an international joint venture partner who can provide technical, managerial and financial expertise and enhance the chances of a successful offering. Examples include the successful offerings by Brilliance China Automotive and Tsingtao Brewery.

4. *Prominent Board Representation*

An independent board comprised of prominent members of the Canadian and international business communities will also enhance the credibility of the Asian issuer. For example, board participation by a well known and well regarded director of a prominent and successful Canadian or Hong Kong listed company will be a significant asset.

B. CORPORATE/COMMERCIAL/TAX RESTRUCTURING

Revisions to the Asian company's incorporation, capital structure and contractual relations will invariably be required to conform with those customary for publicly listed North American enterprises. In particular, it may be necessary to upgrade the documentation relating to the issuer's ongoing contractual relationships to international standards.

1. Reincorporation or Continuance of the Financing Vehicle

Although it is not necessary for the financing vehicle to be incorporated in Canada, the offering entity must be subject to a corporate governance regime pursuant to its incorporating statute which provides North American standards of protection to public and minority shareholders, and which is otherwise essentially similar to the corporate governance regime contained in the *Company Act* (British Columbia) or other Canadian corporations statutes.

One possible alternative is to incorporate or continue the issuer under the laws of a jurisdiction, such as Bermuda or the Cayman Islands, which extends to public shareholders the same degree of shareholder protection as found in Canadian and U.S. corporate legislation and which are, at the same time, "pure" tax havens in the sense that they impose no tax on profits arising outside of the jurisdiction, no withholding taxes on dividends, interest or royalty payments, no stamp duty in respect of share transfers and no estate duty in the event of death of a shareholder.

2. Reverse Take-Overs

In some circumstances, it may be desirable or convenient to achieve a listing on a Canadian exchange by way of a reverse takeover (an "RTO"). This involves a merger between an active Asian operating company and an inactive listed company (a "shell") which has sufficient share distribution to satisfy applicable listing requirements.

Obtaining a listing in this manner requires the approval of the existing shareholders of the shell and the approval of the VSE. The resulting company must meet the VSE's original listing requirements and provide prospectus level disclosure. Often, an RTO may be a faster method of achieving a listing provided that a suitable shell can be obtained.

3. Tax Considerations

Typically, the vehicle used to conduct a public offering in Canada will be a Canadian incorporated public company ("Canadian Pubco") which, in turn, holds an investment in the Asian operating entity ("Asian Opco"), either directly or through one or more holding companies incorporated in tax-haven jurisdictions.

Such a Canadian corporation is subject to Canadian income tax on its worldwide income but, typically, no Canadian tax will be imposed on dividends paid to Canadian Pubco by Asian Opco since such dividends will be deductible from Canadian Pubco's taxable income so long as they are paid out of "Exempt Surplus", as such term is defined in the *Income Tax Act (Canada)*. "Exempt Surplus" basically means income from an active business (net of taxes) carried on in certain countries specified in regulations under the *Income Tax Act (Canada)* by a corporation resident in one of these countries carrying on business through a permanent establishment located in such countries. For this purpose, income earned from an active business in the PRC, Malaysia, Singapore, Indonesia or the Philippines by a corporation resident in that country qualifies as Exempt Surplus regardless of whether or not such income flows through a holding company in a tax haven jurisdiction. Hong Kong and Taiwan, however, are not yet prescribed for this purpose under the applicable regulations.

One of the principal advantages of carrying out a Canadian financing through a Canadian Pubco is that the shares of Canadian Pubco will be a "qualified investment" under the *Income Tax Act (Canada)* for trusts governed by registered retirement savings plans, deferred profit sharing plans or registered retirement income funds. The shares will not be subject to the investment limitations applicable to foreign property held by such deferred income plans and certain other tax exempt entities. This qualification makes investment in the shares of a Canadian Pubco more attractive to institutional investors.

Canadian resident shareholders will receive the normal Canadian income tax treatment on dividend distributions and capital gains received from the disposition of shares of Canadian Pubco. A non-Canadian resident shareholder will be subject to a 25% withholding tax (or such lower rate as may be available under an applicable tax treaty) on dividends received from Canadian Pubco. For example, the applicable treaty rate for an investor resident in the PRC under the tax treaty between Canada and the PRC would be 15% (10% for an investor owing more than 10% of an issuer).

Generally, a non-resident of Canada will not be subject to Canadian tax on the disposition of shares of Canadian Pubco unless the shareholder owns 25 percent or more of the issued and outstanding shares of Canadian Pubco.

C. ACCOUNTING REQUIREMENTS

Many Asian and other foreign issuers contemplating a Canadian public offering find that the application of Canadian accounting requirements and standards to their financial statements is the most difficult Canadian regulatory requirement to satisfy. This includes not only reporting in accordance with Canadian generally accepted accounting principles ("GAAP") but also the establishment of new accounting, auditing and internal financial controls in accordance with investor requirements and international standards.

Asian companies applying for a listing on the VSE Asian Board, for example, are required to provide an auditor's comfort letter commenting on the accounting resources of the issuer and confirming the issuer's ability to prepare financial statements in either Canadian or U.S. GAAP. Generally, the major investment dealers strongly prefer that one of Canada's major international accounting firms be engaged for this purpose.

Canadian securities regulatory authorities will require a restatement of the Chinese issuer's historical financial statements in accordance with Canadian GAAP. For a public offering, five years of audited statements of income, retained earnings and changes in financial position and 2 years of audited balance sheets will be required, as well as possibly audited financial information for the completed part of the current financial year. Exemptions may be available, as in the case of two recent Asian offerings in Canada, where two years of audited statements of income, retained earnings and changes in financial position and a single audited balance sheet were permitted where more historical statements were not available.

V. CONCLUSION

The VSE Asian Board provides an attractive listing alternative for PRC companies wishing to access North American capital markets. The partners and associates at Davis & Company are well-equipped to assist PRC enterprises in all stages of completing a successful Canadian financing. Lawyers at Davis & Company have sophisticated experience in all of the corporate, commercial, finance and tax aspects of structuring an international financing and can assist in all stages of the process including incorporation, organization, offering, listing and ongoing compliance obligations. In addition, we would be pleased to provide introductions to investment dealers, accounting firms, Canadian transfer agents and other professionals in the Canadian business community to assist you with a Canadian financing. For further information, please call either David Davenport at (1)(604)643-2914 or Al Hudec at (1)(604)643-6463.

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