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KEY POINTS

- Shanghai-London Stock Connect (SLSC) is an innovative cross-border financial markets listing and trading mechanism linking Chinese stock market with its British counterpart. It allows Chinese public companies to issue Global Depository Receipts (GDR) to be traded on the London Stock Exchange (LSE). Similarly, UK-listed companies can issue Chinese Depository Receipts (CDR) to obtain a secondary listing on the Shanghai Stock Exchange. SLSC enables British and international investors to purchase the shares of some of the best companies in the world's second largest economy.
- The market scale of GDR amounts to \$2.9trn while the size of the CDR market is predicted to exceed \$800bn, which could generate substantial revenues for investment banks and city law firms.
- The threshold of issuing either GDR or CDR is relatively high as issuers have to have a minimum market capitalisation of RMB20bn (US\$2.92bn). More than 260 of the 1,500 Shanghai-listed companies will be potentially eligible to participate in the project. On 17 June 2019, Huatai Securities, one of China's largest brokerages, has become the first Chinese public company to be dual-listed on the LSE via the latest SLSC. Huatai raised \$1.7bn from selling 82.5m GDRs to international investors. HSBC is said to be the first UK company to apply for a CDR listing in Shanghai.
- SLSC has raised multiple technical and regulatory challenges in relation to time difference, information disclosure, investor protection, cross-border financial supervision, as well as cross-border dispute resolution.

Authors Dr Lerong Lu and Ningyao Ye

Shanghai-London Stock Connect: operating mechanism, opportunities and challenges

This article introduces and analyses the financial and legal aspects of the latest Shanghai-London Stock Connect (SLSC), including its background information, operating mechanism, relevant laws and regulations, as well as practical challenges.

Shanghai-London Stock Connect (SLSC) is a pilot cross-border financial markets listing and trading scheme which links China's Shanghai Stock Exchange (SSE) with the UK's London Stock Exchange (LSE). The bilateral arrangement allows eligible companies listed in either the SSE or the LSE to issue depository receipts which will be admitted to listing on the other side's stock market. The SLSC gives investors in the UK an opportunity to purchase the shares of Chinese public companies. Therefore, British and international investors can enjoy the fast growth of some of the best companies in the world's second largest economy. Meanwhile, investors in mainland China are able to trade the shares of selected public companies listed in London. In the long term, the SLSC is said to help Chinese public companies adopt stricter information disclosure and corporate governance rules, and it could increase the overseas influence of Chinese businesses and currency. Moreover, the SLSC enhances London's status as a leading global financial centre. Obviously, the SLSC will create billion-dollar business opportunities

for investment banks, stockbrokers, and top commercial law firms. Against this background, the article introduces and analyses the financial and legal aspects of the latest SLSC, including its background information, operating mechanism, relevant laws and regulations, as well as practical challenges. The article will be of interest to financial lawyers in London, Shanghai and other major financial centres.

BACKGROUND AND RECENT DEVELOPMENTS OF SLSC

2018 marked the 40th anniversary of China's "reform and open-up policy" which has totally transformed the country's economy and brought China back to the world economic stage. As China vowed to further open up its economy to the rest of the world, the recently launched SLSC is considered a profound initiative to open the door of Chinese capital markets to Western financial institutions and investors. Despite the US-China trade friction and other anti-globalisation movements over past few years, China is determined to position the country as a leader

of globalisation.¹ Accordingly, it is seeking to work closely with the UK to develop a stock trading link between China and the West. The initiative displays China's great efforts to bring its stock market to the global trading system.

Previously, it had been relatively difficult for Western investors to purchase Chinese stocks, bonds, derivatives, and other financial instruments, as Beijing set strict criteria for foreign investors who intend to acquire financial assets in China. It is because the central government is wary of the stability of currency exchange rates relating to Chinese Yuan and the potential control of foreign capital over some Chinese companies in key sectors. For a long time, the only feasible method of investing in Chinese equities was to join the Qualified Foreign Institutional Investor scheme (QFII). QFII allows some licensed international investors to take part in the trading of shares, bonds, and other financial instruments listed in Shanghai and Shenzhen. However, an investment quota of up to \$100bn has been imposed on approximately 300 international investors who have been admitted to the QFII scheme.

It is not the first time for Chinese stock exchanges to establish stock links with their counterparts outside mainland China. For instance, Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect have been in operation successfully since 2014 and

2016 respectively. Technically speaking, the two existing stock links with Hong Kong are fairly easy to run, since all stock exchanges involved are located in the same time zone, and there has been close and long-term co-operation for securities regulators and financial communities in mainland China and the Hong Kong Special Administrative Region. However, stock connect initiatives with markets outside the PRC have witnessed various technical, legal, and regulatory barriers, as well as political and cultural hurdles.

In September 2015, George Osborne, the UK's former Chancellor of the Exchequer, announced a landmark feasibility study into the idea of linking the Chinese and British stock exchanges together, when he attended the 7th China-UK Economic and Financial Dialogue.² "I want to see our stock markets in London and Shanghai formally connected, with UK firms raising funds from Chinese savers, and Chinese firms listing in London," the Chancellor said when he visited the SSE.

In December 2017, London and Beijing restated their commitment to defend global free trade when British Chancellor Philip Hammond attended the 9th China-UK Economic and Financial Dialogue in Beijing.³ The Chancellor stated, "we have agreed to accelerate the final preparations for the London-Shanghai Stock Connect initiative and we have agreed to commence feasibility studies for a UK-China bond connect and for mutual recognition of funds between the two jurisdictions".

From early 2018, both countries have been working on the long-awaited launch of the SLSC. From the Chinese side, the China Securities Regulatory Commission (CSRC) promulgated the "Administrative Measures for the Issuance and Trading of Depository Receipts" and "Regulatory Provisions on the Depository Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange" which set out the listing and trading rules for the upcoming SLSC. From the UK side, the LSE issued the "Consultations on Amendments to Issuance and Information Disclosure Standards" which is regarded as an important prerequisite for starting the SLSC.

On 17 June 2019, Huatai Securities, one of the largest brokerages in China, became the first

FIGURE 1 EAST BOUND: THE LSE COMPANIES LIST SHARES IN CHINA THROUGH THE FORM OF CHINESE DEPOSITORY RECEIPTS

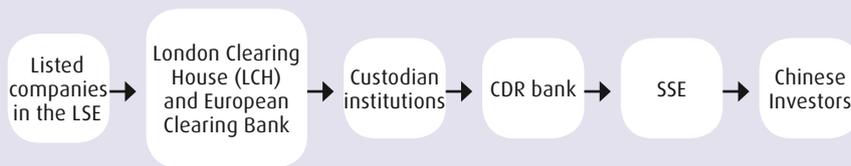


FIGURE 2 WEST BOUND: THE CHINESE COMPANIES LIST A-SHARES IN LONDON BY WAY OF GLOBAL DEPOSITORY RECEIPTS DENOMINATED IN US DOLLARS, WITH RMB AND GBP OPTIONS POSSIBLE



Chinese company to list in London via the latest SLSC pilot scheme.⁴ Huatai raised \$1.7bn from the selling of 82.5 million global depository receipts (GDR), equivalent to 10% of its outstanding share capital. This listing formally kicked off the ground-breaking SLSC initiative as it is said to enrich investment opportunities for both sides' investors. The Chancellor Philip Hammond stated at the SLSC launch event that: "Stock Connect is a ground breaking initiative, which will deepen our connectivity as we look outwards to new opportunities in Asia ... London is a global financial centre like no other, and today's launch is a strong vote of confidence in the UK market".⁵ More than 260 of the 1,500 Shanghai-listed companies will be potentially eligible to participate in the project and obtain a listing in London.⁶ As for the East bound part of the SLSC, the British bank HSBC is said to be the first UK company to apply for a listing in Shanghai.⁷

HOW DOES SLSC WORK? PRACTICE AND REGULATION

SLSC can be divided into two sub-programmes: East Bound and West Bound, which provide the cross-border conversion of depository receipts for those listed companies which plan to obtain a second listing in the counterpart market. Regarding West Bound issuance, Chinese A-Share companies wishing to be traded in the LSE

will proceed through the issuance of Global Depository Receipts (GDR). Meanwhile, East Bound issuance means that UK-listed companies will have the opportunity to list on the SSE directly by issuing Chinese Depository Receipts (CDR). In theory, depository receipts are not shares but they represent equity interests in foreign companies through an offshore custodian bank.⁸ According to CITIC Securities, the market scale of GDR amounts to \$2.9trn; Golden Sachs predicted that the prospective size of the CDR market will reach over \$800bn.⁹ Both West Bound and East Bound pathways are reliant on the issuance of depository receipts which have been an important financial tool in the global capital markets since the introduction of American Depository Receipts (ADR) in the 1920s.

In terms of the cross-border conversion mechanism, the clearing and settlement service for CDR issuers will be served by China Securities Depository and Clearing Corporation Limited (China Clear), and the clearing service for GDR issuers will be provided by London Clearing House and the settlement will be executed via Euroclear Bank.¹⁰ In practice, the UK has few restrictions over the selection of depository institutions and custodian institutions. However, China has introduced strict criteria in this area and allows few institutions to act as depository

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institutions of CDR issuers and custodian institutions of GDR issuers. For example, the depository banks for CDR issuers and custodian institutions for A-share issuers must be served by China Clear with issuers' subsidiaries, commercial banks, and securities companies approved by the CSRC.¹¹ Both sides further underscore that all trading should be in compliance with local rules, and GDR issuers should release a prospectus approved by the UK Listing Authority (UKLA) and the Financial Conduct Authority – in English. CDR issuers should open an office in mainland China to ensure information disclosure and efficient communication with Chinese investors. Given the time difference between the UK and China, both sides initially adopted the “T+1” settlement rule, meaning that the settlement date takes place one business day after the transaction date.

The SSE and CSRC have jointly put forward thresholds for individual investors in China who wish to trade CDRs: currently individual investors should have no less than RMB3m (US\$440,000) in their cash or securities accounts over 20 trading days before applying for a licence to trade CDRs; investors should also have good credit records and no criminal record. Institutional investors wishing to obtain a licence to trade CDRs should apply and submit an application to CDR cross-border conversion institutions in accordance with related rules released by the CSRC and the SSE. CDR holders will be treated as shareholders under Chinese company law, so they will have the right to receive share dividends, to vote on material matters, and to allocate residue assets in the event of insolvency.

Cross-border conversion institutions (also referred to as designated brokers by the LSE) will consist of securities companies that obtain a special licence to conduct business on selling and purchasing CDRs and GDRs on behalf of their clients. The SSE will be responsible for managing the procedure of how to become a cross-border conversion institution which will be the principal market makers for CDR transactions. For an LSE member broker who wishes to become a GDR cross-border conversion institution, it must appoint an SSE member broker to help it to submit the relevant application and supporting documents as required, whereas the SSE and CSRC will

directly designate certain member securities companies to become CDR cross-border conversion institutions. In line with the CSRC rules, the buy-back of GDRs within 120 days is not allowed, in order to prohibit opportunistic GDR issuers from selling GDRs at a higher price but repurchase such securities at a lower price immediately (speculative arbitrage). There are, however, no restrictions on the buy-back of CDRs. To become GDR cross-border conversion institutions, securities brokers have to satisfy the following standards:

- have a full membership of the LSE;
- be qualified as Foreign Institutional Investor (QFII) or RMB Qualified Foreign Institutional Investor (RQFII), or be a subsidiary wholly owned by the QFII or RQFII; and
- comply with the regulatory requirements and rules set by the SSE.

CDR cross-border conversion institutions will have to meet extra requirements imposed by the SSE and CSRC, including:

- being approved by the SSE;
- being approved and rated by the CSRC;
- have a history of overseas trading;
- be able to carry out market-making services, initial liquidity, and bilateral quotation;
- be qualified to be involved in proprietary trading of securities;
- be classified as securities with at least “BBB” rating for a minimum of two years; and
- have over a three-year history in trading overseas securities.

Furthermore, both stock exchanges have set out detailed requirements for eligible companies to list their shares through the stock link programme. In comparison with the CDR issuance, it is relatively easy for GDR issuers to list on the LSE, as they have to meet the following requirements:

- have a market value of over RMB20bn (US\$2.92bn);
- be listed on the SSE;
- be approved by the CSRC;
- allot new shares to be listed on the SSE, which will be the underlying securities to be converted cross-border as GDRs to be traded on the LSE;

- comply with the rules of the UKLA and the LSE admission and disclosure standards; and
- comply with the 25% free float requirement for GDR listing.

For CDR issuers, they must satisfy the following criteria:

- have a market value of over RMB20bn (US\$2.92bn, based on the closing price of the quoted stock 120 days ago);
- have been listed on the LSE for over three years, with the minimum of one year in the Premium Segment of the Main Market;
- issue at least 50 million shares of CDRs worth over RMB500m (US\$73m); and
- obtain the approval from the CSRC in line with the SSE requirements.

In addition, the CSRC has asked CDR issuers to follow the extra requirements as follows:¹²

- have a complete and well-operated organisation;
- have the capability of making profits continuously and a sound financial status;
- have no false record in its financial statements over the latest three years and have no other irregularity;¹³
- have legally operated over three years without ownership disputes over major assets;
- have taken no illegal actions in violating the legal rights of investors and public interest;
- have in place a standardised accounting and sound internal control system;
- directors, auditors and senior management should have a good reputation, qualifications and good credit records; and
- follow other rules issued by the CSRC.

Moreover, the *Measures for the Issuance and Trading of Chinese Depositary Receipts (for trial implementation)* attempts to address the conflict of laws under different jurisdictions towards existing LSE-listed companies. It requires overseas listed companies to disclose the major differences between its local company law and the Company Law of the People's Republic of China, and the relevant impacts on issuing CDRs and investor protection in the prospectus.¹⁴ Further, companies that adopt variable interest entity (VIE) and weighted

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voting rights should disclose information relating to potential risks and corporate governance issues in an obvious place in the prospectus. CDR issuers are required to include a separate chapter on investor protection in the prospectus. Article 14 of 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)* emphasises that, after the CDR listing, these Provisions will be used for the ongoing supervision of the SLSC. However, the *Measures for Ongoing Supervision of Innovative Enterprises Following Listing of Domestically Offered Stocks or Depository Receipts (for trial implementation)* will provide alternative rules in terms of issues not mentioned in the Provisions.

TECHNICAL AND REGULATORY DIFFICULTIES OF SLSC

Given the various differences regarding trading mechanisms, laws, financial regulations, investor sophistication, and culture between China and the UK, there are multiple challenges which need to be solved by joint efforts on both sides. One main concern is the 7-8 hour time difference between London and Shanghai, making it difficult for traders to react to the real-time price changes in another time zone. As a response, the SSE has proposed to open an international sector during London hours to address this problem. Brexit has also cast a dark cloud over the stock link, though closer ties between Chinese and British capital markets would be welcome by London which has to protect its prestigious status as a top global financial centre. Apart from this, there are further regulatory challenges in the following areas.

One major challenge lies in the different regulatory systems between the two countries. With the rapid growth of GDR and CDR issuance in the upcoming years, it makes cross-border securities regulation and supervision an urgent task for both the CSRC and FCA. In comparison with China's heavily regulated financial markets, the UK has adopted a more market-based approach and has relatively lax rules for listed companies in many aspects. This may lead to the problem of regulatory arbitrage and improper competition arising from the deregulation process. Lax regulation in the UK

could have the incentive for parties to favour their domestic UK companies over the counterparties by applying advantageous rules through deregulation. Therefore, China and the UK have been advised to establish a SLSC joint taskforce handling regulatory issues to try to unify the applying laws and regulatory approach.

Another problem is associated with information disclosure. At present, CDR issuers will be individually responsible for information disclosure. According to Chapter 4 of the *Measures*, CDR issuers have an obligation to release all information required by the SSE. This could make CDR issuers overburdened with various information disclosure obligations, which may hit the enthusiasm of potential CDR issuers and could jeopardise the international competitiveness of the Chinese stock market. The legal arrangements for information disclosure under ADR can offer a point of reference for the SLSC. In the US, depository institutions as nominal issuers are responsible for the issuance, registration, and information disclosure of depository receipts, whereas, ADR issuers only need to undertake the responsibilities of issuance, registration, and information disclosure of underlying securities listed abroad.

Furthermore, there are some controversies about whether current regulations can offer good protection for investors who trade cross-border depository receipts. Due to the different geographical location, language, corporate culture, and legal system, the classic problem of information asymmetry in the stock market is that it might be more difficult for investors to acquire the information they need to make informed investment decisions. Considering the long and complex transactional chain relating to depository receipts, the bankruptcy of any parties in the chain such as overseas listed companies, custodian institutions, or depository institutions will result in financial loss to investors who have limited remedies. In the absence of effective dispute resolution mechanisms, it would be difficult for investors to pursue litigation as they will have to overcome the difficulties of interpreting laws, collecting evidence, and enforcing claims. ■

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- 12 CSRC, *Measures for the Issuance and Trading of Chinese Depository Receipts (for trial implementation)*, Art 5.
- 13 The first three provisions have reiterated Art 13 (1) (2) (3) of People's Republic of China Securities Law.
- 14 CSRC, *Measures for the Issuance and Trading of Chinese Depository Receipts (for trial implementation)*, Art 17.