Market participants in the Hong Kong market eagerly await what will be one of the most major developments in the equity market: the October launch of Shanghai-Hong Kong Stock Connect ("Stock Connect"), a pilot programme to enable investors in Mainland China and Hong Kong, through their local securities brokers, to place orders to trade eligible shares listed on the stock exchange of the other side. This follows from the joint announcement by the Securities and Futures Commission ("SFC") and the China Securities Regulatory Commission ("CSRC") on 10 April 2014 and the subsequent signing of a four party agreement on 4 September 2014 by the Stock Exchange of Hong Kong Limited ("SEHK"), Hong Kong Securities Clearing Company Limited ("HKSCC"), wholly-owned subsidiaries of Hong Kong Exchanges and Clearing Limited ("HKEx"), the Shanghai Stock Exchange ("SSE") and China Securities Depository and Clearing Corporation Limited ("ChinaClear").

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 SEHK.

SSE Shares eligible to be traded through the Northbound link will comprise almost all the constituents of the SSE 180 Index and SSE 380 Index, and shares of virtually all SSE-listed companies which have issued both A shares and H shares.

This bulletin focuses on the Northbound link and highlights the frequently asked legal questions from investors and brokers when trading and holding SSE Shares. Other information on Stock Connect for investors and participants (including the draft amendments to the SEHK trading rules and CCASS rules) can be found on the HKEx website.¹


Shanghai-Hong Kong Stock Connect
Do investors have proprietary rights in SSE Shares?

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

The position with respect to SSE Shares under Hong Kong law will be as for Hong Kong shares, namely that Hong Kong law recognises the proprietary interest of investors in shares held for them by their broker or custodian in CCASS. This follows from the decision in CA Pacific Finance Limited, which established that a broker holds securities held in CCASS on trust for its clients who have proprietary rights in those securities.

However, given that SSE Shares are located in Mainland China, a prudent Hong Kong or overseas investor will also wish to know what the equivalent position is on proprietary rights over SSE Shares under Mainland China law.

In Mainland China, shares are normally registered in a securities account opened with ChinaClear in the name of the securities holder. ChinaClear typically opens individualised securities account for each investor in Mainland China. However, the concept of a ‘nominee holder’ is well recognised: in certain circumstances, a securities account may be opened in the name of a nominee holder. The investors for whose benefit the nominee holder is holding the securities are recognised as ‘beneficial owners’.

In relation to SSE Shares, the SSE Shares acquired by investors through Northbound transactions are registered with ChinaClear in an omnibus securities account in the name of HKSCC. The CSRC has expressly stipulated in the Several Provisions on the Pilot Program of Shanghai-Hong Kong Stock Market Connect (the “Stock Connect Rules”) that HKSCC acts as the ‘nominee holder’ of the SSE Shares, whereas Hong Kong and overseas investors will ‘enjoy the rights and interests in such SSE Shares’. This division would correspond to the concepts of ‘nominee holder’ and ‘beneficial owner’ already embedded in existing CSRC regulations.

Accordingly, the regulatory intention is reasonably clear that Hong Kong and overseas investors are to have proprietary rights over SSE Shares as beneficial owners under Mainland China law. Such beneficial owners are to exercise the rights of shareholders, including the right to receive dividends and vote, through HKSCC as the nominee holder.

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

---

3 See articles 7 and 13 respectively of the Stock Connect Rules.
4 See article 18 of the Administrative Measures for Registration and Settlement of Securities. Shanghai-Hong Kong Stock Connect
regarded as part of the general assets of HKSCC available for distribution to creditors.

**Can investors use SSE Shares as collateral or borrow SSE Shares?**

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.

Certain non-trade transfers are expressly permitted under Article 11. These are non-trade transfers in connection with inheritance, divorce, donation, corporate dissolution or assistance with judicial enforcement. However, the granting of a security interest and the borrowing and lending of shares are not included in that list, raising the question of whether such activities over SSE Shares would be prohibited by Article 11.

There are strong arguments that an arrangement that does not involve a transfer of shares from one securities account to another (and a change in beneficial ownership) should not constitute a transfer in contravention of Article 11. If we take this approach, a security arrangement in the form of a charge and assignment by way of security, where the SSE Shares remain in the securities account in the name of the charger with to the custodian bank/broker as chargee, should not be subject to the prohibition in Article 11. This seems to be in line with the position in Mainland China, where the creation of an on-shore pledge over listed securities in the investor’s account in ChinaClear will not constitute a transfer and is expressly permitted under Mainland China law.

Notwithstanding this however, the use of shares as collateral security for margin trading is only permitted in Mainland China in the limited circumstances set out in the Mainland’s rules on margin trading and stock lending and borrowing. Such rules are not applicable in respect of SSE Shares under Stock Connect and so it is possible that SSE and CSRC may prescribe restrictions and conditions for using SSE Shares as collateral for margin trading in Hong Kong under Stock Connect.

In contrast to charge or assignment as discussed above, title transfer collateral arrangements over SSE Shares clearly do involve a transfer of ownership in the SSE Shares to the collateral taker and would appear to contravene Article 11 unless exempted by the CSRC.

Stock borrowing and lending is also not in the list of permitted transfers and thus it would seem that stock borrowing and lending arrangements (as they involve transfers of ownership in the SSE Shares) are also not possible in respect of SSE Shares unless exempted by the CSRC. However, there are indications in the press that SSE may be open to considering margin trading and for stock borrowing and lending under the Stock Connect regime, and the

---

5. It would appear that enforcement of security arrangements must take place by means on off-exchange transfers only.
6. Such as in the form of ISDA Credit Support Annex (English law – transfer)
Shanghai-Hong Kong Stock Connect
market is hopeful that similar rules will be published in respect of Stock Connect soon to provide clarity on this point.

**How will the pre-trade checking requirement be complied with?**

In Mainland China, prior to each sale of shares, SSE will conduct pre-trade checking of buy and sell orders for SSE Shares to ensure that there are sufficient funds and sufficient securities, as applicable, in the applicable account of the investor. The policy objective of this pre-trade checking requirement for sell orders is to prevent over-selling of securities by investors. The rule is relatively straightforward to implement in Mainland China because securities accounts are held directly in the names of individual investors.

A similar requirement applies to sales of SSE Shares through Stock Connect, albeit adapted to a multi-tier holding structure. It is proposed in the SEHK trading rules that there will be two levels of pre-trade checks: SEHK or the wholly-owned subsidiary of SEHK will conduct pre-trade checks over the relevant EP’s designated CCASS account, and in turn, Hong Kong EPs will also conduct pre-trade checks in respect its clients.

However, there remain some uncertainties in practice as to how pre-trade checking will apply to SSE Shares. For example, should fund managers conduct pre-trade checks at the fund level or the fund manager level? In Mainland China, each fund has own securities account so pre-trade checking can easily be conducted at fund level; however, this is less straightforward in Hong Kong. Given existing Mainland China market practice, pending further clarification by regulators, the more conservative approach may be to conduct pre-trade checks at the fund level.

In addition, an investor needs to ensure that the relevant SSE Shares are in the designated CCASS account of its broker before commencement of trading (by 7:45am) on the trade date. Fund clients may want to check that their fund policy or terms and conditions allow such transfer of assets out of the fund custody account prior to trading. Other clients with multiple brokers may find that they will need to select a broker to carry out the relevant trade in advance, so as to ensure that relevant shares are transferred to the applicable broker’s CCASS account in time for the trade.

**Will Hong Kong market participants and investors be subject to Mainland China laws and regulations?**

A fundamental principle of Stock Connect is that ‘home market rules’, that is the laws and rules of the home market of the applicable securities, shall apply to investors in such securities. In respect of SSE Shares, Mainland China is the home market and thus the general principle is that investors in SSE Shares should observe Mainland securities regulations. Nevertheless certain Hong Kong requirements will also continue to apply. We highlight in this section an overview of the key securities regulations under both Mainland China and Hong Kong laws that may be applicable to investors in SSE Shares.
Regulations applicable to Northbound Trades

<table>
<thead>
<tr>
<th>Subject</th>
<th>Mainland China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosure of interest*</td>
<td>✓</td>
<td>x*7</td>
</tr>
<tr>
<td>Short swing rule</td>
<td>✓</td>
<td>x</td>
</tr>
<tr>
<td>Foreign ownership limit</td>
<td>✓</td>
<td>x</td>
</tr>
<tr>
<td>Insider dealing</td>
<td>✓</td>
<td>x</td>
</tr>
<tr>
<td>Market Manipulation</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Stock Borrowing/short selling</td>
<td>✓</td>
<td>?*8</td>
</tr>
<tr>
<td>Contract note rules</td>
<td>x</td>
<td>✓</td>
</tr>
<tr>
<td>Record Keeping</td>
<td>x*9</td>
<td>✓</td>
</tr>
<tr>
<td>Code of Conduct rules</td>
<td>x</td>
<td>✓</td>
</tr>
<tr>
<td>Client Money rules</td>
<td>x</td>
<td>✓</td>
</tr>
<tr>
<td>Client Securities rules</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

**Mainland China law**

**Disclosure of interests:** Under Mainland China law, an investor is obliged to disclose its interest in a SSE listed issuer within 3 days of its interest reaching (or falling below) 5% of the total issued shares of such listed issuer. Such investor shall not trade in SSE Shares within the 3-day period until disclosure has been made. Every subsequent increase or decrease in the investor’s holding by 5% will also trigger a disclosure obligation along with an obligation on the investor not trade in shares until 2 days after the disclosure has been made.

Both the person in whose name the SSE Shares are registered as well as the person who has ‘actual control’ over voting rights of the securities have disclosure obligations. The ‘actual control’ test is satisfied by considering the individual holding of an investor, or, as applicable, by aggregating the holding of other parties ‘acting in concert’ with such investor.

For the purpose of determining whether such 5% test has been reached, all the interests (including A shares, B Shares, H Shares as well as other classes of shares) in such issuer held by the investor shall be included.

**Short swing rule:** Under Mainland China’s Securities Law, if a director, supervisor, senior management personnel, or a person holding 5% or more shares of a listed issuer sells (or buys) shares and makes a profit (a ‘short-

---

* Except for shares dual-listed in Shanghai and Hong Kong for which no exemption has been granted.
* Query whether the sale of SSE Shares are considered to be ‘at or through’ SEHK so that Hong Kong short selling requirements would become applicable.
* Note that the SEHK rules impose additional recordkeeping requirements on exchange participants to comply with Mainland China rules. For example, Mainland China’s 20-year record retention requirement will be passed on by the SEHK Rule 14A.13.
swing profit’) within 6 months of the acquisition (or sale), such a person shall disgorge the profit to the issuer. In determining whether an investor holds 5% or more shares, both SSE Shares and A shares obtained through any other channels (such as QFII and RQFII) and B shares will be aggregated. Nevertheless, clarification may be needed as to whether H shares held by an investor in a A+H listed issuer would also be subject to aggregation for the purposes of the short swing rule.

Foreign ownership limits: The Stock Connect Rules provide that certain foreign ownership limits apply to Mainland China shares. All the shares held by a single offshore investor shall not be more than 10% of the total issued shares of a SSE listed issuer and all the A shares held by offshore investors together shall not be more than 30% of the total issued shares of a SSE listed issuer. In addition, if there is a more stringent limitation applicable to that issuer (e.g., in respect of interests in listed financial institutions such as banks and insurance companies) under existing Mainland China law, then the more stringent limitation shall apply. In determining whether such limits have been reached, all of the investor’s interest in SSE Shares of a SSE listed issuer will be aggregated with shares in that listed issuer obtained through any other channels (such as QFII or RQFII but excluding strategic investment).

Market manipulation: The scope of market manipulation is prescribed by the Securities Law and applicable guidelines issued by the CSRC. For an activity to be market manipulation, an investor must have an intention to manipulate the market and the activity in question must have resulted (or potentially result) in abnormal or hypothetical prices or trading volumes. Note that because the Stock Connect will be authorized by the SFC as an automated trading service, the Hong Kong market manipulation rules will also apply to activities conducted through it.

Insider dealing: Under Mainland China law, insider dealing occurs when an insider, using inside information, trades in securities, divulges insider information to others, or procures others to trade in securities.

The term ‘insider’ is widely defined under Mainland China law and includes every type of individual or entity that might have access to inside information. Examples of insiders include directors, senior management, shareholders who holds 5% or more in a listed issuer (including directors and senior management of such shareholder) and service providers to the listed issuer, for example, sponsors, underwriters, exchanges, registrars and clearing institutions. On the other hand, ‘inside information’ includes any non-public information relating to the operation or financial status of a listed issuer or that has a has material impact on the price of shares.

Although the concept of insider dealing in Mainland China is largely similar to Hong Kong and other jurisdictions, the wording and implementation of the legislation may mean that Mainland China rules could reach a different result in certain situations. While Mainland China law provides certain defences for insider dealing, it is noteworthy that such defences appear narrower than under the comparable insider dealing offence in Hong Kong. For example, there is no express ‘Chinese wall’ defence.
**Hong Kong law**

Trades in SSE Shares involve Hong Kong brokers and investors and hence Hong Kong law will also be relevant. The key Hong Kong requirements that may apply include:

- the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission;
- client money issued under the Securities and Futures Ordinance (Cap. 571) (the “SFO”);
- the market misconduct provisions under the SFO (excluding the insider dealing rules);
- record keeping requirements under the SFO; and
- contract note rules.

Other requirements that apply generally to SFC licensed or registered entities, such as the Financial Resources Rules, as well as the licensing requirements under the SFO will also continue to apply.

**Can investors enter into OTC equity derivatives over SSE Shares?**

There is no prohibition under Mainland China law on the creation of economic interests over SSE Shares held through Stock Connect in the same way as for QFII and RQFII shares. As such, market participants should be able to enter into OTC equity derivatives or market access products that are cash settled and that can be hedged without breaching the prohibition on non-trade transfer and other restrictions.

**Comparison of Stock Connect with QFII / RQFII**

<table>
<thead>
<tr>
<th></th>
<th>QFII / RQFII</th>
<th>Stock Connect</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSRC approval</td>
<td>QFII / RQFII qualification</td>
<td>No approval for investor</td>
</tr>
<tr>
<td>SAFE approval</td>
<td>Investment quota for each RQFII / QFII</td>
<td>Daily quota, aggregate quota for Stock-Connect</td>
</tr>
<tr>
<td>Investment scope</td>
<td>Shares, listed bonds, interbank bond, stock index futures, funds</td>
<td>SSE Shares only (SSE 180/380, A+H)</td>
</tr>
<tr>
<td>Transfer of quota</td>
<td>Prohibited</td>
<td>No individual quota</td>
</tr>
<tr>
<td>Onshore account</td>
<td>Proprietary / client money / open-ended China fund</td>
<td>HKSCC as nominee holder of omnibus account</td>
</tr>
<tr>
<td>Lock-up period</td>
<td>1 year (not for public fund)</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Block trade</td>
<td>Permitted</td>
<td>Not permitted</td>
</tr>
<tr>
<td>Applicable laws</td>
<td>Mainland China law, Mainland China market rules</td>
<td>Mainland China law and market rules, SEHK and HKSCC rules</td>
</tr>
</tbody>
</table>
It has also been queried whether OTC derivatives in the form of synthetic shorts or other bearish products can be entered into in respect of SSE Shares. The general observation among market participants is that the Mainland regulators do not approve of bearish products and, accordingly, as holders of quotas granted by Mainland regulators, QFII or RQFII are generally wary about offering bearish products over A Shares. If, however, the CSRC does eventually allow stock borrowing and covered short-selling under the Stock Connect regime, this could indicate a shift in regulatory thinking.

**Other points**

There are a number of other points of note to market participants including:

- whether sales of SSE Shares can be made to Mainland investors given that Stock Connect Rules refer to ‘Hong Kong’ investors for Northbound trading and in view of current restrictions imposed on Mainland investors accessing A shares through QFII products.
- While there will be Mainland China stamp duty and dividend tax applicable to trading in SSE Shares through Stock Connect, will there by capital gain tax and business tax chargeable to trading of SSE Shares through Stock Connect?
- How will regulatory cross-border enforcement issues or regulatory co-operation be dealt with between the SFC and CSRC?

It is hoped that many of these issues would be clarified by relevant authorities before the official launch of Stock Connect in October.

**Drafting**

When entering into transactions relating to Stock Connect shares (whether cash or derivative transactions, OTC or securitised trades, security or custodial arrangements), it is important to consider the special features of Stock Connect and how the relevant documentation may be impacted. See *Key amendments to client documentation* in the Appendix for a quick overview of the issues.

**Conclusion**

Stock Connect promises to mark an exciting new era for market participants in Hong Kong and Mainland China. Looking ahead, there are already moves towards similar links with other exchanges such the Shenzhen Stock Exchange, fuelling hopes of yet more links to exchanges that list other asset classes. This points to an exciting time ahead for Hong Kong’s equity markets and market players.
Appendix

**Key amendments to client documentation**

Parties will need to consider whether their documentation needs to be amended to account for Stock Connect.

The precise amendments required to the relevant terms will depend on whether such terms relate to general cash trading, private banking, prime brokerage services, custodial services, structured note programmes (or market access product programmes) or OTC derivatives. Amendments may also be required for collateral documents over SSE Shares.

In addition to amendments to the legal terms, it will also be necessary to consider additional risk disclosures and investor representations (particularly bearing in mind that various disclosure and representations, including the investor status representation, currently being used for A Share linked products are generally designed for use with QFII shares).

In general however, we have set out below a list of some of the issues that will need to be dealt with:

- Does the concept of a trading day include a day on which Stock Connect is open for trading?
- Do the settlement mechanics take into account the fact that settlement of SSE Shares follows the A Share settlement cycle?
- What will happen if the buy or sell order does not comply with the relevant restrictions, including pre-trade checking and the relevant daily or aggregate RMB limit?
- What will happen if the relevant SSE Shares purchased (or to which the relevant product is linked) subsequently ceases to be eligible for trading through Stock Connect?
- What will happen if there is a forced sale of the relevant SSE Shares in connection with foreign ownership limits?
- If corporate actions occur in respect of the relevant SSE Shares, what are the rights of the broker / investors? What if the relevant corporate action is a distribution of assets that are not SSE Shares?
- What will happen if Stock Connect is temporarily suspended or permanently terminated?
- Who bears the risk of ‘limited recourse’ against HKSCC?
- Are there any other potential uncertainties that the documentation should cater for?
Shanghai-Hong Kong Stock Connect - Key Legal Questions.

A18663539