

# Legal Commentary

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## Domestic “Bond Connect” – Aiming to Unify China’s Bond Markets

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### Introduction

On 20 January 2022, the *Interim Measures for Interconnection Services between the China Interbank Bond Market and the Exchange Bond Market*<sup>1</sup> (the “**Connect Measures**”) were jointly issued by China’s bond market infrastructures, the Shanghai Stock Exchange (SSE), the Shenzhen Stock Exchange (SZSE), the China Foreign Exchange Trade Center & National Inter-bank Funding Center (CFETS), the China Securities Depository Clearing Corporation (CSDCC), and the Shanghai Clearing House (SCH). The Connect Measures follow the July 2020 announcement of a connect link between the interbank and exchange bond markets by the People’s Bank of China (PBOC) and the China Securities Regulatory Commission (CSRC)<sup>2</sup>, and draft rules dated 2 September 2020 on the opening-up of China’s unified bond market (including via connect link) to foreign investors, the *Announcement on Investment in China’s Bond Markets by Foreign Institutional Investors*<sup>3</sup> (the “**Draft Announcement**”).

According to the Connect Measures, all investors (including foreign investors) that are qualified to access either the China Interbank Bond Market (CIBM) or the exchange-traded bond market may trade bonds traded on the other market through the connect link between the infrastructures of the two bond markets (the “**Connect Regime**”). As of today, the specific launch time for the Connect Regime has yet to be announced; the infrastructures are expected to issue detailed operating rules to launch the Connect Regime in due course after necessary system and technology tests.

<sup>1</sup> 《银行间债券市场与交易所债券市场互联互通业务暂行办法》 [Interim Measures for Interconnection Services between the China Interbank Bond Market and the Exchange Bond Market] (Shanghai Stock Exch. et al., Shang Zheng Fa [2022] No. 21; promulgated and effective 20 January 2022), *available at* [http://www.sse.com.cn/lawandrules/sselawsrules/bond/trading/c/c\\_20220120\\_5688809.shtml](http://www.sse.com.cn/lawandrules/sselawsrules/bond/trading/c/c_20220120_5688809.shtml) (Chinese).

<sup>2</sup> 《中国人民银行 中国证券监督管理委员会公告[2020]第 7 号》 [Announcement of the People’s Bank of China and the China Securities Regulatory Commission [2020] No. 7] (PBOC, CSRC; issued 19 July 2020), *available at* [http://www.gov.cn/zhengce/zhengceku/2020-07/19/content\\_5528196.htm](http://www.gov.cn/zhengce/zhengceku/2020-07/19/content_5528196.htm) (Chinese).

<sup>3</sup> For more information, please refer to our previous newsletter on the Draft Announcement: Opening-up of China’s Unified Bond Markets is Under Way (<https://hankunlaw.com/downloadfile/newsAndInsights/c63a152289ac29929b50ffee68037513.pdf>).

## Key analysis

### I Qualified investors

The Connect Regime comprises two trading links: (1) for qualified investors in the CIBM to trade exchange-traded bonds (the “**Connect to Exchange**”) (including foreign investors that have access to the CIBM through all channels approved by the PBOC, which we expect to include both CIBM Direct and Bond Connect channels); and (2) for qualified institutional investors in the exchange-traded bond market to trade CIBM bonds (the “**Connect to CIBM**”) (including foreign investors that have access to the exchange-traded bond market through channels approved by the CSRC, which we understand only refers to Qualified Foreign Investors (QFIs)<sup>4</sup>).

Subject to the detailed operating rules, we set out below the respective qualified investors in each market that may access the other bond market via the Connect Regime.

	Domestic investors	Foreign investors
<b>CIBM</b>	<ul style="list-style-type: none"> <li>■ banking financial institutions</li> <li>■ securities financial institutions</li> <li>■ insurance financial institutions</li> <li>■ private fund managers that satisfy certain eligibility requirements</li> <li>■ investment products issued by the aforementioned institutions</li> <li>■ non-financial-institution qualified investors</li> <li>■ pension funds, charity funds and endowment funds</li> <li>■ other investors as approved by the PBOC</li> </ul>	<p>Foreign central banks, international financial organizations, sovereign wealth funds, QFIs, and the following financial institutions lawfully registered and incorporated outside China:</p> <ul style="list-style-type: none"> <li>■ commercial banks</li> <li>■ insurance companies</li> <li>■ securities companies</li> <li>■ fund management companies</li> <li>■ other asset management institutions</li> <li>■ investment products issued by the aforementioned institutions</li> <li>■ other medium-and-long term institutional investors approved by the PBOC, such as pension funds, charity funds and endowment funds</li> </ul>
<b>Exchange-traded bond market</b>	<ul style="list-style-type: none"> <li>■ financial institutions</li> <li>■ subsidiaries of financial institutions and private fund managers that satisfy certain eligibility requirements</li> <li>■ investment products issued by the aforementioned institutions</li> <li>■ pension funds, charity funds and</li> </ul>	QFIs

<sup>4</sup> Note: QFIs refer to the qualified foreign investors licensed by the CSRC to invest in China markets, which includes the former qualified foreign institutional investors and RMB qualified foreign institutional investors.

	Domestic investors	Foreign investors
	endowment funds ■ non-financial institutions that satisfy certain eligibility requirements	

## II Trading

### 1. Trading flow

Investors can follow their current trading practices when trading bonds in the other bond market via the Connect Regime.

- **Connect to Exchange.** CIBM participants that wish to trade exchange-traded bonds via the Connect to Exchange can place orders with CFETS (through bond settlement agents, if applicable) from their existing CFETS bond trading accounts and existing SCH custody accounts, and CFETS will transmit order information to the exchanges in real time. Trading orders will be executed pursuant to exchange rules and CFETS will provide trade confirmations to CIBM participants based on the execution information received from the exchanges.
- **Connect to CIBM.** Exchange investors that wish to trade CIBM bonds via the Connect to CIBM can place orders with exchanges (through brokers, if applicable) from their existing CSDCC securities accounts, and the exchanges will transmit order information to CFETS in real time. Trading orders will be executed pursuant to CIBM rules and the exchanges will provide execution information with exchange investors based on information received from CFETS.

### 2. Trading window

The trading window for each trading link under the Connect Regime will also follow the trading window of the relevant trading venue and will be separately announced by the infrastructures.

### 3. Trading process

Article 4 of the Connect Measures generally provides that the matching and execution of bond trades will follow the business rules of the trading and circulation venue where the bonds are traded. As such, subject to the detailed operating rules, CIBM bond trades should be conducted through bilateral negotiation while bond trades executed in the exchange-traded bond market may be conducted via either bilateral negotiation (e.g., for bond trades executed in the SSE fixed income platform) or centralized bidding (e.g., for bond trades executed in the SSE bond centralized bidding platform).

Notably, it was announced with the Connect Measures that market infrastructures will allow certain specified domestic commercial banks to trade bonds by agreement (i.e., bilateral negotiation) in the exchange-traded bond market from the date the Connect Regime is launched. Previously, these specified domestic banks were limited to trading bonds via centralized bidding.

### III Available product

The permissible scope of products for trading by investors via the Connect Regime includes the following.

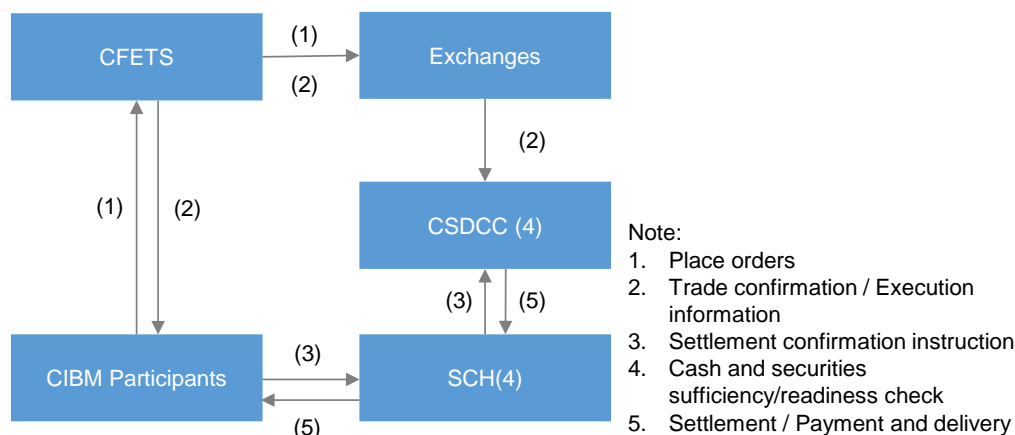
1. All cash bonds, asset-backed securities (ABS) and other permissible cash products with fixed income features by the market infrastructures. Pursuant to Article 11 of the Connect Measures, CFETS and exchanges will determine the list of cash products eligible for trading under the Connect Regime in its respective market and will transmit and post this list on the website of the other market.
2. Via the Connect to Exchange, CIBM participants may trade convertible bonds and exchangeable bonds, provided that they comply with the holding-related rules of the exchanges. While there is no further guidance as to holding-related rules, we understand investors that trade convertible bonds via the Connect to Exchange should comply with, among others, the disclosure of interest rule and short swing profit rule.
3. Primary bond issuances.

The above said, as discussed in Section 5 below, CIBM bonds under the custody of China Central Depository & Clearing Co., Ltd. (CCDC) (e.g., government bonds and enterprise bonds) may not be available for trading under the Connect Regime. Additionally, other bond products (e.g., bond repos) are not available under the Connect Regime.

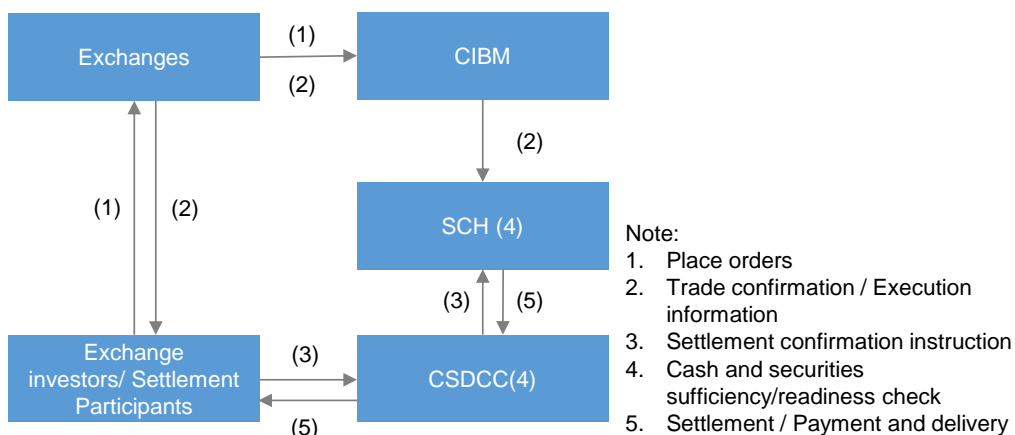
### IV Settlement

Investors under the Connect Regime can follow their existing practice to confirm and send settlement instructions when settling bond trades in the other bond market via the Connect Regime, and the bond registration, custody, and settlement institutions in both markets will handle settlements based on transaction data received from trading venues (i.e., the exchanges and CFETS). Specifically, the settlement mechanisms include the following.

1. **Connect to Exchange.** After a trade has been executed, the exchanges will send the execution information to CSDCC for clearing and settlement. CIBM participants that trade exchange-traded bonds will send a settlement confirmation instruction to SCH, which will in turn send a settlement confirmation instruction to CSDCC after its cash and securities sufficiency/readiness check. After receiving the instruction, CSDCC will handle the payment and delivery with exchange investors and, accordingly, SCH will handle the payment and delivery with CIBM participants. Below is a diagram of the settlement process under the Connect to Exchange.



**2. Connect to CIBM.** After the trade has been executed, CFETS will send the execution information to SCH for clearing and settlement. Settlement participants for the exchange investors that trade CIBM bonds will send a settlement confirmation instruction to CSDCC which will in turn send a settlement confirmation instruction to SCH after its cash and securities sufficiency/readiness check. After receiving the instruction, SCH will handle the payment and delivery with CIBM participants and, accordingly, CSDCC will handle the payment and delivery with settlement participants. Below is a diagram of the settlement process under the Connect to CIBM.



Pursuant to Articles 25 and 33 of the Connect Measures, bond trades executed under the Connect Regime will be settled by SCH and/or CSDCC (as applicable) on a trade-by-trade and gross basis, which is different from trades originating in the exchange-traded bond market, most of which are settled by CSDCC on a netted basis.

**V Nominee holding structure**

The Connect Regime introduces a nominee holding structure, whereby SCH in the CIBM and CSDCC in the exchange-traded bond market will open nominee accounts with each other, so that all the bonds purchased under the Connect Regime will be held in the nominee account opened by SCH (for Connect to Exchange) or by CSDCC (for Connect to CIBM). SCH and CSDCC will separately keep and maintain records of the bonds held in these nominee accounts and the underlying bondholders, which will serve as legal proof of the investors' beneficial ownership.

Article 16 of the Connect Measures further provides that the registration, custody and settlement institutions in the CIBM will also open nominee accounts with each other, but Article 41(2) of the Connect Measures stipulates that SCH is the only registration, custody and settlement institution in the CIBM; CCDC is not included. These two provisions appear contradictory, but a possible interpretation is that Article 16 was intended to introduce the nominee holding structure between SCH and CCDC as well to facilitate investments in bonds in CCDC custody by exchange investors via the Connect Regime. However, CCDC is not currently included as part of the Connect Regime. This could be because government and enterprise bonds in CCDC custody are already available for trading on the exchange-traded bond market based on the link between CCDC and CSDCC, which facilitates cross-market custody transfers (the “**CCDC-CSDCC Link**”). As a result, it would appear for now that bonds in CCDC custody may not be available for trading under the Connect Regime.

To give more practical color, between SCH and CCDC, while they provide similar services, CCDC mainly acts as the central securities depository for treasury bonds, local government bonds, central bank bills, financial bonds, and enterprise bonds. SCH mainly acts as the central securities depository for financial bonds, non-financial enterprise debt financing instruments, and negotiable certificates of deposit.

## Outlook

The foreign investors community is likely to receive the Connect Regime more warmly because it is expected to expand the investible product suite of foreign investors relative to domestic investors. This is so given that domestic investors qualified to trade in the CIBM are often also qualified to trade in the exchange-traded bond market, and foreign investors have had limited access to the exchange-traded bond market (in comparison to the CIBM). The Connect Regime could also bring more liquidity into the exchange-traded bond market. However, the specific launch date of the Connect Regime has yet to be announced and there is no indication when an announcement will be made.

Based on the foregoing, the following issues related to the Connect Regime and the Connect Measures still await further clarification by regulators and market infrastructures.

### **I Will exchange investors be able to trade bonds in CCDC custody via the connect regime?**

We understand from the Connect Measures that registration, custody and settlement institutions in the CIBM should open nominee accounts with each other while in the meantime SCH is defined to be the only registration, custody and settlement institution in the CIBM. This appears to indicate that there would be no links between CCDC and SCH under the Connect Regime and exchange investors would not be able to trade CIBM bonds in CCDC custody via the Connect Regime. Regulators and market infrastructures need to confirm whether this understanding is correct and whether they intend for exchange investors to invest in CCDC custody bonds in the exchange-traded bond market based on the CCDC-CSDCC Link only.

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**II How will the connect regime interact with the bond connect and will the draft announcement be promulgated soon to introduce a multi-tier custody structure for foreign investors to access China's bond markets?**

We note that under the Bond Connect, the Hong Kong Monetary Authority Central Moneymarkets Unit (HKMA CMU) acts as the single nominee holder for all Bond Connect investors and holds one omnibus bond account with each of CCDC and SCH. Therefore, with the launch of Connect Regime, we expect that it will be necessary to have at least a two-tier custody structure, i.e., SCH as the nominee holder for all bonds purchased in the exchange-traded bond market under the Connect Regime and HKMA CMU as the nominee holder for all bonds held by foreign investors that access the exchange-traded bond market via both the Connect Regime and Bond Connect.

**III Will the connect regime override existing restrictions applicable to certain types of domestic investors for their investments in the bond markets?**

For example, certain types of specified domestic commercial banks in China (such as foreign funded banks in China and major PRC banking institutions) can currently trade bonds in the exchange-traded bond market, but non-specified domestic commercial banks (mainly rural banking institutions) are able to trade bonds in the CIBM only. It remains to be elucidated whether these non-specified domestic commercial banks would be allowed to indirectly access the exchange-traded bond market via the Connect Regime.

We will continue to follow the latest developments on the connect between China's two bond markets and provide timely updates.

## ***Important Announcement***

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