

## Shanghai-Hong Kong Stock Connect: Further Clarifications of the Stock Connect Rules

On 26 September, 2014, Shanghai Stock Exchange (“**SSE**”) and China Securities Depository and Clearing Corporations Limited (“**ChinaClear**”) promulgated detailed rules to implement stock trading under the Shanghai-Hong Kong Stock Connect (“**Stock Connect**”). On the same day, the Hong Kong Exchange and Clearing Limited (“**HKEx**”) published a number of approved amendments to its rules and FAQs to clarify certain key aspects of the Stock Connect programme.

The approved amendments to trading rules and clearing rules and revised FAQs for investors and market participants can be found on the HKEx website.<sup>1</sup>

Market participants would be pleased to know that welcome clarifications have been provided in a number of key areas.

### Beneficial Ownership in SSE Shares

Stock Connect comprises the Northbound link, through which Hong Kong and overseas investors may purchase and hold A shares listed on the SSE (“**SSE Shares**”), and the Southbound link, through which investors in Mainland China may purchase and hold shares listed on the Stock Exchange of Hong Kong (“**SEHK**”).

Hong Kong and overseas investors trade SSE Shares through their brokers who are SEHK exchange participants (“**EPs**”). These SSE Shares will be held following settlement by brokers or custodians as clearing participants (“**CPs**”) in accounts in the Hong Kong Central Clearing and Settlement System (“**CCASS**”) maintained by Hong Kong Securities and Clearing Corporation Limited (“**HKSCC**”) as central securities depository in Hong Kong. HKSCC in turn holds SSE Shares of all its participants through an omnibus securities account in its name registered with ChinaClear, the central securities depository in Mainland China.

A major question that market participants are concerned with is whether investors have beneficial ownership of SSE Shares. We previously discussed

### Contents

Beneficial Ownership in SSE Shares .....	1
Non-trade Transfers .....	2
Margin Trading.....	3
Stock Borrowing and Lending .....	4
Covered Short Selling.....	5
Synthetic Short .....	6
Conclusion .....	6

<sup>1</sup> [http://www.hkex.com.hk/eng/market/sec\\_tradinfra/chinaconnect/chinaconnect.htm](http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/chinaconnect.htm)

in our earlier [Bulletin](#) whether Hong Kong and overseas investors would have a proprietary interest in SSE Shares under Hong Kong law and Mainland China law. We concluded that, under Hong Kong law, the proprietary interest of investors in shares held for them by their broker or custodian in CCASS will be recognised, and that Mainland China law recognises both the concepts of “nominee holder” and “beneficial owner”. This has been reinforced in the FAQs, which discusses both concepts at length.

Thus, the regulatory intention is clear that Hong Kong and overseas investors are to have proprietary rights over SSE Shares as beneficial owners under Mainland China law. Pursuant to the ChinaClear Securities Registration Rules, such beneficial owners are to exercise the rights of shareholders, including the right to receive dividends and vote, through HKSCC as the nominee holder. The newly released FAQs confirm that HKSCC will be responsible for collecting and distributing dividends to EPs, obtaining and consolidating voting instructions from EPs, and submitting a combined single voting instruction to the issuer of relevant SSE Shares.

It thus follows that, because HKSCC is only a nominee holder and not the beneficial owner of SSE Shares, in the unlikely event that HKSCC becomes subject to winding up proceedings in Hong Kong, SSE Shares will not be regarded as part of the general assets of HKSCC available for distribution to creditors even under Mainland China law.

The FAQs also state that under the CCASS Rules, HKSCC will not be obliged to take any legal action or enter into court proceedings to enforce any rights on behalf of investors in SSE Shares in Mainland China. This is indeed consistent with the general practice of a central securities depository, whose function is to safe-keep securities and attend to administrative aspects of safekeeping rather than to be involved in private dispute by taking legal action on behalf of investors. This notwithstanding, it should be noted that as a ‘recognized clearing house’ under the Securities and Futures Ordinance (Cap. 571) (the “SFO”), HKSCC has certain statutory duties owed to the public. To this end, it is possible that, in circumstances where the public interest so warrants, HKSCC will be expected to take appropriate actions and this may include taking legal action in Mainland China on behalf of Hong Kong and overseas investors to enforce rights in respect of SSE Shares.

## Non-trade Transfers

In Mainland China, as a general rule, all transfers of shares must take place on a stock exchange. Article 11 of the Stock Connect Rules provides that no off-exchange transfers (or ‘non-trade transfers’) of SSE Shares are permitted unless otherwise stipulated by the CSRC. The FAQs clarify the scope of the various exceptions to this general rule as set out in the implementation rules of ChinaClear and SSE.

Firstly, ChinaClear has provided in its rules that non-trade transfers in certain limited circumstances would not be prohibited. Such circumstances include succession, divorce, company dissolution or winding up, donations to

charitable foundations and assistance in enforcement by court or law enforcement agencies.

In addition, SSE has also provided in its rules that certain types of non-trade transfers would be permissible:

- *Stock borrowing and lending for the purposes of covered short selling.* This allows an investor to borrow SSE Shares from an EP and sell such securities on Stock Connect via that EP. The maximum duration of the loan is one month. The rule is silent as to whether the loan can be rolled over.
- *Stock borrowing and lending for the purposes of satisfying pre-trade checking requirements.* If an EP's client has been unable to satisfy the pre-trade checking requirement, this allows an EP to lend the investor SSE Shares. The maximum duration of the loan is one day, and the loan cannot be rolled over.
- *Transfers between EPs and clients for the purposes of rectifying error trades.* The EP must make an error trade report and provide supporting documents.
- *Post-trade allocation of shares to different sub-funds or funds by a fund manager.* This will allow a manager to purchase SSE Shares with a particular fund allocation in mind and to perform the actual allocation post-trade.

All these relaxations will be welcomed by market participants as they will greatly facilitate the conduct of Northbound trading and the normal course of business operations.

Another significant point to note is that SSE rules have now made it clear that a 'non-trade transfer' of SSE Shares involves a change in 'beneficial ownership' of such SSE Shares. Accordingly, an act that does not involve a transfer of beneficial ownership will not constitute a non-trade transfer. To this end, as mentioned in our earlier [Bulletin](#), a security arrangement that does not involve a change in beneficial ownership of SSE Shares – such as a charge or assignment by way of security where the SSE Shares remain in the securities account of the chargor with the custodian bank/broker as chargee - will not constitute a 'non-trade transfer' and hence will not fall within the prohibition of Article 11 of the Stock Connect Rules. This is a welcome clarification on the meaning and scope of non-trade transfers.

## Margin Trading

Even though taking security over SSE Shares will not constitute a non-trade transfer (since there is no change in beneficial ownership), there are nevertheless limitations on margin trading of SSE Shares. Under SSE rules, margin trading refers to the purchase of securities by an investor using funds provided by a lender, where the investor grants security over securities owned by it to secure its repayment obligations to the lender.

In Mainland China, there are strict laws and regulations prohibiting lending and fund raising activities for the purposes of purchasing stock except in the limited circumstances permitted under the onshore margin trading and securities lending programme. However, neither such general prohibition against lending to buy stock nor the onshore margin trading programme apply to the trading of SSE Shares through Stock Connect.

Notwithstanding this, the SSE rules now provide that margin trading in SSE Shares through Stock Connect may be conducted, subject to certain requirements under SSE rules and the relevant SEHK Rules. To this end, in line with the onshore margin trading regime, margin trading of SSE Shares via Stock Connect will only be permitted in respect of certain eligible SSE Shares, the list of which will be determined by SSE from time to time, and which will be posted on the HKEx website for reference by the investing public. In addition, SSE rules also provide that SSE may suspend margin trading activities in specific SSE Shares when the volume of margin trading activities in such SSE Shares exceeds the threshold determined by SSE, and resume margin trading activities when the volume drops below a prescribed threshold.

The scope of the relevant SSE rules seem to be drafted widely to cover any margin trading conducted by Stock Connect investors in the Hong Kong market. However, the requirements for margin trading of SSE Shares via Stock Connect will be implemented by way of the SEHK Rules, which in principle only binds EPs. Thus there are questions as to whether and if so how SSE's margin trading requirements would apply in practice to margin trading where the lender is not an EP.

Unlike Mainland China, in Hong Kong there are no laws or regulations specifically prohibiting margin trading, so in principle banks and financial institutions are free to lend to investors for the purposes of buying stock and take collateral accordingly to secure such loans. However, to implement SSE's rules on margin trading, it would appear that SEHK would be required to impose restrictions on EPs by requiring margin trading to be limited to the list of SSE Shares approved by SSE and associated reporting on such margin trading by EPs. On its face, this appears to be a somewhat odd result since such restrictions would only apply to EPs but not to banks and financial institutions which are not EPs. It would be preferable if such restrictions are not imposed on EPs at all given the fundamental differences in the margin trading framework between Hong Kong and Mainland China. However, one can also see why SSE may wish to limit the discrepancy in treatment between exchange participants onshore and EPs in Hong Kong by applying similar margin trading restrictions to both onshore and Hong Kong exchange participants.

## **Stock Borrowing and Lending**

Consistent with the amendments allowing for additional forms of non-trade transfers, SSE rules and the FAQs now indicate that stock borrowing and

lending (“SBL”) of SSE Shares through Stock Connect will be permitted subject to certain limitations:

- SBL may only be conducted either to cover a short sale of SSE Shares (discussed below) or to help satisfy the pre-trade checking requirement.
- SBL transactions for covered short sales may not be longer than one month. SBL transactions for compliance with the pre-trade checking requirement may only be for one day and may not be rolled over.
- SBL activity will be subject to a reporting requirement.

Based on the SSE rules and the nature of the non-trade transfer exemptions discussed above, it would seem that any investors would be eligible to borrow stock. However, who could be the stock lenders? The current practice in Mainland China, and as reflected in the SSE rules, is for exchange participants themselves to provide stock loans. It remains to be seen how this would be implemented in Hong Kong, where stock lending by an investment bank is often arranged by an affiliate rather than the EP itself. It would also be interesting to see if Schedule 6 of the SEHK Rules which currently imposes certain collateralisation and other requirements on stock lending conducted by EPs would be applicable in the context of SSE Shares through Stock Connect.

In addition, the extent to which Mainland tax authorities will provide stamp duty relief (if any) to stock lending and borrowing activities, and what requirements may be involved to qualify for such relief, is another area that remains to be clarified.

## Covered Short Selling

It is welcome news that investors will in due course be able to engage in covered short selling of SSE Shares through Stock Connect. In lieu of the SFO requirements on documentary assurance on short selling, it would appear that SEHK will impose certain requirements on short selling through Stock Connect in order to implement the requirements under the SSE rules, including:

- a limitation on the list of SSE Shares which can be sold short;
- an uptick rule;
- flagging of short selling orders by EPs and reporting of open shorts;
- restrictions on the volume of short selling, both on a daily and rolling basis, with the possibility that the SSE may suspend short selling if these thresholds are exceeded.

It should be noted that even if the SFO rules on short selling do not apply to SSE Shares through Stock Connect, Mainland China law will still operate to prohibit naked short selling. In particular, a naked short sale would also be a prohibited ‘non-trade transfer’ in violation of Article 11 and (subject to facts)

other securities trading offences, potentially exposing the investor to criminal and other liability.

Future amendments to the SEHK Rules will provide further details on the scope of permissible short selling and associated requirements. The FAQs indicate that short selling over SSE Share will not be available upon the Stock Connect's launch to allow time for development of appropriate system infrastructure.

## **Synthetic Short**

In light of the proposed stock borrowing and covered short selling rules, it has been raised whether dealers can offer OTC synthetic short or bearish derivative products over SSE Shares held through Stock Connect to their clients transactions.

Up until now, dealers have generally been wary of offering synthetic shorts over SSE Shares because of the risk that regulators in Mainland China could view such transactions unfavourably (and that this could have an adverse knock on effect on the dealers' QFII and RQFII quota). In addition, dealers have not been able to hedge these products effectively since they have no access to the onshore stock borrowing and covered short selling programme.

Given that trading in Stock Connect does not involve any specific quota given to the dealer and there will soon be covered short selling activity which could be undertaken, dealers will have to consider afresh the legal and regulatory risks of potentially offering synthetic short or bearish products over SSE Shares through Stock Connect.

## **Conclusion**

The FAQs and the amendments to the Stock Connect Rules provide the Hong Kong market with the much welcome clarifications at a time when market participants are busy gearing up for the launch of Stock Connect. In particular, the clarifications on non-trade transfer and the proposed margin trading, stock borrowing and covered short selling rules represent a significant effort by HKEx, SSE and the parties concerned to provide a framework for the trading of SSE Shares that not only takes into account both the more liberal existing market conditions in Hong Kong and the more regulated market conditions in Mainland China, but also seeks to achieve a compromise that provides an appropriate level of checks and balances for the relevant activities in light of the special features of each market.

It is hoped that all parties concerned and market participants work together to ensure a smooth and orderly trading of SSE Shares through Stock Connect following its launch. A smooth and orderly launch of Stock Connect will no doubt facilitate further liberalisation in later phases of the Stock Connect scheme and bring about other beneficial market access opportunities between Hong Kong and Mainland China.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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