

# GUIDE TO ISSUES RELATING TO HONG KONG'S STOCK CONNECT

By David Richardson



## The Hong Kong Stock Connect

Stock Connect was launched in November 2014. It essentially links the Shanghai Stock Exchange ("SSE") and the Hong Kong Stock Exchange ("SEHK") by allowing (i) Hong Kong and overseas investors to purchase "A" shares listed on the SSE (the "Northbound link") and (ii) investors in the People's Republic of China ("PRC") to purchase select Hong Kong and PRC companies listed on the SEHK (the "Southbound link"). This quick guide focuses on the Northbound link and highlights the issue of beneficial ownership of Hong Kong and overseas investors that purchase "A" shares ("Stock Connect shares") on the SSE through Stock Connect.

For more information on Stock Connect and China's equity market, refer to Dorsey's "Quick Guide to Hong Kong Stock Connect and China's Equity Market."

## What is Hong Kong Securities Clearing Company Limited ("HKSCC")?

Hong Kong and overseas investors may trade Stock Connect shares through their brokers. After settlement of the trade, Stock Connect shares are held by the brokers or custodians as clearing participants in the Hong Kong Central Clearing and Settlement System ("CCASS"), which is maintained by HKSCC.

HKSCC is Hong Kong's central securities depository and provides clearing, settlement and depository services to the securities market in Hong Kong. It is approved as a "recognized clearing house" by the Securities and Futures Commission ("SFC"), Hong Kong's regulator for the securities market, pursuant to the Securities and Futures Ordinance. In addition, pursuant to the General Rules of CCASS, HKSCC is also a central depository ("CSD") and a securities settlement system ("SSS") and provides depository, nominee, securities and settlement services. Apart from the SFC, HKSCC is also accepted as a central clearing counterparty ("CCP"), SSS and CSD by other international bodies such as the International Monetary Fund. It now also includes features of Stock Connect.

## What is the role of HKSCC in Stock Connect?

HKSCC acts as the participating CCP in relation to China Securities Depository and Clearing Corporation ("ChinaClear"), the sole authorized central securities depository in the PRC for the clearing and settlement of all the "A" shares on the SSE traded on Stock Connect ("Stock Connect shares"). HKSCC also performs post-clearing and settlement functions in relation to Stock Connect shares. Stock Connect shares are registered in the name of HKSCC in ChinaClear's books and records as the nominee holder for HKSCC participants and the underlying investors. Similar to Hong Kong listed shares and other types of securities, HKSCC offers nominee services to HKSCC participants in its role as a CSD. These functions of the HKSCC are set out in the CSD and Clearing Link Agreement entered into between ChinaClear and HKSCC prior to the launch of the Stock Connect.

As the nominee holder for HKSCC participants, HKSCC provides nominee services and performs, among others, the following functions which enable HKSCC participants and the underlying investors to exercise their rights as beneficial owners of the relevant securities:

- » collection or receipt of dividends, interest payments, redemption proceeds, distributions, rights, entitlements and other properties and documents;
- » distribution or payment to HKSCC participants of dividends, interest payments, redemption proceeds, distributions, rights, entitlements and other properties and documents;
- » the seeking of voting instructions from HKSCC participants;
- » the seeking of instructions from HKSCC participants with regard to the exercise of rights and entitlements accruing to relevant securities or the participation in other actions affecting them.<sup>1</sup>

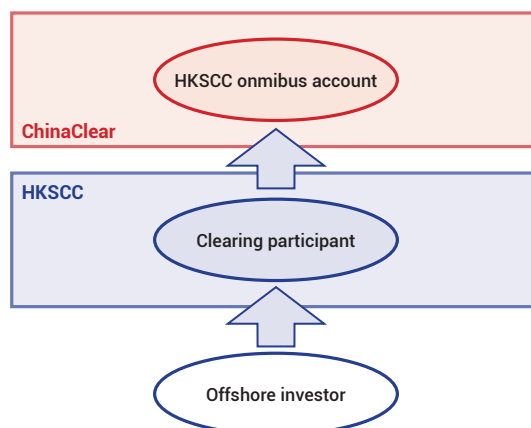
## Purchasing Stock through Stock Connect

When a broker in Hong Kong executes a purchase order through Stock Connect, the trade is cleared through the link between HKSCC and ChinaClear. In this process, ChinaClear buys the stock from the Chinese broker and sells it to HKSCC. HKSCC, having bought the stock from ChinaClear, in turn, sells the stock to the Hong Kong broker. This is important to highlight as the offshore purchaser or broker only faces HKSCC as the clearing house but not ChinaClear or the broker in China. HKSCC, as the clearing house, essentially guarantees the performance of the trade to the offshore investor.

<sup>1</sup> General Rules of CCASS, Chapter 11, Rule 1101.

When the trade is cleared and settled through the clearing link, the shares are then held through the CSD, which is a link between HKSCC and ChinaClear. The shares are held in an omnibus account with HKSCC as the nominee holder for the offshore investor as depicted in the diagram below. The holding of shares by HKSCC as a CSD is a fundamental cornerstone of Stock Connect and is specifically mandated in its regulations.<sup>2</sup> It is the only way for an offshore investor to hold shares and execute trades through Stock Connect.

The diagram below illustrates the structure of an offshore investor holding shares through Stock Connect:



## What are the issues?

Since the launch of Stock Connect, some concerns have been expressed in relation to the programme. Below are some of the various legal and practical issues that offshore investors intending to invest through Stock Connect should consider:

- » recognition of offshore investors' beneficial ownership of Stock Connect shares;
- » mismatch as to the timing for delivery of Stock Connect shares on the trade date versus payment on the following day;
- » requirement to settle in Renminbi;
- » calculation of an offshore investor's shareholding in a listed company in order to comply with foreign ownership limitations and disclosure of interest obligations;
- » restrictions on trading activities (i.e., no day trading, limited margin financing, stock lending or borrowing); and
- » execution risks (i.e., availability of quota, pre-trade checking requirements, SEHK is closed when trading is conducted on the SSE).

In particular, the recognition of offshore investors' beneficial ownership of Stock Connect shares has been in the spotlight.

## Understanding the issue of beneficial ownership

For an investor to understand their beneficial holding of Stock Connect shares, the investor can trace their beneficial interest of Stock Connect shares under (i) Hong Kong law; and (ii) PRC law:

- » **Beneficial ownership under Hong Kong law.** It is well established that HKSCC holds the shares on trust for investors under Hong Kong law. As such, investors have beneficial ownership of the securities held by HKSCC on their behalf.<sup>3</sup> Further, under Hong Kong law, it is recognized that a nominee holder has legal interest in shares for which it is a nominee and that the beneficial interest is held by the person for whom HKSCC acts.<sup>4</sup>
- » **Beneficial ownership under PRC law.** The investor's beneficial ownership in Stock Connect shares under PRC law may be considered in two parts:
  - The nature of HKSCC's interest as the holder of Stock Connect shares as recorded by ChinaClear. There are clear provisions in PRC law that recognize the interest of a registered holder of shares as recorded by ChinaClear including the following:
    - o CSRC's Guidance on Listed Company Articles of Association requires PRC listed companies to set up and maintain a register of shareholders in accordance with records provided by the securities registration and settlement institution (i.e. ChinaClear).<sup>5</sup>
    - o Securities Law of the PRC requires ChinaClear to provide the issuer of securities with the register of securities holders and information regarding securities holders. This means that ChinaClear is to confirm that the securities holders own or hold the relevant securities based on the result of the clearing and settlement arrangements and that the records maintained in relation to such securities are true, accurate and complete.<sup>6</sup>
    - o ChinaClear's Implementing Rules for Registration, Depository and Clearing Services under the Shanghai-Hong Kong Stock Connect Pilot Programme states that HKSCC, as the nominee holder of the Stock Connect shares, is to be registered in the register of shareholders maintained by the SSE listed companies.<sup>7</sup>

<sup>2</sup> Article 6, ChinaClear's Implementing Rules for Registration, Depository and Clearing Services under the Shanghai-Hong Kong Stock Connect Pilot Programme.

<sup>3</sup> CA Pacific Finance Ltd (in Liquidation) and another [1999] 2 HKC 632.

<sup>4</sup> *Ibid.*

<sup>5</sup> Article 30 of CSRC's Guidance on Listed Company Articles of Association.

<sup>6</sup> Section 160 of the Securities Law of the PRC.

<sup>7</sup> Article 7 of ChinaClear's Implementing Rules for Registration, Depository and Clearing Services under the Shanghai-Hong Kong Stock Connect Pilot Programme.

- o ChinaClear's Securities Registration Rules provides that the securities registration records issued by ChinaClear are to be valid evidence of the securities holders' possession or holding of such securities.<sup>8</sup>
- *The concept of "nominee holder" under PRC law.* There are provisions in CRSC's Several Provisions on the Pilot Program of Shanghai-Hong Kong Stock Market Connect that provide for the concept of "nominee holder" as a person who holds securities on behalf of others and recognizes the nature of HKSCC's interest as a registered "nominee holder" of shares as recorded by ChinaClear.<sup>9</sup> Accordingly, the HKSCC acts as the "nominee holder" of the Stock Connect shares whereby Hong Kong and other offshore investors enjoy the rights and interests in such shares.<sup>10</sup> Similar to other existing provisions on other securities, it is made clear that HKSCC has no proprietary interest in Stock Connect shares and as a nominee holder, HKSCC is responsible for its nominee and other services discussed above.<sup>11</sup>

## Rights enjoyed by investors

Hong Kong and other offshore investors of Stock Connect shares may assert or exercise their rights as beneficial owner of such shares. Beneficial owners are able to exercise shareholders rights including, among others:

- » the right to call and participate in shareholders' meetings;
- » the right to propose matters for voting at shareholders' meetings;
- » the right to exercise voting rights and control over the company through voting at shareholders' meetings;
- » the right to subscribe for allocated rights and entitlements; and
- » the right to receive dividends and other distributions declared by the company.<sup>12</sup>

In addition to shareholders' rights, under PRC civil procedure law, a claimant in a legal action is a person who has a direct interest in the relevant case.<sup>13</sup> Where a Hong Kong or offshore investor is able to establish standing as a beneficial owner of Stock Connect shares with direct interest in the relevant claim, such beneficial owner would be able to enforce his rights in the PRC courts. Further, should any investor decide to bring legal action in PRC to enforce his rights in relation to Stock Connect shares, HKSCC will provide the relevant assistance to such beneficial owner where necessary.<sup>14</sup>

In the unlikely event that HKSCC becomes insolvent, the insolvency proceedings will be initiated in Hong Kong. Any claims against HKSCC would be determined pursuant to Hong Kong law. As a well-established principle in Hong Kong insolvency law, the shares held by HKSCC as a nominee holder do not form part of HKSCC's bankruptcy assets, but rather the assets of the investor or beneficial owner.<sup>15</sup> In the PRC, HKSCC is recognized as the nominee holder of the Stock Connect shares for the investor as the beneficial owner, as discussed above. In the unlikely event of HKSCC's insolvency, PRC courts will recognize the liquidator appointed in Hong Kong and give effect to the insolvency ruling of Hong Kong courts, provided that the ruling does not undermine the legitimate rights and interests of the creditors in the PRC.<sup>16</sup> As such, it is clear that Stock Connect shares will not form part of HKSCC's general assets but rather the assets of the investor.

Investors are entitled to rights and interests in respect of shares purchased through Stock Connect.<sup>17</sup> Therefore, in the unlikely event that ChinaClear becomes insolvent, Stock Connect shares recorded in the names of registered holders (being the HKSCC in the case of shares held through Stock Connect) would not form part of ChinaClear's assets on its insolvency. As such, beneficial ownership of shares held through Stock Connect is recognized in both Hong Kong and China. ChinaClear is currently the sole securities depository in China. In the unlikely event of its bankruptcy, it is expected that the CSRC would designate another entity to take over the registration, clearing and settlement functions of ChinaClear to ensure the on-going operation of the securities market.



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<sup>8</sup> Article 5 of ChinaClear's Securities Registration Rules.

<sup>9</sup> Article 18 of the Administrative Measures for Registration and Settlement of Securities.

<sup>10</sup> Articles 7 and 13, respectively, of the Several Provisions on the Pilot Program of Shanghai-Hong Kong Stock Market Connect.

<sup>11</sup> Rule 824 of the CCASS Rules and Section 8 of the CCASS Operational Procedures; Article 118 of the Measures for the Shanghai-Hong Kong Stock Connect Pilot Programme by the SSE.

<sup>12</sup> See CSRC's "FAQ on Beneficial Ownership" dated 15 May 2015 <[http://www.csrc.gov.cn/pub/csrc\\_en/newsfacts/PressConference/201505/t20150515\\_277108.html](http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201505/t20150515_277108.html)>

<sup>13</sup> Article 119 of the Civil Procedure Law of the PRC.

<sup>14</sup> General Rules of CCASS, Chapter 8, Rule 824.

<sup>15</sup> See [1999] 2 HKC 632.

<sup>16</sup> Article 5 of the Enterprise Bankruptcy Law of the PRC.

<sup>17</sup> Article 13 of the Stock Connect Rules.