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# China's New Third Board Market: Opportunities and Challenges

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## Abstract

The New Third Board Market is China's OTC market, established in 2006. Compared to China's Main Board Market and the Second Board Market, it attracts a lot of start-up companies needing financing with lower listing requirements. Meanwhile, it is full of opportunities and challenges that appeal to numerous securities traders and investors with the rapid development momentum. This paper is intended to build a comprehensive and systematic knowledge framework of China's New Third Board Market for those enterprises and individuals interested in it, and to provide a research base for future researchers.

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## 1. Introduction

After more than 30 years of development, China's economy is in a critical period of economic restructuring. Building an effective financial market has a significant and positive meaning for China's economic restructuring [1]. The so-called New Third Board Market (China's OTC market) is established in this context. Since its birth in 2006, the New Third Board Market has been greatly concerned with China's financial industry. The establishment of China's New Third Board Market enables Chinese multi-level capital market to be more complete. It offers a highly efficient financing platform for high-tech, high-growth and high-innovation enterprises during their early establishment. There is also a wealth of investment opportunities provided for institutions and individuals with investment willingness and capacity. In 2014, the investment boom in the New Third Board Market became a hot event in Chinese society. The system construction and the future development of the New Third Board Market have aroused the interest of many researchers as well. This paper summarizes previous studies on China's New Third Board Market. The purpose of this paper is to build a comprehensive and systematic knowledge framework of the New Third Board Market for those enterprises and individuals interested in it; and to provide a research base for future researchers.

## 2. Reasons for Establishing China's New Third Board Market

### 2.1. Structure of China's Stock Markets

China's stock markets include three main parts. The Main Board Market is composed of Shanghai Stock Exchange and Shenzhen Stock Exchange, both of which are traded by active competitive bidding, well supervised by CSRC (China Securities Regulatory Commission). In China, the stock market established for a specific function: providing service for large enterprises only. Given the seriously unfavorable policy condition, few small and medium-sized firms are funded on Main Board market[2]. In order to solve this problem, Small and Medium-sized Enterprise Board Market was established within Shenzhen Stock Exchange. It applies distinguished stock code from the Main Board Market, serving as a direct funding channel for SMEs.

In 2009, Growth Enterprise Market (GEM) was set up by Shenzhen Stock Exchange. GEM is regarded as China's second Main Board Market, aiming at providing services for innovative enterprises and high-growth firms.

The so-called New Third Board Market was founded in 2006 as China's OTC market. China's multi-layer stock markets are basically set up since then. The typical stock market should be a pyramid-shaped market – OTC market at the bottom, Growth Enterprise Market and Small and Medium-sized Enterprise Market in the middle and the Main Board Market at the top position. However, China's current structure of capital market is upside down where the Main Board market is most capable while the other two stock markets still need further development[3].

### 2.2. History of China's OTC market

The organization that supports the operation of the New Third Board Market is National SME share transfer system, a national securities exchange.

China's OTC market has gone through three main phases. The first phase began in July, 1992. National Association of Securities Dealers Automated Quotations System (STAQ) was launched to resolve the problem of juridical person shares and floating stocks. After almost one year, in April of 1993, the national electronic securities trading system (NET) was started in Beijing as well. Nevertheless, due to weak supervision, STAQ and NET were suspended from trading in September of 1999, indicating the end of first phase.

The second phase was marked with the Agency Share Transfer System by the Securities Association of China established in June 2001, which is commonly named 'The Third Board Market'. During that period, six security companies qualified under this type of trading and more than 300 business departments were using electronic trading approach. The Third Board Market does not only solve floating issues of shares of listed firms in STAQ and NET system, but also include companies delisted from the Main Board Market, listed companies of regional trading centers and other companies with historical issues.

The third phase started from January of 2006, when Pilot Project of Zhongguancun Private Company Share Transfer was launched, which marked the real OTC Market's establishment in China. In this paper, we investigate the third phase of China's OTC market, namely the New Third Board Market.

In 2006, unlisted companies of Zhongguancun Science and Technology Garden initiated negotiable quotation in Agency Share Transfer System. Previous design of regulations and rules of the New Third Board Market was completed at the beginning of 2011. At 3rd of August in 2012, Pilot Project of Private Company Share Transfer was expanded to Shanghai Zhangjiang High-technology Garden, Wuhan Donghu Innovative-technology Garden and Tianjin Binhai High-tech Zone.

The National Equities Exchange and Quotations System Co., Ltd (NEEQ) was founded in September 2012. That indicates the official existence of the New Third Board Market. At the end of 2013, policies of the New Third Board Market were changed. The limitations of only serving companies in national high-tech zones were

broken and all firms accordant with trading requirements can apply for listing . At 24th January in 2014, first batch of firms outside national high-tech zone started trading on NEEQ.

### *2.3. Role of the New Third Board Market*

Although the existing time of the New Third Board Market is short and the development is also inadequate, it plays a significant role of promoting the development of China's economy and capital market.

- Providing convenient funding channel for high-growth enterprises in early stage

The major task of economic development and economic structural transformation is to strongly support enterprises with high innovation and growth capability. All levels of China's capital markets should provide the targeted support for economic development and transformation. However, plentiful small and medium-sized enterprises can't access financing on the Main Board Market for their characteristics of small scale, quick iteration of technology, high input and high risk. In addition, small and medium-sized innovative firms find it hard to obtain loans from bank, as a result of their high business risks, unstable performance and limited guarantee ability [1]. All these traditional financing difficulties could be overcome on the New Third Board Market. The mission of the New Third Board Market is to offer funding for high-tech enterprises in early stage [4] so that it is the emphasis of China's economic structural transformation [1].

- An Important Part of Multi-layer Stock System in China

The initiation of establishing the New Third Board Market is to fund innovative high-growth technology companies and to foster enterprises with development potential for the Growth Enterprise Market even for the Main Board Market [2]. Moreover, High-tech companies trading in the pilot project of the New Third Board Market are supposed to solve the problem of original capital withdrawal [4]. As a consequence, capital is invested into SMEs more intensively with a guarantee for smoothly withdrawal. In a word, the New Third Board does not only promote the development of venture capital, but also optimizes the exit channels of venture capital [1].

Under the current legal system of financial industry, there exists no direct board transfer system for company stock to be directly transferred across the Main Board Market, the Second Main Board Market and the New Third Board Market. However, from the perspective of function, the New Third Board Market could be viewed as incubator for the Main Board Market and the Second Main Board Market, as well as container for firms unlisted from them.

## **3. Participants of the New Third Board Market**

### *3.1. Market Supervisors and Regulators*

The National Equities Exchange and Quotations System Co., Ltd (NEEQ) is the operation management institution of the New Third Board Market. Shanghai Stock Exchange, Shenzhen Stock Exchange, China Securities Depository and Clearing Corporation Limited, China Financial Futures Exchange, Shanghai Futures Exchange, Zhengzhou Commodity Exchange and Dalian Commodity Exchange are the shareholders of NEEQ. The functions of NEEQ include: establishment, maintenance and improvement of stock-exchange-related technology system and facilities; development and modification of national equities exchange system business rules; acceptance and examination of the applications of stock listing and other related business and the arrangement of the listing of qualified companies; organization and supervision of stock exchange and the related activities; supervision of the participants (lead securities firms) of the national equities exchange system; supervision of listed companies and other information disclosure agents; management and announcement of related information of national equities exchange system, and; other functions as approved China Securities

Regulatory Commission (CSRC) [5]. The establishment, operation and daily management of the New Third Board Market are under the supervision of CSRC.

### *3.2. Listed Companies*

As of January 27th, 2015, there were 1828 companies listed on the New Third Board Market, and over 500 enterprises were awaiting approval. These enterprises are distributed in 30 provinces and autonomous regions of China, among which Beijing leads at the top (359 enterprises), followed by Jiangsu (161 enterprises). The New Third Board Market showed a slow growth in the number of listed enterprises before 2012 and a significant rise during 2012 to 2013 when it gradually received much attention from new business owners. During 2014, the number of listed companies soared to 1200 (data source: the web site of NEEQ). The companies listed on the New Third Board Market are usually characterized by high innovation, high growth or high technology, which certainly indicates that the New Third Board Market is playing a role it ought to bring into play.

### *3.3. Investors*

At the beginning of the establishment of the New Third Board Market, qualified investors included legal persons, other organizations and natural persons. According to the "Experimental Measures" revised in 2009, qualified investors "shall have corresponding risk identification and tolerance". Therefore, institutional investors, such as legal persons, trust agencies and partnerships were included as qualified. And severe restrictions were placed on natural person investors: only the natural person shareholders who hold shares before the company listed, those holding shares through directed replenishment or equity incentive and those holding shares through inheritance or judicial decisions are considered as qualified investors, and they can only trade the shares of their holding companies. This regulation, which was designed to protect investors, decreases the liquidity in the market [6].

Nowadays, according to Article [7] of the Detailed Rules of the National Equities Exchange and Quotations System on Management of Investor Fitness (for Trial Implementation): the corporate bodies having the registered capital of 5 million yuan or more; the partnership enterprises having the total paid-in capital of 5 million yuan or more and the qualified natural person investors can apply for the participation in the public equities exchange of listed companies.

Natural person investors are subject to the following condition: the one need own securities assets(including customer's settlement funds, and the stocks, funds, bonds, brokerage collection financial products listed in Shenzhen Stock Exchange and Shanghai Stock Exchange and national equities exchange system, excluding the assets of credit securities account) at least 5 million yuan in the previous trading day. And the natural person should have more than two years of investment experience in securities or a professional background related to accounting, investment and finance. Investment experience starts from the date when the first stock exchange under the account in the name of investors was made in the national equities exchange system, Shanghai Stock Exchange or Shenzhen Stock Exchange.

### *3.4. Securities Traders*

Securities traders are very important market participants of the New Third Board Market.

According to the existing policy of the New Third Board Market, securities traders refer to the securities companies engaged in some or all of the following operations under the national securities exchange system: recommending business (recommending the stock listing of applicant companies, making continuous

supervision of listed companies and providing related services for listed companies in stock issuance, M&A, etc.), providing brokerage services (opening of securities accounts, buying and selling of stocks and other services), market making, and other services as stipulated by NEEQ.

Securities traders engaged in recommending business shall have the qualification for securities underwriting and recommendation business; those engaged in business transactions shall have the qualification for securities brokerage; those engaged in market making shall have the qualification for proprietary trading business. Securities companies shall apply to NEEQ for archival purposes before the start of their business in the securities exchange system.

#### **4. Operation of the New Third Board Market**

The New Third Board Market has expanded twice since its establishment, and its policies are constantly reformed and improved. The existing rules of operation are as follows:

##### *4.1. Requirements and Procedures for Listings on the New Third Board Market*

- Requirements for listings on the New Third Board Market[8]

A joint-stock company applying for listing on NEEQ is not subject to the restrictions on the nature of the ownership of a shareholder, and any company seeking a listing on the New Third Board Market is no longer required to be recognized as a high-tech enterprise. It shall comply with the following requirements: the company must be established according to the law and subsist for at least two years; it must have well-defined business and the ability to continue as an ongoing business; it must have a sound corporate governance mechanism and carry out its operations in a lawful and regulated manner; it must have well-defined shareholding and the issue and transfer of its shares must be legal and compliant; and it must be recommended by a securities trader and subject to its ongoing supervision.

Unlike the Main Board market and the Second Board market, the requirements for listing on the New Third Board Market exclude the financial indicators. These requirements describe the basic conditions necessary for the start-up enterprises and conform to the purposes of the New Third Board Market.

- Procedures for listings on the New Third Board Market.

Applicant companies shall enter into an agreement on recommended listing and ongoing supervision with securities traders qualified for such recommendation, and they shall prepare application in accordance with the relevant provisions to NEEQ. After applicant companies obtain NEEQ's approval documents of listing, they shall enter into an agreement on listing with NEEQ, an agreement on securities registration with China Securities Depository and Clearing Company Limited (CSDCC) and disclose the public transfer statements as stipulated by NEEQ, and then they may apply for completing the listing procedures.

The restrictions on the exchange of the shares directly or indirectly held by controlling shareholders and actual controllers of listed companies will be lifted in three lots. The restrictions on 1/3 of the shares before the listing of company will be lifted on date of listing, 1/3 one year and 1/3 two years after listing.

Stock exchange can be made through agreement, market making, auction or other forms approved by CSRC. The exchange form of listed stocks can be converted with the approval from NEEQ. When the listed stock exchange is made through agreement, NEEQ will provide call auction exchange arrangement. When the listed stock exchange is made through market making, there must be two or more leading securities firms engaged in market-making business ("market makers") to provide market making quotation service.

Market makers shall continuously publish bid-ask quotations in NEEQ and fulfill the obligations of transaction with investors within the scope of quotation price and quantity. In general, no transaction can be concluded between investors through market making [8].

## 4.2. Market-Maker System

Market-maker system is defined as a securities exchange form under which the securities dealers with certain strength and credibility, acting as licensed dealers, continuously publish bid-ask quotations of specific securities for public investors and, with their own funds and stock quotations, make transactions with investors in the securities market [9].

There are many advantages in introducing the market-maker system to the New Third Board Market. Firstly, the market-maker system contributes to the achievements of the valuation of innovative enterprises. Under the market-maker system, market makers' quotations are formed based on the comprehensive analysis of the market, the information of all participants and the assessment of their own risks and benefits [10]. Investors make decisions on the basis of quotations and they in turn affect market makers' quotations, which promotes securities prices to move closer to their actual value [10].

Secondly, it can improve market efficiency of the New Third Board Market. The market-maker system permits investors to immediately make transactions based on market makers' quotations without the orders of counterparties, so as to maintain the continuity of securities exchange and improve liquidity.

Thirdly, it can effectively stabilize the market and promote the balanced market operation. In case the stock price booms or busts, the participation of several market makers with a certain amount of cash and market-making stocks in market making is conducive to curbing excessive speculation and they act as a "stabilizer" of the market [9].

According to the statistics of NEEQ, by January 27<sup>th</sup> 2015, only 140 firms are trading by market makers and the remaining 1688 firms are trading by negotiating transfer method. In the future, there will be much more firms choosing market makers as their trading manner.

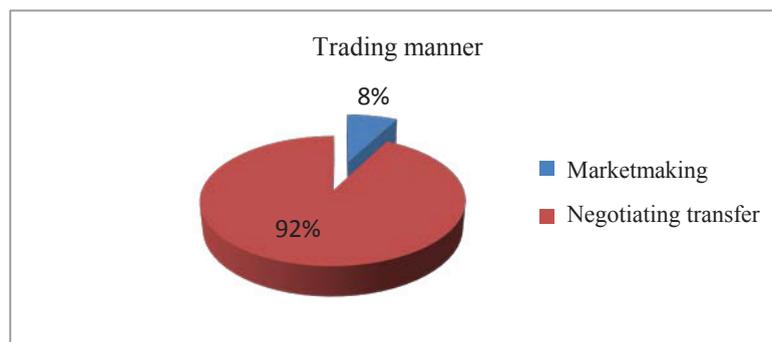


Fig. 1. Trading manners of listed firms on New Third Board

## 5. Opportunities of the New Third Board Market

### 5.1. Perspective of Enterprises

The New Third Board Market boasts enormous attraction from the perspective of enterprises hoping to get listed or having already been listed on it. Listed companies come from more than 15 primary industries, containing more than 80 sub-industries. 27% of them belong to computer & Internet industry and 35% of them belong to manufacturing industry (figure 2). Computer & Internet industry is the so-called technological innovation intensive industry. It proves that the development of New Third Board Market is in line with the intention of government. The rapid development of the New Third Board Market also attracts companies in traditional industries such as manufacturing.

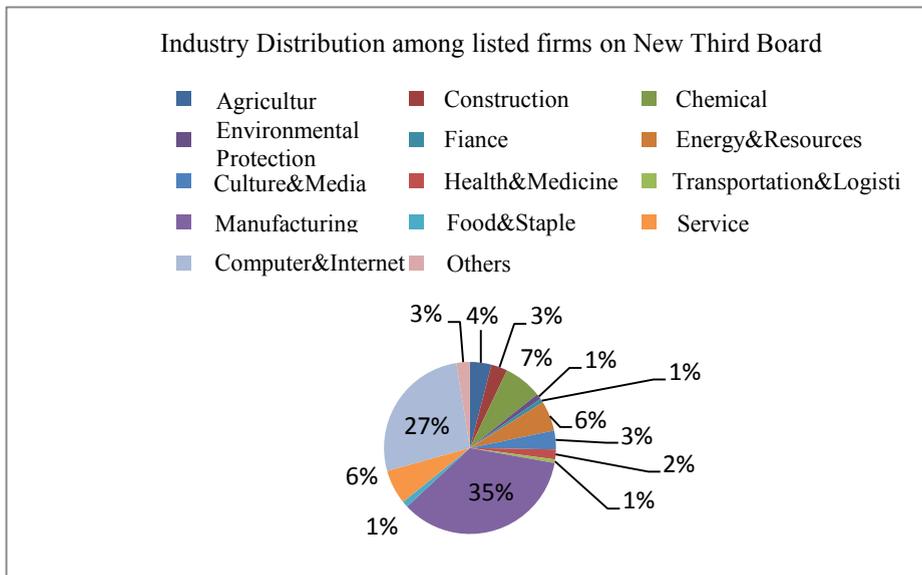


Fig. 2. Industry Distribution among listed firms on New Third Board

For enterprises, financing opportunities come not only from the financing function of the New Third Board Market itself but also from traditional financing channels that become accessible through upgrade of credit worthiness after going public. For example, Jiangsu Gm-winlead Intelligent Technology Co.,Ltd, a technology company of the intelligent building industry, landed 10 million yuan of line of credit from Bank of Suzhou Co., Ltd. shortly after debuting on the New Third Board Market.

In addition, once firms go public on the New Third Board Market, the listed behavior will enhance the reputation of firms, standardize financial regulation and establish modern corporate governance system [11]. In the listing process, companies will improve the governance structure and management system since professionals like equity companies, accountants, lawyers and other concerned experts take responsibility of due diligence and moderate information disclosure [4].

Meanwhile, after being listed on the New Third Board Market, companies will further improve transparency of corporate value and maximization of shareholder value; and their value can be reflected by indicators such as P/E ratio and trading price. In return, the more transparent corporate value and standardization of equity will facilitate the firms' equity transfer and pledged financing [12]. Considering the reasons above, there has been a rocketing number of listed companies and huge trading amount on the New Third Board Market. For detailed data see the table below (data source: NEEQ).

Table 1. The surge of New Third Board Market

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number of listed companies	10	24	41	59	74	97	200	351	1572
Total equity (Million shares)	5.77	12.36	18.86	23.59	26.90	32.57	55.27	95.77	631.46

### 5.2. Perspective of Investors

For investors, with the rapid development of the New Third Board Market there are ample investment opportunities, prepared ad hoc for professional investment institutions. The New Third Board Market provides value assessment and guidance of listed companies for PE investors [14]. Beyond that, the New Third Board Market may become an alternative exit channel for private equity (PE) funds [13]. For investors in PE markets, the New Third Board Market offers a new exit avenue besides merger and acquisition, equity transfer, IPO and management buy-out [14].

### 5.3. Perspective of Securities Traders

Securities traders are supplied with considerable profiting opportunities by the New Third Board Market since they can earn profit through sponsoring business, charging objective fees for sponsoring listing, as well as subsequent and continuous annual fees for supervision and guidance. If the listed companies conduct private placement, sponsoring securities traders can charge fees based on certain proportion of raised amount. Marker making business is also one of the sources of income for securities traders.

Besides, securities traders can net substantial income from direct investment and asset management by virtue of their solid financial strength and market analysis ability. In the future, there is possibility that securities traders may get much profit once the transferring system from the New Third Board Market to the Main Board and the Secondary Board market is established [15].

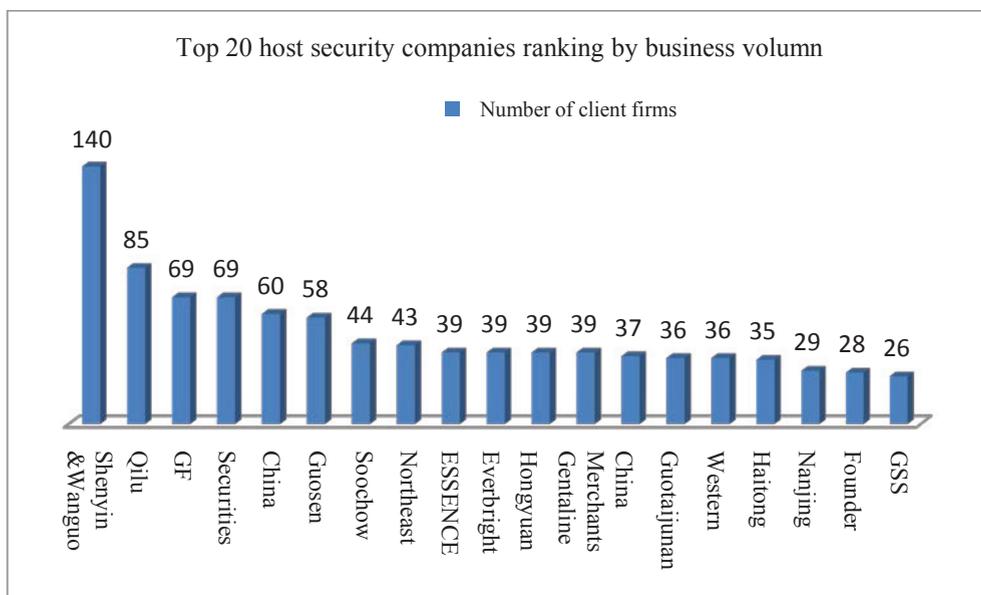


Fig. 3. Top 20 host security companies ranking by business volumn

Nowadays there are 80 securities traders in the New Third Board Market. As figure 3 shows, Shenyin wanguo securities co., LTD is the most prominent securities trader in this market. With the rapid development of the New Third Board Market, brokerage business space will produce tremendous growth.

## 6. Challenges of the New Third Board Market

### 6.1. Regulatory Challenges

For a long time, there are a lot of chaotic phenomena in China's stock market. Problems of getting listed through "packaging" or "disguising", unreal information disclosure, inside trading, and controlling share price cropped up one after another, severely damaging the confidence of the investors and affecting the healthy development of the capital market[16]. At present the benchmark for getting listed in the New Third Board Market is quite low and the procedure is simple. Administrative power does not have excessive intervention on this market, posing challenges to the supervision system design. Under the present supervision policies, the New Third Board Market has strict regulations on securities trade and the investor, but the information disclosure requirement is not strict.

So, after a large number of enterprises, investors and securities traders flock to the New Third Board Market, the effect of exiting supervision rule needs time to test.

### 6.2. Challenges for Investors

It is impossible for either the individuals or institutional investors to get back the capital by investment to the New Third Board Market within a short period, and even in the best scenario, the return on investment would not be that high. Therefore, the investment on the New Third Board Market is more appropriate on value rather than opportunistic behaviors. In this way, in terms of capital use, it can better promote the development of SMEs [17]. This investment model is rather challenging to the investor's risk bearing ability, market analysis ability and enterprise evaluation ability.

Moreover, by the end of 2014, the average number of shareholders of listed companies on the New Third Board Market stood at 38 (data source: NEEQ), implying high concentration of equity and poor liquidity. There are a lot of family enterprises and mom-and-pop companies. Meanwhile, regulations of the New Third Board Market are relatively loose. All these facts indicate that investors need to possess fairly sophisticated expertise and high tolerance towards risk, for the New Third Board Market is a high-risk and high-yield market. These will bring more risks and challenges for investors.

### 6.3. Challenges for Securities Traders

Currently, there are only 115 securities traders in Mainland China, roughly the same number as in Taiwan with much smaller economic. Obviously, for the New Third Board Market where the number of listed companies far outweighs the number of Securities traders, over 100 securities companies would be greatly inadequate [16]. And with the improvement of market-maker system, there will be more listed companies on the New Third Board Market doing transactions through market makers. It will request stronger service ability and more risk tolerance of securities traders.

In the future, more security institutions and investment institutions would be willing to participate in the game of the New Third Board Market despite the fact that the business abilities of these securities traders are unbalanced. Huge challenge facing by majority of security traders is the improvement of professional ability. Meanwhile, the increase in the number of securities traders has also brought new challenges to the supervision.

## 7. Conclusion

As the youngest part of China Capital Markets, China's New Third Board Market is at the bottom of those markets. It plays an important role to create financing opportunities for high-growth, high-tech, high-innovation and start-up companies and support their growth. After two expansions, organizational structures and regulations of the New Third Board Market have improved and they are function as planned.

Because of the low "threshold" of application for the New Third Board Market, more and more enterprises want to participant in it. The New Third Board Market is in the period of high-speed growth. It brings a considerable number of opportunities for securities traders and investors. Meanwhile, as the other side of a coin, the high speed growth of market size also brings challenges to securities traders, investors and market managers.

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