

THE BOND CONNECT – ANOTHER EFFORT OF MARKET LIBERALISATION THROUGH HONG KONG

The launch of the northbound trading link of the Bond Connect (**Northbound Trading Link**) was announced on 2 July 2017, right following the 20th anniversary of the return of Hong Kong's sovereignty to the PRC. Trading officially commenced on 3 July 2017, with participation by 70 international investors and 19 onshore quoting institutions and a turnover of over RMB7 billion by the close of the day.

The Mainland and Hong Kong first launched the Stock Connect in 2014, initially establishing mutual market access between Shanghai and Hong Kong, and subsequently between Shenzhen and Hong Kong as well. The latest introduction of the Bond Connect represents yet another significant milestone in connecting the two financial markets a step further. Since Hong Kong is a free and open market, like the Stock Connect, the Bond Connect is essentially a connection between China and the world through Hong Kong.

Since 16 May 2017 when the People's Bank of China (**PBoC**) and the Hong Kong Monetary Authority (**HKMA**) jointly announced their collaboration in setting up the Bond Connect, a series of regulations and guidelines¹ have been issued to formulate the basic framework and key rules for implementing the Northbound Trading Link.

OVERVIEW

The Bond Connect is an arrangement that enables the Mainland and overseas investors to trade various types of debt securities (collectively as bonds) in each other's bond markets through connection between the relevant

Key issues

- Overview of the Bond Connect
- Trading link
- Settlement Link
- Pending issues and outlook

¹ Clifford Chance has prepared English translation of the major regulations, operational rules and policy Q&As issued by the relevant regulators and infrastructure institutions. Should you need a copy, please contact the Clifford Chance contact persons at the end of this newsflash.

respective financial infrastructure institutions. The Bond Connect is intended to include both the "Northbound Trading Link" and the "Southbound Trading Link". To date, only the Northbound Trading Link has been launched to enable overseas investors from Hong Kong and other areas (**Overseas Investors**) to invest in the China Interbank Bond Market (**CIBM**), through mutual access of bond market infrastructures in respect of trading, custody and settlement, etc. No investment quota has been imposed for the Northbound Trading Link so far.

As a general rule, the Northbound Trading Link will be subject to existing laws and regulations of the Mainland and Hong Kong, and relevant trading and settlement activities must comply with the regulatory provisions and business rules of the jurisdiction in which the trading and settlement take place. Especially in the settlement link, this general rule is critical to the multi-layered custody arrangement and recognition of beneficial ownership of Overseas Investors.

Compared with the ability presently available to various types of foreign investors to access the CIBM, the Northbound Trading Link is more flexible in that it allows Overseas Investors to invest in the CIBM on an offshore basis without having to change their business practices. By relying on the infrastructure connection and a multi-layered custody arrangement, the Bond Connect should provide higher efficiency for market entry. In addition, Overseas Investors may participate in sub-underwriting of primary bond issuance in the CIBM, which is currently not available under the direct access model.

The diagram in the Appendix attached provides a high-level description of the Northbound Trading Link in terms of the trading, account structure and settlement arrangement.

TRADING LINK

Overseas Investors may send trading orders through the offshore electronic trading platform(s) recognized by PBoC (which currently is Tradeweb), and execute trades on the onshore electronic trading platform (i.e. the China Foreign Exchange Trading System (**CFETS**)). Salient points relating to such trading include:

- *Scope of eligible Overseas Investors.* The scope of eligible Overseas Investors is the same as that having direct access to the CIBM. This includes all foreign central banking types of institutions under PBoC Circular [2015] No. 220 and overseas institutional investors under the PBoC Announcement [2016] No. 3. An eligible Overseas Investor may submit a CIBM market entry filing with the PBoC Shanghai Head Office through a qualified agent (including CFETS, CCDL, SHCH and onshore CIBM settlement agents).
- *Available products for trading.* Eligible Overseas Investors may trade in all kinds of bonds that are traded on the CIBM.
- However, at this present stage, Overseas Investors are only allowed to trade in cash bonds under the Northbound Trading Link.
- *Trading method and counterparties.* Trades under the Northbound Trading Link must be initiated by way of a request for quote (**RFQ**) and be completed between onshore dealers (a list of which is made available by

CFETS) and Overseas Investors, which reflects a dealer-versus-client model.

SETTLEMENT LINK

Once a transaction is confirmed by an Overseas Investor and its trading counterparty, CFETS will send an execution confirmation to the onshore custody institution for settlement, namely the China Central Depository & Clearing Co., Ltd. (**CCDC**) or the Shanghai Clearing House (**SHCH**), depending on where the bonds to be delivered are deposited. Relevant key aspects relating to the custody and settlement include:

- *Nominee account structure.* Under the nominee holding structure, the offshore custody institution (i.e. the Central Moneymarkets Unit (**CMU**) under HKMA), opens nominee account(s) with CCDC and SHCH to record the aggregate bond balance respectively. The CMU opens accounts to record the bonds for the beneficiary ownership of Overseas Investors in accordance with applicable CMU rules.
- PBoC closely follows the definition of nominee holder and beneficial owner under international standards and the Stock Connect, clarifying that (i) the CMU, being the nominee holder, is entitled to exercise creditor's rights over the bonds in its own name subject to the decision of the Overseas Investor; and (ii) the Overseas Investor, being the beneficial owner, must hold bonds through the CMU and enjoy the rights and interests of the bonds purchased through the Northbound Trading Link. Hong Kong law will apply where the Overseas Investors exercise their creditor's rights and where beneficial owners are to be identified.
- *Mutli-layered custody.* Under the multi-layered custody arrangement, CCDC/SHCH will serve as the ultimate central securities depository (**CSD**) which handles bond depository, custody and settlement for the CMU in Mainland China. The CMU is the sub-CSD which handles bond depository, custody and settlement for the accounts opened with it for the beneficial ownership of the Overseas Investors.
- *Settlement.* CCDC and SHCH provide delivery-versus-payment (DvP) settlement services for CMU and its counterparties. The CMU, the CMU members and other custodians or sub-custodians (if any) engaged by the Overseas Investors will provide relevant bond settlement service to those who apply to open accounts with them under the multi-layered custody structure in accordance with the CMU rules and other applicable rules outside China. Bond delivery will be handled through the operation of CCDC/SHCH, while cash payment will be completed via PBoC's Cross-border Interbank Payment System (**CIPS**).

Gross trade-by-trade settlement is adopted in the current Northbound Trading Link, under which an Overseas Investor should ensure it has sufficient bonds and cash for settlement, failing which it would be fully liable.

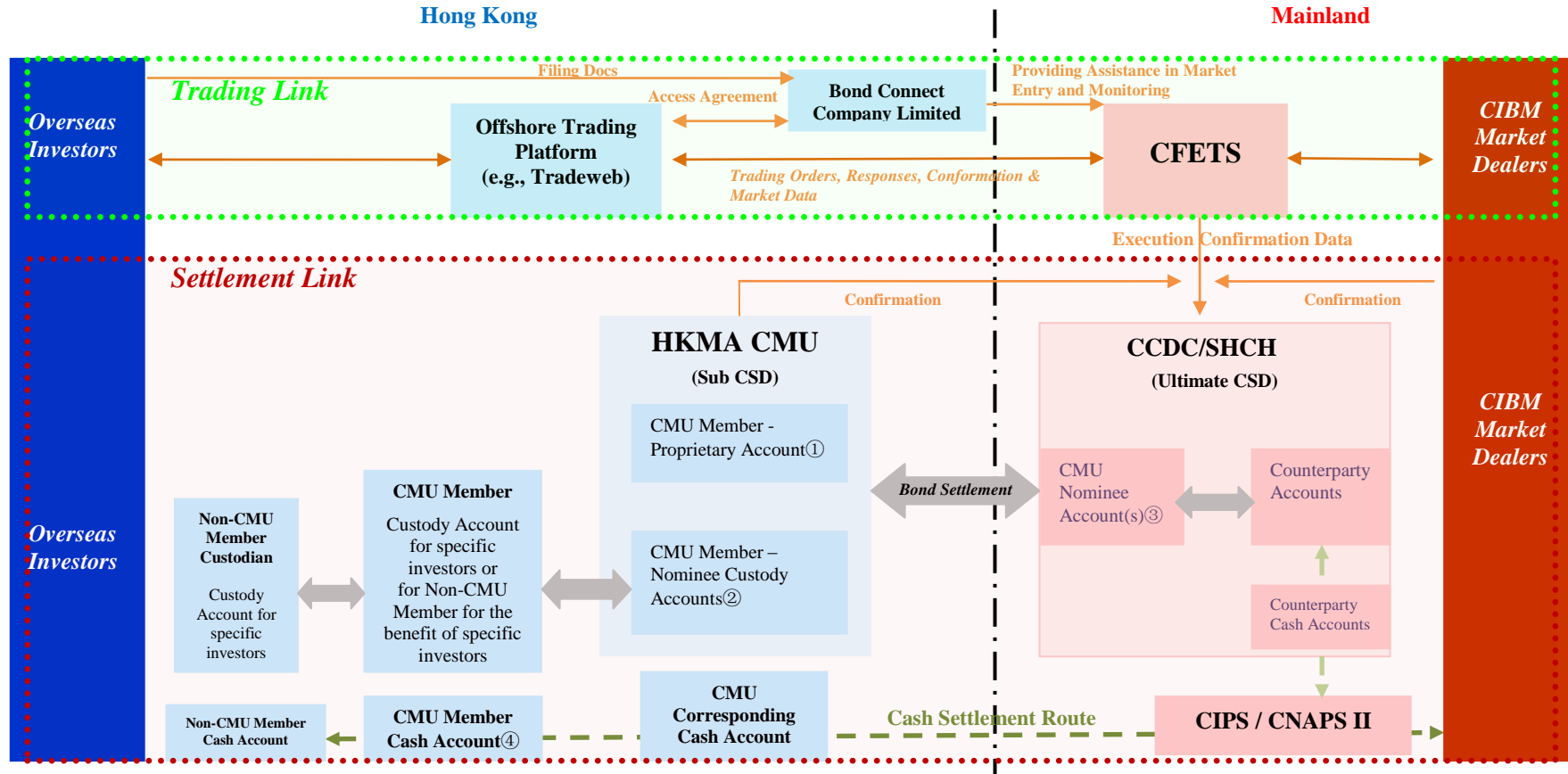
- To facilitate cross-border transactions of the Overseas Investors, settlement cycle is now extended to T+2 (previously only T+0 or T+1 is available).

- *Currency conversion.* The Overseas Investors may invest in the CIBM with either RMB or foreign currencies. For investment with foreign currencies, an Overseas Investor must open a special RMB cash account with the designated Hong Kong RMB clearing bank or qualified RMB business participating banks in Hong Kong for handling currency conversion and settlement.

PENDING ISSUES AND OUTLOOK

- *Southbound Trading Link.* According to PBoC, the Southbound Trading Link will be rolled out in due course based on the overall arrangement of financial collaboration between the Mainland China and Hong Kong.
- *Tax treatment.* Relevant tax treatment applicable to the Northbound Trading Link has yet to be released. It is expected that a separate tax circular will address these issues.
- *Offshore China bond-linked financing.* It remains unclear whether, and to what extent, offshore financing activities involving bonds purchased through the Northbound Trading Link, such as bond borrowing and lending and bond pledge, would be permitted by Mainland regulators.
- *More accurate risk assessment and pricing in the CIBM.* PBoC has published a new circular to allow global rating agencies to engage in credit rating business in the CIBM. This is a step forward in promoting the CIBM into a more liberalized and internationalized market.
- *Inclusion in international bond indices.* Recently, several international bond index providers (such as Bloomberg and Citi) have announced that they will include onshore Chinese bond into their bond indices. It is expected that the Bond Connect would facilitate further inclusion of onshore Chinese bonds into the mainstream bond indices (such as Citi WGBI, JPM GBI-EM and Barclays capital bond composite global index).
- *More flexibility anticipated under the Northbound Trading Link.* It is expected that in the future, SHCH may provide CCP settlement services based on market demands. CFETS may adjust the current RFQ trading method where needed. CIPS Phase II may also be launched to further extend its time of operation so as to offer a more flexible business mode for cash clearance.

Appendix



Settlement Link Note:

- ① "CMU Member - Proprietary Account" is used for recording securities beneficially owned by the CMU Member itself. CMU Member is the Overseas Investor under the Northbound Trading Link.
- ② "CMU Member – Nominee Custody Account" is used for recording bonds held on behalf of specific Overseas Investors by the CMU Member as nominee (opened at the request of CMU Member). All instructions to debit or credit a Nominee Custody Account must be sent to the CMU by the CMU Member.
- ③ The aggregate balance of bonds held in Proprietary Accounts and Nominee Custody Accounts of all CMU Members under Northbound Trading Link shall be equal to the aggregate balance of bonds held in the CMU Nominee Account(s) at the CCDC/SHCH. The CMU system will generate the account position report for the Proprietary Account(s) and Nominee Custody Account(s). The CMU Member will need to refer to its own internal records to identify the beneficial ownership of bonds held in the Nominee Custody Account(s).
- ④ Corresponding to bond transactions via Nominee Custody Accounts, the CMU Members complete cash settlement across the books maintained under the CMU Member Cash Account opened with qualified account banks in Hong Kong.

CONTACTS**Beijing****Yang Tiecheng**
Partner**T** + 86 10 6535 2265
E tiecheng.yang
@cliffordchance.com**Kimi Liu**
Senior Associate**T** + 86 10 6535 2263
E kimi.liu
@cliffordchance.com**Shanghai****Ge Yin**
Counsel**T** + 86 21 2320 7202
E yin.ge
@cliffordchance.com**Zheng Ting**
Associate**T** + 86 21 2320 7232
E ting.zheng
@cliffordchance.com**Hong Kong****Mark Shipman**
Partner**T** + 852 2825 8992
E mark.shipman
@cliffordchance.com**Francis Edwards**
Partner**T** + 852 2826 3453
E francis.edwards
@cliffordchance.com**Terry Yang**
Partner**T** + 852 2825 8863
E terry.yang
@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 40th Floor, Bund Centre, 222 Yan An East Road, Shanghai 200002, People's Republic of China

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