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Primary Roadblock for Participation in Stock Connect by Retail Funds Being Removed - Beneficial Ownership under Stock Connect Clarified by Regulators

By Sandra Lu, Vivien Teu and Lily Luo

Since the formal launch of Shanghai-Hong Kong Stock Connect ("**Stock Connect**") in November 2014, the initiative of investment in A-shares via Stock Connect by foreign retail funds is much lower than expected, and the usage of Stock Connect by retail funds has not been extensive. The primary roadblocks halting fund managers from actively participating in Stock Connect are certain legal issues rather than technical issues. According to a survey on asset manager members conducted by Hong Kong Investment Funds Association ("**HKIFA**") last December, 85% of respondents cite beneficial ownership ("**BO**") as the top concern delaying their participation in Stock Connect, as well as in the upcoming Shenzhen-Hong Kong Stock Connect. Retail funds managers are extremely sensitive about whether the legal entitlement of their funds to SSE Securities assets can be assured, and whether they can bring legal action in Mainland China to enforce the rights in relation to SSE Securities.

We have been engaged by a large number of overseas fund managers to issue legal opinions about BO since the launch of Stock Connect. Based on CSRC Provisions[1], *SSE Measures*[2], CSRC Implementing Rules[3], and other current effective and applicable PRC[4] laws and regulations, we formulate the views that:

i. Nominee Holding Arrangement under Stock Connect - SSE Securities purchased by Northbound Investors[5] through Northbound Trading Link shall be registered under the name of Hong Kong Securities Clearing Company Limited ("**HKSCC**"). HKSCC shall provide nominee services for Northbound Investors. SSE Securities purchased by Northbound Investors shall be credited into the securities account with CSDCC opened by HKSCC as the nominee holder of SSE Securities and in the name of "Hong Kong Securities Clearing Company Limited". HKSCC has no proprietary interests in SSE Securities. The concepts of "nominee holder", "beneficial owner" can be found in other laws and regulations in PRC which are not tailor-made for the Stock Connect[6].

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ii. Rights and Interests Enjoyed by Northbound Investors - Northbound Investors shall enjoy the rights and interests of SSE Securities that they purchased through Northbound Trading Link. HKSCC shall exercise the shareholder's right towards the SSE listed companies in its own name while being subject to Northbound Investors' decisions. Therefore, (a) Northbound Investors are the ultimate beneficiary of the rights and interests of SSE Securities which include but are not limited to obtaining dividends and bonuses of SSE Securities, voting on the matters of SSE listed companies who issue SSE Securities; (b) given that SSE Securities are registered under the name of HKSCC on behalf of Northbound Investors, HKSCC as the nominee holder will be treated as the shareholder of SSE Securities to collect dividends and bonuses of SSE Securities and to handle corporate actions in respect to SSE Securities; and (c) Northbound Investors' rights and interest over SSE Securities will be exercised through HKSCC.

iii. Enforcement Issues relating to Rights and Interests of SSE Securities - With respect to certain rights and interests of SSE Securities that can only be exercised via legal action in PRC competent courts (such as certain minority shareholders' rights to revoke a defective resolution of a shareholders' meeting or a board meeting, or to initiate shareholders' derivative suit against any director or senior management personnel of the listed company who makes the listed company suffer any loss due to his/her illegal performance of duties or against any other person who infringes the company's legitimate rights and interests), it is uncertain whether such rights could be enforced and whether the PRC competent courts will recognize the shareholder's status of a Northbound Investor with a certification of its holding of SSE Securities given by HKSCC and thus accept the lawsuit directly initiated by the Northbound Investor to enforce the rights and interests over SSE Securities.

However, without formal clarification on BO from regulators and in consideration of the uncertainty about whether CSRC, SSE, CSDCC, and/or the PRC competent courts will recognize the certification of a CCASS participant's or its client's holding in SSE Securities issued by HKSCC, whether PRC competent courts will accept the legal actions initiated by foreign fund managers acting for and on behalf of the funds, fund managers with fiduciary obligations towards funds and fund investors and under stress to assure the ownership and segregation of funds assets, are still hesitant to make decisions on investing A-shares via Stock Connect. Such concern and hesitation should be largely relieved after a series of correlated actions taken by regulators in Mainland China and in Hong Kong recently. After fully detecting and understanding the importance of clarity and certainty about BO, regulators, stock exchanges, clearing houses, industrial associations in Mainland China and in Hong Kong have worked closely together to optimize relevant rules and regulations, and give clarification on this pivotal legal issue. In late March 2015, Hong Kong Exchanges and Clearing Limited ("**HKEx**") released amendments to CCASS General Rules, CCASS Operational Procedures, Information Books and FAQs to clarify BO issue from Hong Kong side. CSRC published its *FAQ on Beneficial Ownership under SH-HK Stock Connect* on 15 May 2015 ("**CSRC FAQ on BO**").

According to the amendments to CCASS General Rules having taken effect on 30 March 2015, the SSE Securities that are credited to the omnibus account maintained by HKSCC with CSDCC shall be held by HKSCC as a nominee holder only. HKSCC has no proprietary interest in, and is not the beneficial owner of, any SSE Securities held or recorded in such accounts. All proprietary interests in respect of SSE Securities belong to CCASS participants or their clients (as the case may be). HKSCC provides services to CCASS participants to enable them and their clients (as appropriate) to exercise their rights as owners of proprietary interests in China Connect Securities, including the right to receive dividends and other distributions and the power to exercise voting rights. Unless specifically provided for in the CCASS General Rules, HKSCC will not exercise any right arising from or in relation to any SSE Securities without the instruction of CCASS participants. Where any CCASS participant or any of its clients who is the beneficial owner of SSE Securities decides to bring legal action in Mainland China to enforce its rights in relation to the SSE Securities, HKSCC will: (a) upon the request of the CCASS participant and after receiving the necessary information, documentation and indemnities as HKSCC may reasonably require from the CCASS participant, provide certification to CSDCC for the purpose of providing evidential proof of the relevant CCASS participant's or its client's holding in SSE Securities at the relevant time; and (b) upon the request of the CCASS participant, assist the CCASS participant or its client in bringing the legal action in Mainland China in the manner as may be required under Mainland China law, after having regard to its statutory duties and subject to such conditions as HKSCC may reasonably require (including payment of fees and cost up-front and indemnities to the satisfaction of HKSCC).

Correspondingly, it is clarified in CSRC FAQ on BO that (a) there is concept of nominee shareholding, SSE Securities are registered in the name of HKSCC and Northbound Investors are entitled to proprietary interests in such securities; (b) the exercise of shareholder rights by Northbound Investors as beneficial owners of SSE Securities shall be in accordance with the laws and regulations of Hong Kong, i.e., pursuant to the CCASS General Rules and the CCASS Operational Procedures issued by HKSCC, beneficial owners of SSE Securities shall exercise their rights over such securities through HKSCC as the nominee holder, covering the following: 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 at shareholders' meetings, and the right to receive dividends and the distribution of earnings from investment, etc.; (c) CSRC will fully respect the certification issued by HKSCC as long as such certification is treated as lawful proof of a beneficial owner's holding of SSE Securities under Hong Kong law; and (d) PRC law does not expressly provide for a beneficial owner under the nominee holding structure to bring legal proceedings, nor does it prohibit a beneficial owner from doing so. CSRC understands that HKSCC as the nominee holder of the SSE Securities may exercise shareholder rights and take legal actions on behalf of Northbound Investors. Article 119 of the *Civil Procedure Law of the People's Republic of China* states that "the claimant in a legal action shall be an individual, legal person or any other organization that has a direct interest in the relevant case". As long as a Northbound Investor can provide evidential proof of direct interest as a beneficial owner, the Northbound Investor may take legal actions in its own name in PRC competent courts.

The above regulatory updates on BO mainly specify the provisions already written in the regulations and rules in relation to Stock Connect, while the highlights are placed on express mentioning of "nominee holder", "beneficial owner" terms by both CSRC and HKEx, the express illustration of HKSCC's role and support in the legal action in PRC to enforce the rights of beneficial owners of SSE Securities (including issuing certification of holding in SSE Securities, assisting in bringing legal action in PRC), and most importantly CSRC's recognition of the certification of holdings of SSE Securities issued by HKSCC, CSRC's understanding about the feasibility on Northbound Investors' directly bringing legal action in its own name to a PRC competent court.

As mentioned in our opinion iii, whether PRC competent courts will accept the legal action independently initiated by the Northbound Investor with the certification of holding in SSE Securities issued by HKSCC has yet to be tested. Regardless of the feasibility of independently taking legal action in PRC by Northbound Investors, HKSCC as nominee holder of SSE Securities is definitely entitled to bring legal actions for and on behalf of Northbound Investors. Reading together with the latest amendments to CCASS General Rules, it is at least viable that HKSCC will assist in bringing legal action to PRC competent courts in relation to SSE Securities with the satisfaction of certain conditions.

In conclusion, the primary roadblock for overseas retail funds' participation in Stock Connect is being removed by the close cooperation between regulators in Mainland China and Hong Kong. The industry warmly welcomes such progress and applauds them for their commitment and hard work. It is foreseeable that there will be a robust growth of participation in Stock Connect by retail funds following this.

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1. *Certain Provisions on Pilot Programme of Shanghai-Hong Kong Stock Connect* issued by China Securities Regulatory Commission ("**CSRC**") on 13 June 2014
2. *Trial Measures of Shanghai Stock Exchange for Pilot Programme of Shanghai-Hong Kong Stock Connect* issued by Shanghai Stock Exchange and effective on 26 September 2014
3. *Implementing Rules of China Securities Depository and Clearing Company Limited on Registration, Depository and Settlement Business for Pilot Programme of Shanghai-Hong Kong Stock Connect* issued by China Securities Depository and Clearing Company Limited ("**CSDCC**") and effective on 26 September 2014
4. "PRC", for the purpose of this article, refers to Mainland China, and excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan District.
5. "Northbound Investors" refers to the overseas investors investing eligible stocks listed and traded on SSE under Stock Connect regime, including the retail funds or the retail funds managers (as the case may be).
6. *Measures for the Administration of Securities Registration and Settlement* issued by CSRC in 2006 and as amended in December 2009 provide that a "nominee holder" is the person who holds securities on behalf of others. *Rules of China Securities Depository and Clearing Corporation Limited on Securities Registration* issued by CSDCC on 25 July 2006 provides that "The nominee holder shall be entitled to relevant rights vested in the securities holder, and meanwhile shall assume relevant obligations to the beneficial owner of the securities held in the name of the nominee holder, whereas the beneficial owner shall realize its relevant rights through the nominee holder. Prior to exercising relevant rights of the securities holder, the nominee holder shall consult with the beneficial owner of the securities held in the name of the nominee holder, and act on the opinions of the beneficial owner. The nominee holder shall not prejudice the interests of the beneficial owner….The securities holding certification issued by the nominee holder to the beneficial owner shall be the lawful certificate proving the securities holding of the beneficial owner".