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Shanghai-Hong Kong Stock Connect – The Train Steams Ahead

Introduction

The Shanghai-Hong Kong Stock Connect programme ("Stock Connect") has moved rapidly forward since we last updated you in our briefing published in April which can be found at the following link Shanghai-Hong Kong Cross-Border Share Trading Plan.

As the plans for Stock Connect developed, it became clear that there were a number of issues which required further work by the authorities in Hong Kong and China. On 26 September, 2014, the Shanghai Stock Exchange ("SSE") and China Securities Depository and Clearing Corporations Ltd ("ChinaClear") issued detailed rules to implement stock trading under Stock Connect. The Hong Kong Exchange and Clearing Limited ("HKEx") published on the same day a number of approved amendments to its rules and FAQs to clarify certain key aspects of Stock Connect. These documents provide industry participants with welcome clarifications in a number of key areas.

This briefing will summarize the developments and focuses on Stock Connect from the perspective of investors seeking to access China A Shares via the Northbound Trading Link as opposed to investors seeking to access H shares from mainland China.

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Quotas

Trading under Stock Connect will initially be subject to a maximum cross-border investment quota, together with a daily quota that will be monitored on a real time basis. A Northbound Trading Link will be established which will permit Hong Kong investors to place orders to trade eligible shares quoted on the SSE ("SSE Securities") subject to an aggregate quota of RMB300 billion and a daily quota of RMB13 billion. A Southbound Trading Link will also be established which will permit mainland Chinese investors to place orders to trade eligible shares listed on the SEHK subject to an aggregate quota of RMB250 billion and a daily quota of RMB10.5 billion.

While the quotas under Stock Connect are not as large as some of the quotas granted under the QDII, QFII and RQFII programs, we understand that the SEHK intends to discuss allocating further quota with SSE and ChinaClear once the above quotas are 80% utilised. It would appear that the authorities are amenable to expanding the scheme provided that there is sufficient demand.

Beneficial Ownership of A Shares

One of the main points focused on by market participants was the issue of whether investors had beneficial ownership of SSE Securities acquired through Stock Connect.

In its FAQ's[1] HKEx states:

"Hong Kong Securities Clearing Company Limited ("HKSCC") is the "nominee holder" of the SSE Securities acquired by Hong Kong and overseas investors through Shanghai-Hong Kong Stock Connect"[2].

The FAQs also discuss the issue of whether the concept of nominee holder is recognised in Chinese law. The FAQs state that the CSRC Stock Connect Rules, as departmental regulations have legal effect in Mainland China and expressly provide for the concept of a "nominee holder". They further re-iterate that the concept of nominee holder is provided for in the SSE Stock Connect Pilot Provisions and the ChinaClear Stock Connect Implementing Rules.

It is noted that there are also other laws and regulations in mainland China which provide that securities can be registered in an account opened in the name of such "nominee holder"[3]. The

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[1] HKEx-Shanghai-Hong Kong Stock Connect FAQ for Investors

[2] *See, article 7, Several Provisions on the Pilot Program of Shanghai-Hong Kong Stock Market Connect, the "**CSRC Stock Connect Rules**"》; article 118, Shanghai Stock Exchange Shanghai-Hong Kong Stock Connect Pilot Programme Provisions, the "**SSE Stock Connect Pilot Provisions**"; and article 6, ChinaClear's Implementing Rules for Registration, Depository and Clearing Services under the Shanghai-Hong Kong Stock Connect Pilot Programme, the "**ChinaClear Stock Connect Implementing Rules**".*

reference to "nominee holder" in the Settlement Measures expressly recognises the concept of a "beneficial owner" of securities.

The intention of the authorities that Hong Kong and international investors are to have proprietary rights over SSE Securities under Chinese law is therefore clear.

While HKSCC is the "nominee holder", it holds the SSE Securities on behalf of Hong Kong and international investors who are the beneficial owners of the relevant securities. The FAQs note that under the CSRC Stock Connect Rules, it is expressly provided that investors enjoy the rights and benefits of the SSE Securities acquired through Stock Connect in accordance with relevant laws[4]. Accordingly, investors rather than any broker, custodian or intermediary through whom such investors hold the SSE Securities should be recognised under the laws and regulations of Mainland China as having beneficial ownership in the SSE Securities.

The FAQs also address what may occur on the insolvency of HKSCC. The FAQs note that as HKSCC is only the nominee holder of SSE Securities acquired by Hong Kong and overseas investors, such SSE Securities will not be regarded as the general assets of HKSCC under Hong Kong and Mainland China law and will not be available to the general creditors of HKSCC on its insolvency.

It is further noted in the FAQs that as a company incorporated in Hong Kong, any bankruptcy proceedings against HKSCC will be initiated in Hong Kong and any claims against HKSCC will be determined as a matter of Hong Kong law and that in that event, ChinaClear and the People's courts will recognize the liquidator of HKSCC as the entity having the power to deal with SSE Securities in the place of HKSCC.

Non-Trade Transfers

Under Article 11 of the CSRC Stock Connect Rules, transfers of SSE Securities should only be conducted on the SSE and off-exchange trading is not allowed unless otherwise permitted. The FAQs have clarified the scope of the exceptions to this general rule, as set out in the implementation rules of ChinaClear and SSE.

ChinaClear in its rules has clarified that non-trade transfers are permitted in certain prescribed situations which include succession, divorce, company dissolution or winding up, donations to charitable foundations and assistance in enforcement by court or law enforcement agencies.

The SSE has provided in its rules (Article 29 of the SSE Stock Connect Pilot Provisions) that the following types of off-exchange or "non-trade" transfer of SSE Securities are allowed:

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[3] *Article 18, the Administrative Measures for Registration and Settlement of Securities, the "**Settlement Measures**".*

[4] Article 13, CSRC Stock Connect Rules.

(a) Stock borrowing and lending for covered short selling purpose (not more than one month duration);

(b) Stock borrowing and lending for the purpose of satisfying the pre-trade checking requirement (one-day duration which cannot be rolled over);

(c) transfers between exchange participants and their clients for the purpose of rectifying error trades;

(d) post-trade allocation of shares to different funds/sub-funds by fund managers; and

(e) other situations specified by SSE and ChinaClear.

The SSE rules have importantly now also clarified that a "non-trade transfer" of SSE shares involves a change in beneficial ownership of those SSE shares. As such, an act which does not involve a transfer of beneficial ownership will not constitute a non-trade transfer. A security arrangement that does not involve a change in beneficial ownership of SSE Securities such as a charge or assignment by way of security where the SSE Securities remain in this securities account of the chargor will not constitute a "non-trade transfer" and accordingly will not come within the prohibition of Article 11 of the CSRC Stock Connect Rules.

Stock Borrowing and Lending

The FAQs confirm that stock borrowing and lending of SSE Securities will be allowed:

(a) for covered short selling: an investor borrows SSE Securities and sells it on SSE through an exchange participant via Northbound trading; and

(b) for meeting the pre-trade checking requirement in certain circumstances (such as where an exchange participant client has been unable to effect a transfer of shares to the exchange participant clearing account in time to meet the pre-trade checking requirement).

Stock borrowing and lending in SSE Securities will be subject to restrictions set by SSE to be incorporated into the rules of SEHK. These include:

(a) Stock borrowing and lending agreements for covered short selling purpose cannot be longer than one month;

(b) Stock borrowing and lending agreements for pre-trade checking purpose cannot be longer than one day (roll-over not allowed);

(c) Stock lending will be restricted to certain types of persons to be determined by SSE; and

(d) Stock borrowing and lending activities will be required to be reported to SEHK.

Margin Trading

Although the taking of security over SSE Securities will not constitute a non-trade transfer as there is no change in beneficial ownership, there are limitations on margin trading of SSE securities as there are strict laws and regulations in China which prohibit lending and fundraising activities for the purposes of purchasing stock except in limited circumstances.

The FAQs however provide that subject to conditions, margin trading in SSE Securities via Stock Connect may be conducted in accordance with requirements set by SSE and amendments to the rules of the SEHK in due course.

Currently investors in China can only conduct margin trading in certain A shares that the SSE has determined are eligible for margin trading and stock borrowing and lending. Investors conducting margin trading in SSE Securities via Stock Connect will be subject to a similar restriction. An Eligible SSE Securities List for Margin Trading, the scope of which will be determined by SSE from time to time, will be posted on the HKEx website for reference.

The SSE may also suspend margin trading activities in specific A shares when the volume of margin trading activities in such A shares exceeds the threshold determined by SSE and resume margin trading activities when the volume drops below a prescribed threshold. When SEHK is notified by SSE that such suspension and resumption involves an SSE Security on the Eligible SSE Securities List for Margin Trading, exchange participants and investors will be informed through the HKEx website. Margin trading in the relevant SSE Security will be suspended/resumed in Hong Kong accordingly.

Covered Short Selling

In a very positive development the FAQs provide that covered short selling will be permitted subject to a number of requirements set by SSE.

These requirements include:

(a) the eligibility of SSE Securities that can be short sold;
(b) flagging of short selling orders by exchange participants when inputting them into the system;
(c) the input price of a short selling order must not be lower than the last traded price (and in the absence of the last traded price, the previous closing price), of the relevant SSE Security;
(d) in respect of each SSE Security, restrictions will be imposed on (i) the total quantity that can be short sold on each trading day, and (ii) for a rolling period;
(e) reporting of open short positions; and

(f) according to the relevant rules of SSE, SSE may suspend short selling activities in specific A shares when the volume of short selling activities in such A shares exceeds the threshold determined by SSE and resume short selling activities when the volume drops below a prescribed threshold. When SEHK is notified by SSE that such suspension and resumption involves an SSE Security on the Eligible SSE Securities List for Short Selling, exchange participants and investors will be informed through the HKEx website, and short selling in the relevant SSE Security should be suspended/resumed in Hong Kong accordingly.

The FAQs state that covered short selling of SSE Securities will unlikely be available at the initial launch of Stock Connect and that SEHK will keep the market informed of developments and proposed timing of implementation.

Taxation

Under existing tax law in China, a 10% tax is normally levied on unrealized and realized capital gains. Historically China has not enforced this tax on investments under the QFII or RQFII programmes, although most participants in these programs make withholding tax provisions for this.

HKEx has stated at a recent event hosted by the Irish Funds Industry Association in Hong Kong that they expect that an announcement will be made in respect of tax prior to the launch of Stock Connect. HKEX indicated that it was working on a proposal whereby an exemption period would be announced which would enable the Chinese tax authorities to finalise their view on whether to impose tax on unrealized and realized capital gains made in relation to SSE Securities acquired under Stock Connect. Once that determination had been made, a second exemption period from tax would begin in order to give market participants a period in which to implement the systems necessary to comply with the relevant ruling from the Chinese tax authorities. In the event that it is decided to impose tax HKEx stated that such tax would be imposed from the end of the second exemption period and would not be retrospective. We look forward to formal clarification of this position.

Extension of Stock Connect to Shenzhen

While there is no indication of timing with respect to any extension of Stock Connect to Shenzhen, it has been reported recently that the Chinese authorities are prepared to permit Shenzhen and Hong Kong to explore how they can increase co-operation based on the experience of Stock Connect. As the home to the ChiNext board (China's NASDAQ type market for high-tech firms), Shenzhen is likely to be an attractive market to international investors. Should this development proceed it would certainly add to the appeal of Stock Connect for Funds.

Practical Next Steps

For promoters and investment managers of Irish regulated funds who intend participating in Stock Connect there are a number of practical issues to be considered:

1. Funds will need to discuss with their custodian at an early stage whether the custodian can offer access to Stock Connect. Some custodians have developed specific product offerings for Stock Connect which seek to address the concerns raised about custody of assets where shares were required to be moved to the relevant broker on T-1. Custodians who are clearing members of the SEHK are in a position to provide the SEHK with the relevant visibility on their stock holdings without moving the shares to the broker on T-1. We understand that certain custodians who are not clearing members of the SEHK are also developing solutions. In all cases our advice is to contact your custodian at an early stage of the process to understand their product offering.

2. Based on responses to submissions which we have recently made on behalf of various clients to the Central Bank, Funds can expect that the Central Bank will request that custodians confirm that assets which are acquired pursuant to Stock Connect are held in accordance with the custody requirements imposed on UCITS. This is something that should be raised at the initial discussions with your custodian as it will almost certainly be something that is required by the Central Bank as part of the process to approve any changes to the Fund's prospectus.

3. Funds will also need to review the relevant prospectus or supplement to assess what, if any, changes are required to be made to a funds investment objective and policy. The result of that review will determine whether shareholders in the relevant fund are required to be notified of any change to the investment policy or whether shareholder consent is required for any proposed changes.

4. In addition to potential changes to a funds investment objective or policy, consideration will need to be given to the additional disclosures which will be required to be inserted into the prospectus to provide investors with detail on Stock Connect.

5. As well as additional disclosures on Stock Connect, managers will need to consider the nature and extent of additional risk disclosures to be inserted in the prospectus or relevant supplement. On the specific issue of tax disclosures managers should be aware that such disclosure will be require to be signed off by local tax counsel and managers should be addressing tax disclosures with their tax advisers as early as possible in the process.

6. Funds will need to also be aware of the disclosure of interest rules in China, the short swing profit rules and foreign ownership limits.

7. If Funds are registered in numerous jurisdictions, advice on the impact of the proposed changes to accommodate Stock Connect should be sought from local counsel. For example, funds registered in Taiwan may only acquire up to 10% NAV in China A Shares.

8. The costs associated with participating in Stock Connect and the timing required to amend Fund documentation, execute required agreements and obtain the approval of the Central Bank to any such changes will vary depending on the facts of each case, however, Funds seeking to participate in Stock Connect at an early stage should be actively engaging with their custodians and lawyers as soon as is possible.

Conclusion

The Stock Connect programme is generating huge anticipation in Hong Kong and further afield and we are seeing a lot of Funds updating their documentation to enable them to participate in the Stock Connect. It will provide another option to Funds and will sit alongside the existing QFII and RQFII schemes (Appendix 1 contains a comparison of the main provisions of the three schemes) as a way to directly access China A Shares. Indeed for certain managers such as hedge fund managers it will provide the first opportunity to acquire China A Shares directly.

Dillon Eustace is actively assisting its clients in preparing for the launch of Stock Connect and we would be delighted to speak with managers who are considering participating in Stock Connect to provide further insight and assistance.

APPENDIX 1

COMPARISION BETWEEN QFII SCHEME, RQFII SCHEME and STOCK CONNECT

Criteria	QFII	RQFII	STOCK CONNECT
Eligible institutions	Fund managers, securities companies, commercial banks and Other institutional investors (such as pension funds, charitable foundations, endowments, trust companies, sovereign wealth funds, etc.) subject to satisfying certain track record, P&L and balance sheet requirements.	The below are the new requirements under the amended RQFII scheme. Hong Kong based subsidiaries of fund management companies and securities companies incorporated in Mainland China have been eligible to apply for RQFII quota since the scheme's inception in 2011. Applicants must: (i) have a Type 9 (asset management) licence from the SFC and conduct asset management business; (ii) be in a stable financial condition and have a good credit standing; (iii) have an effective corporate governance and internal control system, and its relevant professionals must satisfy the relevant eligibility requirements applicable under local law;	All accredited Hong Kong and overseas investors investing via Hong Kong based brokers and custodians. Investors in China who are seeking to access the Southbound Trading Link are subject to certain requirements.

		(iv) not have had any material penalty imposed by the relevant local regulator since its establishment (if it has a track record period of less than three years) or in the last three years; and (v) satisfy such other requirements of CSRC as it may stipulate in accordance with the principle of prudential regulation.	
Currency of funds to be remitted into and outside China	US dollar, UK pound, Japanese yen, HK dollar and Euro.	RMB (repatriation can be in a freely exchangeable foreign currency).	RMB
Maximum quota available to each applicant	US $1 billion save for sovereign funds, central banks and monetary authorities.	No maximum quota.	The Northbound aggregate quota is set at RMB 300 billion. The Southbound aggregate quota is set at RMB 250 billion. The Northbound daily quota is set at RMB 13 billon, while the Southbound daily quota is set at RMB 10.5bn.
Permissible Investments	Scope of permissible investments: • Shares, bonds and warrants listed or transferred on stock exchange;	Same as QFII	All constituent stocks of the SSE 180 Index and SSE 380 Index and all SSE listed A shares that are not included as constituent stocks of the relevant indices which have corresponding H

	• Fixed-income products traded in the inter-bank bond market; • Securities investment funds; • Stock index futures; and • Other financial instruments permitted by CSRC.		shares listed on SEHK, except the following: (a) SSE listed shares, which are not traded in RMB; and (b) SSE listed shares which are included in the "risk alert board." B Shares, exchange traded funds, bonds and other securities will not be included initially.
Deadline for remittance of investment principal	The investment principal must be remitted within six months after the quota is obtained from SAFE. The minimum amount to be remitted is US $20 million.	Save for open-ended funds, the investment principal must be remitted within six months after obtaining the quota from SAFE. For open-ended funds, the quota must be "effectively utilised" within one year after being granted by SAFE. No minimum amount is specified.	Daily liquidity. Trade settlement subject to quota being available.
Lock-up period	Three months for Long-Term Funds and Open-end China Funds. One year for Other Funds.	None for open-ended funds. For all other funds one year following (i) the date on which the investment principal is fully remitted into Mainland China, or (ii) if the investment	Daily liquidity.

		principal has not been fully remitted into Mainland China within one year following the date on which the RQFII quota is granted, the expiry date of such one year.	
Repatriation of funds	Weekly liquidity for Open-end China Funds based on net subscription or redemption. Monthly liquidity for Long-Term Funds and Other Funds. There is a monthly net repatriation cap, being 20% of the total onshore assets of a QFII or fund (in case of Open-end China Funds) as of the end of the preceding year.	Daily liquidity for open-ended funds based on net subscription or redemption. Monthly liquidity for other funds.	Daily liquidity.
Repatriating investment principal	SAFE approval is required (except for Open-end China Funds). Investment quota will be reduced accordingly except for Open-end China Funds.	No SAFE approval is required. Investment quota will be reduced accordingly except for open-ended funds.	Daily liquidity.

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