DRAFT PROVISIONS ON THE SUPERVISION AND ADMINISTRATION OF DEPOSITORY RECEIPTS UNDER THE LONDON-SHANGHAI STOCK CONNECT SCHEME RELEASED

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On August 31, 2018, the China Securities Regulatory Commission ("CSRC") released a draft of the *Provisions on the Supervision and Administration of Depository Receipts under the Stock Connect Scheme between the Shanghai Stock Exchange and the London Stock Exchange* ("Draft Provisions") for "public consultation". The Draft Provisions set out the framework for the long-awaited London-Shanghai Stock Connect program ("London Connect"), suggesting an imminent launch, likely before the end of 2018 in line with the timetable previously suggested by People's Republic of China ("PRC") government officials.

BACKGROUND

The London Connect is a market connect scheme between the London Stock Exchange ("LSE") and the Shanghai Stock Exchange ("SSE") proposed by Chinese President Xi Jinping during his visit to the United Kingdom in October 2015. Since 2015, the two governments have worked hand in hand to develop the current framework outlined in the Draft Provisions.

The Draft Provisions contain 30 articles that address, among other things:

- establishing the review and approval regime for Chinese Depository Receipts ("CDR") issuance;
- setting up the cross-border conversion mechanism for CDRs;
- clarifying continuing regulatory and supervisory requirements for CDRs;
- setting up the regulatory framework for Global Depository Receipts ("GDR") issuance by Chinese-listed companies; and
- reinforcing enforcement activities against misconduct with clearly defined legal responsibilities.

HOW WILL THE LONDON CONNECT WORK?

When the London Connect launches, investors in London will be able to access PRC A-shares that have related GDRs listed on the LSE. Also, qualifying LSE-listed issuers will be able to access Chinese investors in Shanghai by listing CDRs on the SSE.

In the United Kingdom, the Shanghai-London Connect Segment will be a segment of the LSE's Main Market (a regulated market) for the admission to trading of GDRs representing PRC A-shares that are listed on the Main Board Market of the SSE. Trading in the GDRs will take place on the LSE's International Order Book trading service.

Companies interested in applying for the London Connect will need to meet certain thresholds as set forth by the stock exchanges (LSE and SSE) and local regulators (Financial Conduct Authority ("FCA") and CSRC). For example, the LSE's currently proposed Admission and Disclosure Standards provide in Schedule 7 that issuers seeking admission to trade GDRs on the London Connect must:

- have published an FCA-approved prospectus;
- have an FCA-approved application to admit GDRs to the official list;
- have securities listed on the Main Board Market of the SSE; and
- have a market capitalization equal to or above RMB20 million (around US$2.91 million).

The proposed LSE Admissions and Disclosure Standards are unconfirmed and remain subject to change.

Additional ongoing disclosure requirements and regulations will apply to GDR issuers, such as the European Union Market Abuse Regulation and the national law and regulations of the GDR issuers' country of incorporation.

There will also be limits that cap how many securities can be issued and regulations on how they are traded and settled on the LSE and the SSE. For example, Article 8 of the Draft Provisions provides that the number of outstanding CDRs shall not exceed the amount cap approved by the CSRC and that this amount cap will be readjusted if the number of underlying stocks changes (e.g., in the event of a stock dividend, stock split, or reverse stock split). Secondary listings in London must also be priced at a minimum of 90% of the Shanghai-listed stock's average closing price over the previous 20 trading days.

HOW DOES THE LONDON CONNECT COMPARE TO THE EXISTING HONG KONG CONNECT SCHEMES?

The London Connect will differ from the Hong Kong-Shanghai Stock Connect (launched in 2014) and the Hong Kong-Shenzhen Stock Connect (launched in 2016) (together, the "Hong Kong Connects") in some key areas:

- The London Connect will be restricted to certain securities listed on the LSE and the SSE. The London Connect will only have access to the SSE, whereas the Hong Kong Connects give investors access to the SSE and the Shenzhen Stock Exchange. Thus, investors' access to the PRC securities markets will be reduced by comparison.
- Investors using the Hong Kong Connects to execute northbound trades deal directly through local Hong Kong stockbrokers in PRC A-shares while investors who wish to use the London Connect to trade in PRC A-shares ("London Eastbound Investors") will trade GDRs (claims on foreign shares) through custodians on the London Connect. This method creates a delay between the execution of the trade and the movement of funds from buyer to seller. However, this feature was specifically designed to address the challenges posed by the time difference between London and Shanghai.

- London Eastbound Investors' access to SSE-listed issuers and PRC A-shares will be much more limited than is available through the Hong Kong-Shanghai Stock Connect. While unconfirmed, it is likely that only the largest-capitalized, "blue chip" Shanghai-listed issuers will be permitted to issue GDRs on the LSE. There is no word yet on which London issuers will be permitted to issue CDRs on the SSE. In addition, it is proposed that while SSE-listed issuers will be able to use GDRs to raise new capital, London-listed issuers will only be able to issue CDRs using existing shares. It is currently unclear how the issuance of CDRs without new capital issuance will operate. Finally, while the list of eligible stocks on the Hong Kong Connects is subject to periodic change, individual approval in order to be listed as eligible stocks is not required by an issuer from the CSRC. In contrast, under the London Connect, each issuer and the number of CDRs capable of being issued by that issuer are subject to the regulatory review and approval of the CSRC.
- PRC regulators have not currently clarified any restrictions on PRC investor eligibility to invest in CDRs. The market believes that PRC individuals who are not institutional investors will need to have capital of not less than RMB5 million (about US$732,000) to be eligible, a much higher threshold than the RMB500,000 (about US$73,200) minimum needed by PRC investors to trade through the Hong Kong Connects.

The London Connect will contain the following provisions, which are similar to those relating to the Hong Kong Connects:

- Like the Hong Kong Connects, there will be trading quotas imposed on the London Connect. However, unlike the Hong Kong Connects, where there is a maximum daily trading limit on all stocks available on the Hong Kong Connects as a whole, the London Connect will impose a limit on the number of CDRs available for trading by each issuer. The CSRC will determine CDR limits on a case-by-case basis.
- Each market's own laws and regulations will apply to local market activity, which will be monitored by the relevant local market regulator. Thus, PRC laws and regulations will apply to trading on the SSE, and the CSRC will be the primary regulator overseeing and supervising market activity on the SSE. United Kingdom laws and regulations and, as applied, European Union laws will apply to trading on the LSE, and the FCA will oversee and supervise market activity in London.

WHAT DOES THIS MEAN FOR INVESTORS AND ISSUERS?

The London Connect is a start for European investors who are inexperienced in PRC and Hong Kong securities trading and welcome news amidst the uncertainty of Brexit. However, it will not offer the full range of groundbreaking features offered by the Hong Kong Connects.

There will also be a likely benefit of direct access to PRC investors for London issuers permitted to issue CDRs, and depending on the finalized rules, London issuers may also be allowed to obtain that benefit without a need to comply with SSE regulations, as well as United Kingdom Listing Rules.

Meanwhile, relevant PRC issuers should benefit from a new way to access foreign funds.

The proposed launch of the London Connect reaffirms the desire of PRC regulators to attract foreign-listed PRC issuers (especially PRC tech titans) back home to benefit the PRC's existing A-share market as well as its domestic tech sector and, hopefully, lessen capital outflows. At the same time, CDRs were introduced in Beijing this year for the purpose of acting as instruments that permit Chinese investors to obtain stakes in foreign-listed companies via domestic stock exchanges. With the ongoing PRC-U.S. trade wars, the PRC is looking for alternatives to the United States, and London has always been its entry point to Europe and the West. Brexit notwithstanding, the London Connect is a tacit acknowledgment of this, and the PRC regulators have every intention to ensure its success.

So far, market-watchers have been cautiously optimistic — some Chinese securities companies have submitted their applications to be market makers under this mechanism. However, just as the market is watching and waiting for the outcome of Brexit negotiations, the London Connect will itself take time to develop — a measured pace that should sit comfortably with the PRC regulators.