



HAN KUN LAW OFFICES

# Legal Commentary



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## Stock Connect from HK to UK - Similar Stocks, Different Connect

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Following the launch of the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect in November 2014 and in December 2016 respectively, on 12 October 2018 the China Securities Regulatory Commission ("**CSRC**") officially published the *Provisions on the Supervision and Administration of Depository Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (for Trial Implementation)* (《上海证券交易所与伦敦证券交易所市场互联互通存托凭证业务监管规定(试行)》) (the "**New Provisions**"), which formally established the Shanghai-London Stock Connect scheme.

The establishment of the Shanghai-London Stock Connect is an important achievement resulting from discussions between China<sup>1</sup> and the UK regarding the countries' economic and financial futures. The scheme provides a new channel for domestic investors to invest in overseas capital markets as well as an alternative for domestic-listed companies to obtain financing outside of China. The scheme also makes domestic shares available for overseas investors and facilitates the further internalization of domestic capital markets.

In this article, we intend to introduce the main contents of the New Provisions and provide our general understanding of the Shanghai-London Stock Connect scheme.

### I General Introduction to Depository Receipts Business under the Shanghai-London Stock Connect

Depository receipts business under the Shanghai-London Stock Connect refers to the depository receipts ("**CDRs**") publicly issued in the Chinese domestic market and listed on the Shanghai Stock Exchange ("**SSE**") by qualified issuers of overseas securities listed on the

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<sup>1</sup> "China" and "domestic" (for the purposes of this article only) refer to the territory of the People's Republic of China, excluding the Hong Kong Special Administrative Region, the Macao Special Administrative Region and Taiwan; "overseas" (for the purposes of this article only) refers to countries and regions outside of China.

London Stock Exchange ("LSE"), and depository receipts ("GDRs") offered overseas and listed on the LSE by qualified SSE-listed domestic companies. Thus the Shanghai-London Stock Connect scheme includes both CDRs and GDRs.

## II CDRs under the Shanghai-London Stock Connect

### i. Securities Underlying CDRs

The securities underlying CDRs are existing shares of qualified overseas issuers listed on the LSE. CDRs are not currently permitted to represent newly-issued shares.

### ii. Main CDR Participants

- 1. Issuers of Underlying Overseas Securities.** The New Provisions require overseas issuers to be qualified LSE-listed companies within the scope recognized by CSRC. According to the *SSE's Q&A on the Shanghai-London Stock Connect Scheme (上交所就沪伦通答记者问)*<sup>2</sup>, the qualified LSE-listed companies under the Shanghai-London Stock Connect scheme are those with a premium listing on the LSE, and their listings and market values must additionally meet certain criteria set by CSRC<sup>3</sup>.
- 2. Domestic CDR Investors.** Domestic investors who hold and trade CDRs are required to meet the investor suitability requirements stipulated by the SSE.
- 3. CDR Sponsors and Sponsor Representatives.** According to the New Provisions, sponsors and their representatives are required to perform sponsorship duties in accordance with the *Measures for Administration of Sponsoring Business for Securities Issuing and Listing (《证券发行上市保荐业务管理办法》)*, the *Sponsor Due Diligence Code of Conduct (《保荐人尽职调查工作准则》)* and the *Implementing Provisions for Due Diligence Work on Sponsorship of Domestic Offerings of Stocks or Depository Receipts of Innovative Enterprises (《保荐创新企业境内发行股票或存托凭证尽职调查工作实施规定》)*. In addition, overseas issuers and their sponsors are required to file with the local CSRC where the overseas issuer's domestic office is located for the purpose of handling securities matters regarding sponsorship arrangements.
- 4. CDR Depositories.** CDR depositories are required to comport with the relevant

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<sup>2</sup> Please see [http://www.sse.com.cn/aboutus/mediacenter/hotandd/c/c\\_20180831\\_4631629.shtml](http://www.sse.com.cn/aboutus/mediacenter/hotandd/c/c_20180831_4631629.shtml).

<sup>3</sup> We note Article 6 of the consultation draft of the *Interim Measures on the Listing and Trading of Depository Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所市场互联互通存托凭证上市交易暂行办法》)* has listed the detailed requirements on the issuers of underlying overseas securities.

Please see

<http://www.sse.com.cn/disclosure/announcement/general/a/20181012/b4f1c82bee683f7b82210549190a59b1.pdf>.

requirements set out in the *Measures for Administration of Issuance and Trading of Depository Receipts (for Trial Implementation)* (《存托凭证发行与交易管理办法(试行)》) and assume the corresponding legal obligations. Where a commercial bank serves as a CDR depository, it is required to obtain a depository license in accordance with the *Provisions on Matters Concerning Commercial Banks Serving as Depositories in the Pilot Program on Depository Receipts* (《关于商业银行担任存托凭证试点存托人有关事项规定》). The New Provisions do not prohibit foreign-invested banks from acting as CDR depositories. Thus the foreign-invested banks with a depository license may also act as CDR depositories.

5. **Cross-border Conversion Institutions.** "Cross-border conversion" refers to the conversion of underlying shares into depository receipts and vice versa. Institutions in China that perform these services ("**Chinese Cross-border Conversion Institutions**") are required to be domestic securities companies that are licensed for proprietary trading, possess adequate experience in international business and have sound and effective internal controls. Qualified domestic securities companies that engage in cross-border conversion are required to make a filing in accordance with SSE rules. Chinese Cross-border Conversion Institutions may trade the shares that underlie CDRs and certain investment instruments (e.g. money management instruments, financial products or instruments designed to hedge market risks associated with the underlying shares and foreign exchange risks) in accordance with regulations of competent authorities for the purpose of cross-border conversion and risk hedging. The outstanding assets that Chinese Cross-border Conversion Institutions may hold in overseas markets are subject to limitations stipulated by CSRC.
6. **CDR Custodians.** Chinese Cross-border Conversion Institutions are required to appoint banks qualified to hold securities investment funds to serve as CDR custodians. Custodians provide custody services in accordance with the *Trial Measures for the Administration of Overseas Securities Investment by Qualified Domestic Institutional Investors* (《合格境内机构投资者境外证券投资管理试行办法》); overseas custodians will be appointed to provide overseas custody services.

### iii. **CDR Issuance Approval Procedures**

1. **Approval Authorities.** Overseas issuers seeking to list CDRs are required to file an application with CSRC. CSRC has designated the SSE to accept application documents, and the SSE will review the applications it receives and assess the overseas issuers' eligibility to list CDRs in accordance with SSE rules. CSRC will review applications in accordance with applicable laws and make final decisions on all applications.
2. **Application Documents.** The New Provisions set out the detailed application

documents which the overseas issuers need to submit when applying to issue CDRs in the Chinese domestic market, including but not limited to the application report, a prospectus and confirmation statement signed by authorized directors, and relevant resolutions of the overseas issuers. The New Provisions expressly require the content and format of the prospectus to comply with *Rules No. 23 on the Preparation of Disclosure Documents by Companies Offering Securities to the Public: Guidelines on the Content and Format of Prospectuses of Pilot Red-Chip Enterprises Publicly Offering Depository Receipts* (《公开发行证券的公司信息披露编报规则第 23 号 - 试点红筹企业公开发行存托凭证招股说明书内容与格式指引》).

#### **iv. Initial Liquidity Establishing Arrangement**

After a CDR issuance has been approved, the Chinese Cross-border Conversion Institution will acquire underlying shares with proprietary funds, by accepting purchase orders from non-specified investors who meeting suitability requirements or through other lawful means. Upon delivery of the underlying shares, the depository will issue the corresponding depository receipts to the Chinese Cross-border Conversion Institution or investors in accordance with applicable rules and depository agreements.

Where the amount of outstanding CDRs meets the listing requirements stipulated by the SSE, the overseas issuer can apply to the SSE to publicly list its CDRs.

#### **v. Cross-border Conversions of CDRs**

Once CDRs become listed, the Chinese Cross-border Conversion Institutions may instruct the depository to convert the overseas underlying securities into CDRs and vice versa. When converting CDRs into the underlying overseas shares, the depository will cancel the CDRs in accordance with relevant rules and the terms in the depository agreements, and deliver the underlying overseas shares to the Chinese Cross-border Conversion Institutions. Qualified domestic investors may also have cross-border conversions carried out on their behalf in accordance with SSE rules.

#### **vi. Limit on CDRs Outstanding**

CSRC limits the number of CDRs that an overseas issuer may have outstanding. While the New Provisions do not specify how the maximum number of outstanding CDRs is determined, the limit may be adjusted to account for certain transactions that affect an issuer's outstanding CDRs, such as stock dividends, stock splits, reverse stock splits and changes to CDR conversion ratios.

#### **vii. Accounting and Auditing Standards**

Overseas issuers are required to prepare financial reports in accordance with Chinese Accounting Standards ("**CAS**") or other accounting standards recognized by the Ministry of

Finance ("MOF"). The New Provisions require financial reports to be audited in accordance with approved accounting standards by a domestic accounting firm licensed for securities and futures business, or by a foreign accounting firm that has been approved by CSRC and MOF.

#### viii. Rights Issues

Overseas issuers that proceed with rights issues after publicly listing CDRs in the Chinese domestic market must meet the relevant requirements and file an application with CSRC for approval.

#### ix. Ongoing Supervision

- 1. Applicable Regulations.** The New Provisions also govern the ongoing supervision of listed CDRs. Supervision issues not covered in the New Provisions will be handled by reference to the relevant provisions applicable to overseas-listed red-chip enterprises in the *Implementing Measures for Ongoing Supervision of Innovative Enterprises Following Listing of Domestically Offered Stocks or Depository Receipts (for Trial Implementation)* (《创新企业境内发行股票或存托凭证上市后持续监管实施办法(试行)》) (the "**Implementing Measures for Ongoing Supervision**"), and other relevant CSRC regulations and SSE rules.
- 2. Exceptions to the Application of the Implementing Measures for Ongoing Supervision.** The following two circumstances are outside the scope of the certain requirements found in the Implementing Measures for Ongoing Supervision. First, the reporting obligations of Article 36 do not apply in the case of material asset transactions by overseas issuers outside the ordinary course of business, such as asset acquisitions, sales or other transactions, unless the asset acquisition is financed through the issuance of CDRs. Second, the Chinese Cross-border Conversion Institutions with holdings of the underlying overseas shares and CDRs as a result of fulfilling market making obligations are not subject to the provisions regarding changes in domestic CDR holdings in Chapter 4, Sec. 2.
- 3. Disclosure Requirements.** Overseas issuers are required to disclose periodic reports, including annual and semiannual reports. Disclosure of quarterly reports in an overseas issuer's home market is required to be made concurrently in the Chinese domestic market.

### III GDRs under the Shanghai-London Stock Connect

#### i. Securities Underlying GDRs

The securities underlying GDRs may be either existing shares or newly-issued shares of domestic SSE-listed companies. However, the New Provisions also prohibit the issuance

of GDRs representing newly-issued shares in certain circumstances; for example, if the application documents for the current offering contain misrepresentations, misleading statements or major omissions.

## ii. Main GDR Participants

1. **Domestic Listed Companies.** Domestic listed companies seeking to issue GDRs on the LSE are **required** to meet certain criteria set by the LSE. Domestic listed companies are also required to meet the requirements set out in the *Securities Law of the People's Republic of China* (《中华人民共和国证券法》), *Special Provisions of the State Council Concerning the Floatation and Listing Abroad of Stocks by Joint Stock Limited Companies* (《国务院关于股份有限公司境外募集股份及上市的特别规定》), and other applicable laws, regulations and relevant CSRC provisions regarding offering and listing securities by domestic companies in overseas markets.
2. **Overseas GDR Depositories and Cross-border Conversion Institutions.** The overseas depositories and overseas securities institutions conducting cross-border conversions ("**UK Cross-border Conversion Institutions**") will appoint domestic securities companies that will file with the SSE and trade the underlying domestic shares represented by GDRs. These domestic securities companies will supervise the cross-border conversions conducted by the UK Cross-border Conversion Institutions to ensure compliance with applicable laws and regulations. The UK Cross-border Conversion Institutions may trade the corresponding shares underlying GDRs and certain investment instruments (e.g. money market funds and treasury bonds) in accordance with regulations of the competent authorities for the purpose of cross-border conversion and risk hedging. The outstanding assets that UK Cross-border Conversion Institutions may hold in domestic markets are subject to limitations stipulated by CSRC.
3. **GDR Custodians.** Overseas depositories and the UK Cross-border Conversion Institutions will appoint and entrust assets to custodians that serve as custodians to qualified foreign institutional investors or qualified securities investment funds. Such custodians will perform custody obligations with reference to the *Measures for Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* (《合格境外机构投资者境内证券投资管理暂行办法》).

## iii. Issuing Price of GDRs Representing Newly-issued Shares

The issue of GDRs representing newly-issued shares may not, in principle, be lower than 90% of the average price of the underlying shares in 20 transaction days prior to the date of pricing. However, the New Provisions do not provide specific exemptions to this pricing method. For example, if the current market price does not reflect the true value of the domestic listed companies, whether an alternative method can be adopted to determine the issuing price.

#### **iv. Cross-border Conversions of GDRs**

GDRs may be exchanged for the underlying domestic shares in accordance with relevant rules and regulations. However, GDRs that domestic listed companies initially issue to the public are not permitted to be converted into domestic underlying shares within 120 days of the listing date. GDRs subscribed to and held by the domestic listed company's controlling shareholder, actual controller and entities under its control are not permitted to be transferred within 36 months of the listing date.

#### **v. Limit on GDRs Outstanding**

CSRC limits the number of GDRs that a domestic issuer may have outstanding. Similar to CDRs, the New Provisions do not specify how the maximum number of outstanding GDRs is determined, although the limit may be adjusted to account for certain transactions that affect an issuer's outstanding GDRs, such as stock dividends, stock splits, reverse stock splits and changes to GDR conversion ratios.

#### **vi. Equity Ownership Limitation by Overseas Investors**

A single overseas investor may hold no more than 10% of the equity in a single domestic listed company under the New Provisions. The aggregate A-shares holdings of all overseas investors in a listed domestic company may not exceed 30% of the total outstanding shares. For ownership purposes, equity that investors and persons acting in concert hold in a domestic listed company through GDRs or other means is considered on a consolidated basis. These ownership limitations do not apply to overseas investors' strategic investments in domestic listed companies.

The New Provisions provide a complete picture of the Shanghai-London Stock Connect, with general rules and regulations that will serve as the guidelines for further detailed rules and operating mechanisms. To this end, the SSE has published several consultation drafts of specific rules relating to the Shanghai-London Stock Connect for public comment<sup>4</sup>. The market has also been very active to promote the achievement of the Shanghai-London Stock Connect scheme. As of the date of this article, there have been 17 domestic securities companies which have participated in testing to qualify for CDR cross-border conversion organized by the SSE and it is said that the first market makers of CDR will be selected from those tested securities companies<sup>5</sup>. It has also been reported that HSBC Holdings plc, an LSE-listed company, will become the first company to list CDRs on the SSE<sup>6</sup>. As for the offering and listing of GDRs, the board meeting and the shareholders' meetings of Huatai Securities, which is listed on both the SSE and the Hong Kong Stock Exchange, have approved the company's plan to list GDRs

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<sup>4</sup> Please see [http://www.sse.com.cn/disclosure/announcement/general/c/c\\_20181012\\_4655446.shtml](http://www.sse.com.cn/disclosure/announcement/general/c/c_20181012_4655446.shtml).

<sup>5</sup> Please see <https://baijiahao.baidu.com/s?id=1614551569939278927&wfr=spider&for=pc>.

<sup>6</sup> Please see <https://www.ft.com/content/e9b519b8-d28b-11e8-a9f2-7574db66bcd5>.

representing newly issued A-shares on the LSE<sup>7</sup>.

The above is a preliminary introduction to the new regulations for the Shanghai-London Stock Connect scheme. If you need further information on the above matters, please contact:

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<sup>7</sup> Please see <http://www.sse.com.cn/disclosure/listedinfo/announcement/>  
and [http://www.hkexnews.hk/listedco/listconews/SEHK/2018/0925/LTN20180925050\\_C.pdf](http://www.hkexnews.hk/listedco/listconews/SEHK/2018/0925/LTN20180925050_C.pdf).



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