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Dear Patricia

Re: Ability of Irish UCITS and AIFs to invest via China Bond Connect

The China Bond Connect (“Bond Connect”) initiative, which launched in July 2017, is a very significant development for the international funds industry in Ireland. In providing access to the China bond market for international investors, Bond Connect represents an alternative to the existing CIBM Direct, QFII and RQFII routes and is therefore of significant interest to international fund promoters distributing Irish domiciled investment funds.

Given the proposed inclusion of bonds traded on the China Interbank Bond Market (“CIBM”) in a number of internationally recognised indices including, Bloomberg Barclay Global Aggregate Index (potential inclusion from April 2019), FTSE World Government Bond Index and JP Morgan Government Bond-Emerging Market Index, it is also extremely important that Irish collective investment schemes tracking those indices are able to obtain access to the China bond market in the most straightforward and efficient manner possible (and without having to go through the process of obtaining relevant quotas under QFII and RQFII and implement the attendant infrastructure in relation to investment through PBOC CIBM direct or either of the above channels). A lead-in time to allow for opening of the relevant accounts will be required to ensure that Irish collective investment schemes can access Bond Connect in time for the inclusion of CIBM bonds on these indices.

Following engagement with the Hong Kong Exchange (“HKEX”), the Hong Kong Monetary Authority (“HKMA”) and other industry participants involved in the structuring of Bond Connect, we are of the firm view that it is appropriate for Irish domiciled UCITS and AIFs to invest via Bond Connect. In order to facilitate the review of Bond Connect by the Central Bank, we have outlined in this paper how the custody and settlement arrangements for Bond Connect fulfil the depositary requirements

as per the UCITS and AIFMD frameworks and have sought to address the questions raised by the Central Bank in response to previous industry submissions in respect of the Stock Connect scheme. This is on the basis that the Bond Connect infrastructure draws heavily upon that implemented by the HKEX when implementing Stock Connect and we are conscious that the Central Bank invested significant time in 2015 in evaluating investment through the Stock Connect regime. We have included in Appendix 1 hereto a table which sets out some of the key differences between Stock Connect and Bond Connect.

For the reasons set out in this paper, Irish depositaries are satisfied that they will be in a position to comply with their safekeeping obligations in respect of Irish collective investment schemes accessing Bond Connect.

We welcome the opportunity to discuss any aspect of our analysis with you and look forward to engaging with you on this subject in the near future. As noted above, we have also had input from Hong Kong industry bodies including Bond Connect Company Limited (“BCCL”) in preparing this briefing note and are aware that Julien Martin, CEO of BCCL, has previously met with the Central Bank in order to provide an overview of Bond Connect. We confirm that BCCL has confirmed its availability to engage further with the Central Bank on a call or in writing in the event that you have any particular questions arising from your review of this submission which might require their input.

Yours sincerely



Aoife Coppinger
Regulatory Affairs Manager

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Overview

In 2017, the People's Bank of China ("PBoC") approved collaboration between China Foreign Exchange Trade System & National Interbank Funding Centre ("CFETS"), China Central Depository & Clearing Co., Ltd ("CCDC"), Shanghai Clearing House ("SHCH") (collectively the "Mainland Financial Infrastructure Institutions"), and Hong Kong Exchanges and Clearing Limited ("HKEX") and the Central Moneymarkets Unit ("CMU") of the Hong Kong Monetary Authority ("HKMA") (collectively the "Hong Kong Financial Infrastructure Institutions"). The aim of such collaboration was the development of the bond markets in Hong Kong and Mainland China through establishment of mutual bond market access between Mainland China and Hong Kong by way of a scheme now commonly known as "Bond Connect".

While the infrastructure contemplates two-way access between Hong Kong and China, at present it is only open in respect of investment through Hong Kong into the CIBM (generally referred to as "Northbound" access). Northbound trading commenced on 3 July 2017, offering CIBM access to a broader group of international investors. This submission is concerned with the ability of Irish collective investment schemes to invest into the CIBM through the Northbound access scheme.

BCCL is a joint venture established by CFETS and the HKEX to support Bond Connect related trading services. BCCL supports the admission and registration of Northbound investors, liaises closely with the recognised access platforms through which international investors are able to trade CIBM instruments, and conducts investor education activities in relation to Bond Connect.

This paper is intended to provide information in relation to the Bond Connect structure, together with relevant supporting materials. In terms of structure, we have considered the various queries raised by the Central Bank in respect of submissions made in 2015 regarding the Stock Connect scheme and sought to address those items of concern to the extent that they may also apply in respect of Bond Connect. As noted above, the analysis contained herein addresses Northbound trading only and is particularly focussed upon any concerns which the Central Bank might have in respect of custody and settlement arrangements for Northbound trading in the CIBM via Bond Connect.

Northbound Custody Arrangements

Bond Connect has a trading link and a settlement link. The settlement link of the Northbound Trading is responsible for the settlement and custody of CIBM bonds and involves the HKMA's CMU and China's central securities depositories, CCDC and SHCH.

Northbound Trading under Bond Connect adopts a multi-layered custody arrangement whereby CCDC/SHCH performs the primary settlement function as the ultimate central securities depository, which handles bond custody and settlement for the CMU in Mainland China.

The CMU is the nominee holder of CIBM bonds acquired by overseas investors via the Northbound Trading. The CMU handles custody and settlement for the accounts opened with it for the beneficial ownership of those overseas investors.

There are two levels in Bond Connect below CCDC and SHCH:

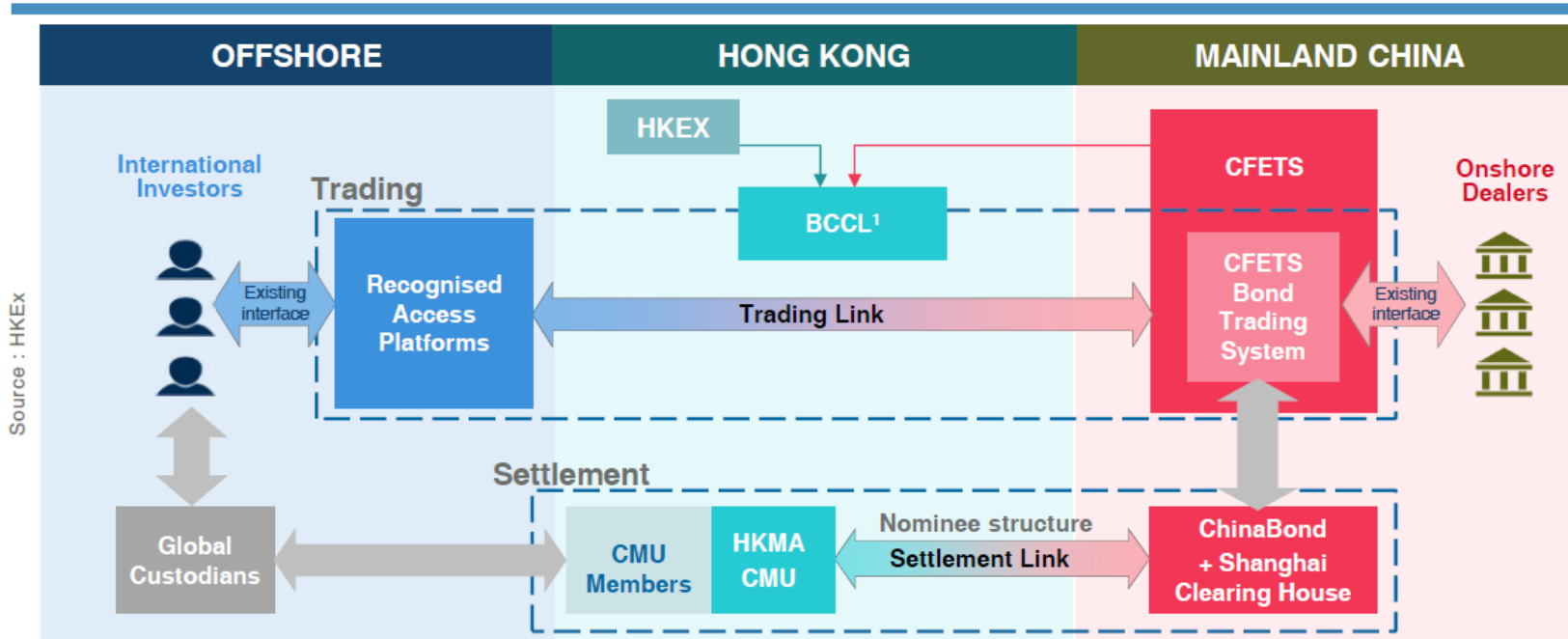
- 1) the CMU as “nominee holder “of CIBM bonds and
- 2) overseas investors as “beneficial owners” of CIBM bonds through CMU members.

CMU members will be appointed as sub-custodians of the relevant Irish fund and are subject to the same regulatory, safekeeping and due diligence requirements as any other duly appointed sub-custodian.

Overseas investors invest through offshore electronic trading platforms where trade orders are executed on CFETS, CIBM’s centralised electronic trading platform, between investors and onshore market makers.

The CMU is responsible for clearing and settlement of the trades with China market clearing houses, the SHCH and CCDC. Bonds are held in omnibus accounts in SHCH and CCDC, in the name of CMU for all overseas investors. CMU provides nominee services to its own members for their securities purchased through Bond Connect. See diagram below.

Bond Connect Northbound Operating Model



(1) Bond Connect Company Limited, jointly owned by CFETS and HKEX, will support and assist admission and registration for Northbound investors, and liaise closely with the recognised Access Platforms under Bond Connect

International investors trade via global platforms with assets held in custody via a Hong Kong (CMU) nominee structure; Mainland regulators fulfil their requirements for transparency and control

For a comparison between Stock Connect and Bond Connect, please refer to Appendix 1.

1. Real Time Delivery Versus Payment

There is no requirement to pre-fund when trading via Bond Connect. Since August 2018, the pre-trade checking requirement in Bond Connect has been eliminated due to the upgrade by Bond Connect of its settlement system to fully implement real-time delivery-versus-payment (“RDVP”). Payment for settlement of the CIBM bonds under Bond Connect will be made to the CMU.

In the Cross Border Interbank Payment System (“CIPS”) RDVP settlement flow, once a transaction is completed in the trading system and passed to CCDC or SHCH’s system and the transaction is confirmed by the CMU for settlement purpose, the two Mainland CSDs will lock up the relevant bonds in the system and at the same time initiate payment instructions to the CMU via CIPS system. If CMU’s account has sufficient funds then the payment instructions will be settled and the securities settlement will also be performed on a RDVP basis. In case CMU’s account has insufficient funds then the payment instructions will queue in the system pending for payment until sufficient funds are available. At no point during the process will the bonds rest with a broker.

2. Capacity of CMU Acting in Connection with Bond Connect

CMU was established in 1990 and is a debt securities clearing and settlement system which provides clearing, settlement and custodian services for debt securities issued by both public and private sector entities. It is a designated system under the Payment Systems and Stored Value Facilities Ordinance (*Chapter 584 of the Laws of Hong Kong*), which provides the legal basis for settlement finality for any transactions effected through CMU. CMU is subject to the ongoing statutory oversight of the HKMA which is carried out by the Financial Market Infrastructure Oversight team at the HKMA. (See section 4, 11, 13, 15 & 20 of the HKMA CMU: Principles for Financial Market Infrastructure; Disclosure for Central Moneymarkets Unit)¹

The members of CMU are local custodians which are appointed by the global custodian of the investor. To become a member of the CMU, a financial institution must be regulated by any one of the following authorities: (i) Hong Kong Monetary Authority (ii) Securities and Futures Commission; (iii) Office of the Commissioner of Insurance or (iv) Mandatory Provident Fund Schemes Authority. The HKMA may, in its absolute discretion, approve or dis-approve an application from such a financial institution to become a CMU Member. The HKMA may also exercise its discretion to grant

¹ https://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/cmu_disclosure_framework.pdf see appendix 2

CMU membership to any institution (overseas or otherwise) which is not regulated by an authority referred to above.

The Principles for Financial Market Infrastructures to Designated Clearing and Settlement Systems (“PFMI”) which were issued jointly by the Committee on Payments and Market Infrastructures (“CPMI”) and the International Organization of Securities Commissions (“IOSCO”) have defined what they regard to be a Securities Settlement System (“SSS”). CMU has confirmed that it qualifies as an SSS and this has been supported by a related report published by HKMA.² (Please see Page 6 of the HKMA CMU: Principles for Financial Market Infrastructure; Disclosure for Central Moneymarkets Unit & Question 2 of the Bond Connect Settlement Link FAQ³ August 2018 addressing the role of CMU under Bond Connect.)

Furthermore CMU believes that it qualifies as a third-country SSS within the exclusion set out in (1) Article 22a(4) of the UCITS V Directive and (2) Article 21(11) of the AIFM Directive, in respect of the bonds invested by UCITS and held by CMU/HKMA as a nominee holder under Bond Connect. (See Page 6 of the HKMA CMU: Principles for Financial Market Infrastructure; Disclosure for Central Moneymarkets Unit & Question 3 of the Bond Connect Settlement Link FAQ August 2018 addressing whether CMU needs to be appointed as a delegate for the purposes of the UCITS Directive and the AIFMD.)

Please see section 4 relating to Safekeeping Requirements for Depositories below for more information.

3. Responsibilities of CMU as Nominee

Under Bond Connect, the CMU holds CIBM bonds as nominee on behalf of CMU members, who in turn provide services directly or indirectly to overseas investors using Bond Connect. The CMU has opened nominee accounts with two Mainland CSDs, the CCDC and SHCH, to settle Bond Connect transactions and hold CIBM bonds on behalf of CMU members. These nominee accounts are held in accordance with the CMU Membership Agreement, the CMU Reference Manuals and other

² HKMA’s assessment of Central Moneymarkets Unit against the Principles of Financial Market Infrastructures: https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/oversight/CMU_assessment_2016.pdf
Disclosure Framework for Central Moneymarkets Unit: https://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/cmu_disclosure_framework.pdf

³ See Appendix 2

relevant documents. The rights and obligations of the CMU and the CMU members are governed by Hong Kong law.

Under a multi-layered custody arrangement, the CCDC / SHCH will serve as the ultimate CSD which handles custody and settlement for the CMU in Mainland China. The CMU is the sub-CSD which handles custody and settlement for the accounts opened for the beneficial ownership of the overseas investors.

At the CMU level, the CIBM bonds acquired through Bond Connect are allocated to, and recorded as separate holdings of, the relevant CMU members (either as their proprietary investment or as client assets in their custody role).

CMU members will each be duly appointed sub-custodians of the Global Custodian on behalf of the relevant Irish fund. Each CMU Member segregates Bond Connect securities in accordance with the terms of the respective sub-custodian agreement as set out in the UCITS and AIFMD guidelines.

The market infrastructure under Bond Connect is the same as for other CSDs and for Stock Connect.

4. Safekeeping Requirements of Depositaries

As outlined in section 2, CMU has determined that it qualifies as a third country SSS and is therefore exempt from the requirements applicable to delegates under UCITS and AIFMD. (See Question 3 of the Bond Connect Settlement Link FAQ August 2018 addressing whether CMU needs to be appointed as a delegate for the purposes of the UCITS Directive and the AIFMD.)

UCITS V Directive - Article 22 provides that the assets of UCITS must be entrusted to Depositaries for safekeeping. Where a Depositary decides to delegate the safekeeping function to a third party (i.e. a delegate or sub-custodian), it must ensure that such delegate or sub-custodian is able to meet the requirements set out in Article 22a (3) at all times during the performance of the tasks delegated to them. Article 22a(4) of this Directive, however, states that the provision of certain services by third-country SSS, such as CMU, shall not be considered to be a delegation of custody functions, hence excluded from the requirements applicable to delegates / sub-custodians.

AIFM Directive - Article 21(8) provides that the assets of alternative investment funds (AIFs), or alternative investment fund managers (AIFMs) acting on behalf of AIFs, must be entrusted to Depositaries for safekeeping. Where a Depositary decides to delegate the safekeeping function to

third parties, it must ensure that the delegates or sub-custodians are able to meet the requirements set out in Article 21(11)(d) of the AIFM Directive at all times during the performance of the tasks delegated to them. The last paragraph of Article 21(11) of the AIFM Directive, however, states that the provision of services as specified by the SSS Directive⁴ by SSS as designated for the purposes of that Directive or the provision of similar services by third-country SSS, such as CMU, shall not be considered to be a delegation of custody functions, hence, excluded from the requirements applicable to delegates / sub-custodians.

5. Segregation of Assets

As noted in the Bond Connect Settlement Link FAQ August 2018 (Q6), under Bond Connect, a purchase of CIBM bonds is recorded in book entry form after the transaction is cleared and settled. Assets are distinctly segregated into three levels across the Mainland and offshore CSDs:

i. At the Mainland/Onshore CSD (i.e. CCDC/SHCH) level

The CIBM bonds purchased will be held in the omnibus securities account maintained with the relevant Mainland CSDs in the name of the CMU, which holds the CIBM bonds as nominee holder for CMU members and their underlying clients.

ii. At the Offshore CSD (i.e. CMU) level

Each CMU Member's account in the CMU system is separate from the other CMU Members' accounts and therefore the CIBM bonds held in the account of a CMU Member are segregated from those held in other CMU members' accounts.

iii. At the CMU Member level

Each investor is required to open a segregated debt securities account (at the level of the investor, be it a Fund or a Sub-fund) with its local custodian (a CMU Member) which in turn opens and maintains segregated sub-accounts within its account in the CMU system to hold its or its clients' CIBM bonds at individual eligible investor level.

The account number of each investor's sub-account is required to correspond to the investor's CFETS ID, which is assigned by CFETS to the investor when it completes its application for Bond Connect. Each investor's sub-account is separate from the other investors' sub-accounts with the same CMU

⁴ Directive 98/26/EC on settlement finality in payment and securities settlement systems.

Member and the CIBM bonds held in an investor's sub-account are therefore segregated from those held in other investors' sub-accounts.

System processes and operational procedures have been established to ensure a timely and daily reconciliation of the holdings of CIBM bonds of CMU members in the CMU system with those of CMU's omnibus accounts maintained with the Mainland CSDs.

6. Recordkeeping and Title of Assets

The requirement that depositaries *'maintain appropriate internal control systems to ensure that records clearly identify the nature and amount of all assets under custody, the ownership of each asset and where documents of title to that asset are located'* is met through three levels of reconciliation: (i) between CSDs and CMU; (ii) within CMU going through the same reconciliation procedures as it does for all CIBM bonds in the usual manner; and (iii) through CMU providing reports and information to CMU participants to enable them to conduct their own checking and internal record reconciliation.

Article 9 of the Interim Measures for Bond Connect ("Article 9") specifies the requirements for reconciliation. It specifies that "onshore and offshore electronic trading platforms and depositaries shall timely, accurately and completely record, inter alia, the trade, depository holdings, settlement and other data of overseas investors".

According to Article 9:

- onshore and offshore depositaries *"shall enter into agreements at each level to agree on the payment of principal and interest, set out responsibilities and ensure payment to each investor is in full and on schedule. A lower level depository shall report information about Overseas Investors and their depository and settlement data to an upper level depository in a timely manner level by level"*; and
- a lower level (i.e. offshore) depository is *"responsible for the authenticity, accuracy and completeness of the data reported. The Onshore depositaries or other institutions appointed by the PBoC shall timely, accurately and completely report cross-border RMB payment information to the RMB Cross-border Payment Management Information System (RCPMIS). The electronic trading platforms and depositaries shall set up a mechanism for information sharing and communication"*.

As far as settlement and holding reconciliations are concerned, we understand the above requirements have been reflected in CMU's agreements with the upper level CSDs (i.e. CCDC and SHCH) as well as its lower level local custodian (i.e. CMU members).

The Bond Connect Settlement Link FAQ August 2018 indicates that CMU has set up a mechanism with CCDC and SHCH to exchange information on a daily basis on transactions, settlement status, as well as holdings information. For CMU members, CMU provides account statements at the end of each business day setting out information about transactions and holdings for reconciliation purposes. The reconciliation mechanism aims to ensure that:

- (a) the records of CCDC, SHCH and CMU for transactions that require settlement are consistent;
- (b) the balance of CIBM bonds in CMU's respective omnibus accounts with CCDC and SHCH matches with the aggregate balance of CIBM bonds recorded in the CMU system; and
- (c) the daily balance of CIBM bonds at the end of the settlement day in each CMU Member's account is accurate.

CMU also requires each CMU Member to reconcile all reports, including the holdings report, on a daily basis. If there is any discrepancy, CMU members are required to report to the HKMA as soon as practicable.

7. Failure or Default of the CMU

As referenced in the Bond Connect Settlement Link FAQ August 2018 (Q15), currently CMU is the only approved offshore CSD acting as the nominee holder of CIBM bonds under Bond Connect. CMU is not the beneficial owner of the CIBM bonds. Investors will be recognised as the beneficial owners of the bonds via a segregated account structure in CMU. (See further section 8 below relating to the recognition of beneficial ownership in China.) Therefore, the CIBM bonds would not be treated as assets of CMU in the event of failure or default of CMU.

The term "Overseas Investors" referred to in the PBoC FAQ on Bond Connect is understood to mean the beneficial owners in Hong Kong or overseas investors who ultimately own the CIBM bonds under the nominee holding arrangement; and "nominee holder" includes those who hold CIBM bonds for their own account or on behalf of the accounts of others. The nominee holders should be central securities depositories or custodian banks, and as mentioned above, CMU is currently the only

offshore depository recognized by PBoC to hold an omnibus nominee holder account with the two Mainland CSDs, under Bond Connect.

The bonds purchased by the overseas investors will be registered in the bond account of CMU in CCDC and SHCH, and the overseas investors will enjoy the legitimate rights and interests related to the bonds. CMU will exercise the legitimate rights to the issuers of the bonds based on the right registration of its nominal holdings through CCDC and SHCH and will be entitled to the rights and interests of the CIBM bonds pursuant to Mainland China law.

The CMU Membership Agreement, the CMU Reference Manuals and other relevant documents set out how CMU holds the CIBM bonds in the nominee holder accounts on behalf of CMU members. The legal relationship between HKMA and the CMU members is governed by Hong Kong law. Therefore, any overseas investor whose CIBM bonds are held in a nominee account with CMU would be identified as beneficial owner of those CIBM bonds in accordance with the relevant documents mentioned above. Additionally, the Onshore/Offshore CSD agreements between the HKMA and CCDC and SHCH, contain provisions to ensure there is nothing misleading in the agreements which could infer that HKMA would be deemed to have beneficial ownership over the CIBM bonds held in the CMU's nominee holder accounts.

As outlined further in section 9 below, in PBoC's FAQ on Bond Connect (Q6), PBoC confirmed that an eligible offshore investor (as the beneficial owner of the CIBM bonds) should be able to exercise its rights as beneficial owner of the CIBM bonds if that investor is able to provide evidence which shows that it is the beneficial owner of the CIBM bonds and that it has a direct interest in the claim. In such case, the investor may take legal action in its own name to enforce its rights in the Mainland courts directly. PBoC pointed out that subject to an eligible offshore investor providing evidence that it is the beneficial owner of the relevant CIBM bonds (namely, certificate or proof provided by CMU and CMU members showing that such investor is the legitimate beneficial owner under Hong Kong law), the offshore investor should be entitled to bring legal proceedings in its own name in the Mainland courts.

CMU will attend to receipts of interest payments and repayments of principal but they will not generally take enforcement actions against issuers of debt securities. The rights of the Overseas Investors as beneficial owners of CIBM bonds shall be exercised in accordance with the laws and regulations of Hong Kong regarding nominee holders and custody arrangements.

The issue of taking legal proceedings for the enforcement of rights is addressed in Question 7 in the PBoC's FAQ on Bond Connect, which states that there is no express provision in Mainland China law which prohibits a beneficial owner from taking legal action directly in the Mainland courts.

On the basis of the information outlined above, depositaries should be satisfied that its clients' securities held in the market would be protected. UCITS/AIF clients should be able to enforce their legal entitlement to their CIBM bonds in the event of insolvency of CMU.

8. Beneficial Ownership in China

Part Two of the Bond Connect Settlement Link FAQ August 2018, titled "Investor Rights", expressly deals with the question as to whether overseas investors enjoy beneficial rights in bonds held through Bond Connect. In particular, it notes that the Bond Connect structure mirrors the provisions of the existing Stock Connect regime in relation to the recognition of beneficial ownership by the ultimate underlying investors. It goes on to note that, under Stock Connect, the concepts of "nominee holder" and "beneficial owner" are recognised in China, highlighting in particular the circulars issued by the China Securities Regulatory Commission in 2015 which confirmed beneficial ownership under the nominee structure.

The Bond Connect Settlement Link FAQ August 2018 goes on to note that the PBoC specifically addressed the question of beneficial ownership in a Bond Connect context through the PBoC FAQ⁵, highlighting in particular the following:

- (a) Question 5 of the PBoC FAQ on Bond Connect, confirmed that Bond Connect adopts the internationally accepted nominee holding arrangement and recognises the beneficial ownership of the offshore investors in the CIBM bonds that are held by CMU through the nominee holding arrangement. PBoC expressly indicated that the meaning of the terms "nominee holder" and "beneficial owner" of CIBM bonds under Bond Connect follow international rules and are the same as those under Stock Connect. On this basis, HKMA recognises that beneficial ownership in CIBM bonds held through Bond Connect would be similarly respected by Mainland regulators and Chinese courts.

⁵ The PBoC FAQ dated 22nd June 2017 is available on this website [link](#). Only Chinese is available.

(b) Question 6 of the PBoC FAQ confirmed that an eligible offshore investor (as the beneficial owner of the CIBM bonds) should be able to exercise its rights as beneficial owner of the CIBM bonds.

In addition to its analysis of Mainland China law in relation to beneficial ownership, the Bond Connect Settlement Link FAQ August 2018 also takes the opportunity to confirm that beneficial ownership would be recognised as a matter of Hong Kong law. In particular, it states that any overseas investor whose CIBM bonds are held by the CMU on a nominee basis would be identified as the beneficial owner of those CIBM bonds in accordance with the CMU Membership Agreement, CMU Reference Manuals and other relevant documents. It goes on to confirm that the rights of overseas investors as beneficial owners shall be exercised in accordance with the laws and regulations of Hong Kong regarding nominee holders and custody arrangements.

9. Enforcement of Legal rights

The Bond Connect Settlement Link FAQ August 2018 references the PBoC's FAQ which outlined that the position for Bond Connect was essentially the same as Stock Connect in that investors' beneficial ownership in CIBM bonds held through Bond Connect will be similarly respected by Mainland regulators and Chinese courts.

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.

Under Hong Kong law, beneficial ownership has been considered in *CA Pacific Finance Ltd (in Liquidation)* and another [1999] 2 HKC 632 and it is clear that, as a matter of Hong Kong law, the CMU will hold the shares on trust for investors and that the investors will have beneficial ownership. The *CA Pacific* case established that a broker holds securities held in the Hong Kong Central Clearing and Settlement System on trust for its clients who have proprietary rights in those securities.

The position is slightly different in China. As a civil law jurisdiction, China has not traditionally provided for equitable ownership or trust concepts. However, a number of these concepts have been included in recent years. As from 2006, the CSRC Securities Registration Measures specifically provide for the concept of a “nominee holder” and “beneficial owner” in that a nominee holder can hold shares for others who are beneficial owners. This provision forms the basis upon which QFII / RQFII asset managers hold A Shares (as nominee holder) for their investors (the beneficial owner). This concept was expanded under Stock Connect which provides specifically that the HKSCC is “the nominee holder” and that investors would enjoy rights and interests in shares according to law.

We understand that a number of Chinese Counsel have advised that it is entirely possible and indeed likely that a beneficial owner would be allowed to take legal action to enforce their rights as beneficial owner. This is based on the reasoning that, if Chinese law affords rights (in this case beneficial ownership) to a party then, as a general rule, the court would empower a party to seek to enforce those rights and therefore beneficial owners would be able to sue. In this regard, there are a number of cases where the rights of beneficial owners have been expressly recognised and given effect to. We would note that these cases were outside the scope of Stock Connect or Bond Connect and the Chinese courts do not, unlike common law jurisdictions, have a system of binding precedent.

In the Shanghai-Hong Kong Stock Connect FAQ (Version Date 12 August 2016), the Hong Kong Securities Clearing Company Limited (“HKSCC”) notes that it is not currently aware of any express provision in Mainland China law which prohibits a beneficial owners or an investor from taking legal action directly in the Mainland courts to enforce its rights, or which provides an express framework for a beneficial owner or an investor to take such legal action. However, it is noted that Article 119 of the Civil Procedure Law in Mainland China provides that a claimant in a legal action shall be a person who has a direct interest in the relevant case. Thus, there is ground to believe that if an investor can provide evidence to show that it is the beneficial owner (such as certification of its beneficial ownership) and that it has a direct interest in the matter, it may be able to take legal action in its own name to enforce its rights in the Mainland courts directly. It is also noted that there are a number of cases where the Mainland courts have recognised the rights of beneficial owners based on policy and general legal principles.

As part of its assessment of beneficial ownership, the Bond Connect Settlement Link FAQ August 2018 addresses in question 5 how beneficial owners may exercise their legal rights over the CIBM bonds acquired through Bond Connect, making the following observations:

- CSDs, including the CMU, generally do not take enforcement actions against issuers of debt securities. This is a matter of international practice common to all CSDs rather than a feature specific to CMU or Bond Connect.
- The issue of taking legal proceedings for the enforcement of rights is addressed in Question 7 in the PBoC FAQ, which states that there is no express provision in Mainland China law which prohibits a beneficial owner from taking legal action directly in the Mainland courts. It goes on to note that, if an offshore investor is able to provide evidence which shows that it is the beneficial owner of the CIBM bonds and that it has a direct interest in the claim, it may take legal action in its own name to enforce its rights in the Mainland courts directly.
- In this regard, the PBoC had noted that it would be necessary for the offshore investor to provide evidence that it is the beneficial owner of the relevant CIBM bonds (referencing a certificate or proof provided by CMU as relevant evidence) and that it has a direct interest in the claim, then it may take legal action in its own name to enforce its rights in the Mainland China courts directly. The HKMA has confirmed in the Bond Connect Settlement Link FAQ August 2018 and elsewhere that the CMU would provide such evidence in order to facilitate action by beneficial owners (pursuant to clause 5.5.5 of the CMU Reference Manual). The offshore investor should be entitled to bring legal proceedings in its own name in the Mainland China courts.

10. Bond Ownership Certification

The PBoC FAQ (Q7) addresses the question of recognition of certificates of bond ownership and states the following “ *The rights of beneficiary owners to initiate legal proceedings under the nominee holding arrangement is not explicitly stipulated or prohibited by Mainland China laws. Just like the Shanghai Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, we understand that CMU, as the nominee of foreign investors, shall be registered as the bond holder that can exercise relevant rights of creditors and initiate legal proceedings. According to Article 119 of the Civil Procedure Law, the plaintiff shall be a citizen, legal person, or an organization that have direct interest in the case. If foreign investors are able to provide evidence that they have direct interest in the case as the beneficiary owner of the bonds, they may file a lawsuit in the mainland courts in their own name.*”

PBoC has mandated CMU to perform depository services including bond registration and depository services under Bond Connect. CMU is required to open nominee holder accounts with the onshore depositories (i.e. CCDC and SHCH) respectively for the purpose of recording outstanding amount of all of the CIBM bonds that CMU holds as nominee on behalf of CMU members. CMU recognises foreign investors as beneficial owners under a nominee structure in accordance with the laws of Hong Kong. The PBoC FAQ has stated that if the laws in Hong Kong recognise bond holder certificates issued by CMU and its participants as legitimate evidence of securities entitlement of foreign investors, it will do the same.

The Bond Connect Settlement Link FAQ August 2018 (Q5) also notes that the certificates of bond holding issued by the CMU (which shows bond holdings of a CMU member), plus similar bond holding documentation provided by the relevant CMU member, which serves as a local custodian, as well as the relevant global custodian (if applicable), may be used as documentary evidence to support the end investor's beneficial ownership in the CIBM bonds under Bond Connect.

Appendix 1 - Comparison of Stock Connect and Bond Connect

Source: Standard Chartered Bank

Segregation structure on Stock Connect and Bond Connect

Stock Connect	Bond Connect
<p>There are 3 levels of segregation for SSE securities:</p> <p>(A) Onshore Level: ChinaClear Level</p> <ul style="list-style-type: none"> • Held in an omnibus stock account in the name of HKSCC • All the shares in this account are held by HKSCC nominee holder for CCASS Participants and their underlying clients • HKSCC account is held separately from the accounts of other clearing participants of ChinaClear <p>(B) Offshore Level: HKSCC Level</p> <ul style="list-style-type: none"> • SSE Securities are allocated to, and recorded as separate holdings of, the CCASS participants that have acquired the relevant number of SSE Securities • HKSCC provides multiple stock segregated accounts to CCASS Participants for holding client securities <p>(C) Offshore Level: CCASS Participant Level</p> <ul style="list-style-type: none"> • SSE Securities are held for the participant's clients • Securities held by intermediaries for clients are held on trust on a fiduciary basis • SSE Securities are recorded in their respective stock accounts in CCASS. • Each CCASS Participant Account is separated from the other participants accounts • Securities held in CCASS Participant account are segregated from those held for other participants and from HKSCC's own assets • Optional use of a segregated account – SPSA 	<p>There are 3 levels of segregation for Bond Connect securities:</p> <p>(A) Onshore Level: CCDC / SHCH Level</p> <ul style="list-style-type: none"> • Held in an omnibus stock account in the name of HKMA • All the shares in this account are held by CMU nominee holder (in name of HKMA) for CMU Terminal Participants and their underlying clients • CMU account is held separately from the accounts of other clearing participants of CCDC/ SHCH <p>(B) Offshore Level: CMU Level</p> <ul style="list-style-type: none"> • CIBM Bonds are allocated to, and recorded as separate holdings of, the CMU terminal participants that have acquired the relevant number of Bonds • CMU provides multiple stock segregated accounts to CMU Terminal Participants for holding client securities <p>(C) Offshore Level: CMU Terminal Participant Level</p> <ul style="list-style-type: none"> • CIBM Bonds are held for the participant's clients • CIBM Bonds are recorded in their respective stock accounts in CMU Terminal. • Each CMU Terminal Participant Account is separated from the other participants accounts • Securities held in CMU Terminal Participant account are segregated from those held for other participants and from CMU's own assets • Mandatory requirement for segregated accounts at the end beneficiary (+ CFETS Trading ID) level

a. Roles and Responsibilities

	Stock Connect	Bond Connect
Nominee Holder	HKSCC Nominees Limited	Pending final confirmation of nominee company name
Legal Owner	HKSCC Nominees Limited	HKMA CMU
Beneficial Owner	End Investor	End Investor

b. Beneficial Ownership

PBoC Rules – “The bonds bought through the Northbound Trading Link by the Foreign Investors shall be registered under the name of the Offshore Custody Institution (i.e. the bond depositary and custody institution(s) recognized by the Hong Kong Monetary Authority) – and the Foreign Investors shall enjoy the rights and interests of the securities according to the applicable law.”

PBoC Q&A – “The manner in which the overseas investor exercises actual rights to the bond ownership should be arranged according to the relevant laws and regulations of Hong Kong Special Administrative Region that govern the nominee structure”.

PBoC Q&A – “The actual entitlement owner of the bond under the Northbound Bond Connect should exercise rights over the bond issuer via CMU

Reconciliation process on Stock Connect and Bond Connect

Stock Connect

Bond Connect

Reconciliation is ultimately achieved through 3 levels of procedures:

- (A) Reconciliation of transactions executed on SSE
- Ensure ChinaClear and HKSCC's records on transactions that require settlement are consistent
 - Ensure the daily stock balance at the end of the trading day in each CCASS Participant's account is accurate

- (B) Post-settlement reconciliation of Stock Balance
- Ensure that the stock balance of HKSCC's omnibus account with ChinaClear matches with the aggregate balance of stocks recorded in CCASS

- (C) Reports provided to CCASS Participants for their own reconciliation purposes
- HKSCC makes available various reports for download by CCASS Participants in order that they may perform further reconciliation of their holdings in CCASS with the holdings in their own records

Reconciliation is ultimately achieved through 3 levels of procedures:

- (A) Reconciliation of transactions executed on CIBM
- Ensure CCDC/ SHCH and CMUs records on transactions that require settlement are consistent
 - Ensure the daily bond balance at the end of the trading day in each CMU Participant's account is accurate

- (B) Post-settlement reconciliation of Bond Balance
- Ensure that the Bond balance of CMU's omnibus account with CCDC/SHCH matches with the aggregate balance of stocks recorded in CMU terminal

- (C) Reports provided to CMU Terminal Participants for their own reconciliation purposes
- CMU makes available various report(s) for download by CMU Terminal Participants in order that they may perform further reconciliation of their holdings in CMU Terminal with the holdings in their own records

c. Enforcement Rights

Stock Connect

Bond Connect

- Under the laws and regulations of Mainland China, it is the Hong Kong and overseas investors recognized as having beneficial ownership in SSE Securities.

- HKSCC not currently aware of any express provision in Mainland China Law which prohibits a beneficial owner or an investor from taking legal action directly in the Mainland courts to enforce its rights; Article 119 of the Civil Procedure Law in Mainland China provides that a claimant in a legal action shall be a person who has a direct interest in the relevant case

- In CCASS Rule 824, HKSCC is prepared to provide assistance to the beneficial owners of SSE Securities where necessary.

Stock Connect FAQ 2.38 – 2.42:

http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/FAQ_En.pdf

- PBoC Q&A - CMU as a nominee holder for overseas investors will be registered as the bond holder in China and has the rights to exercise its rights as a creditor and lodge a law suit when there is a dispute.

- PBoC Q&A - According to the Civil Procedure Law of the People's Republic of China, the overseas investor, with the evidence as the actual entitlement owner of the bond, may lodge an independent law case in an onshore court.

Process flow for Realtime DVP Settlement for China-Hong Kong Stock Connect:

Stock Connect	Bond Connect
<p>Settlement Instruction (SI) transactions (i.e. custodian and custodian or custodian and broker transactions) for Stock Connect can be settled on Free of Payment (“FOP”) basis, Delivery versus Payment (“DVP”) basis or Real-time DVP (RDVP) basis in HKD, RMB or USD.</p> <p>Process flow:</p> <ul style="list-style-type: none"> - Once a transaction is matched, Central Clearing and Settlement System (CCASS) will put on-hold the relevant securities in the relevant stock account of the delivering China Connect Clearing Participant (CCCP). - Meanwhile, CCASS will issue a CHATS Payment Instruction (CPI) to the Designated Bank of the receiving CCCP for money settlement. The Designated Bank of the receiving CCCP will have to instruct payment to the Designated Bank of the delivering CCCP via the Real Time Gross Settlement (RTGS) system. - Upon receipt of payment confirmation from Hong Kong Interbank Clearing Limited (HKICL), CCASS will effect the delivery of the relevant securities from the delivering CCCP to the receiving CCCP immediately. 	<p>Bond Connect transactions have to be settled on a FOP (FOP is allowed under certain circumstances such as when an Eligible Investor wishes to change its local and/or global custodian and the Eligible Investor has no CNY position outstanding with the Hong Kong Settlement Bank.) or RDVP⁶ basis in Renminbi (RMB).</p> <p>Process flow:</p> <ul style="list-style-type: none"> - Once a transaction is confirmed by the CMU for settlement purpose, the respective Mainland CSD (i.e. CCDC or SHCH) will lock up the relevant bonds in the system. - At the same time, CCDC or SHCH will initiate payment instructions to the CMU via CIPS system. - If CMU’s account has sufficient funds then the payment instructions will be settled and the securities settlement will also be performed on a RDVP basis.

⁶ Bond Connect settlement occurs on a real-time basis as specified in Section 6.4.8 and Section 7.4.8 of CMU Reference Manual at http://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/CMU_Ref_Man.zip). Real-time settlement is sometimes referred to as Real-time Delivery versus Payment (RDVP) or sometimes referred to as Delivery versus Payment (DVP).

Appendix 2 - List of supporting documentation



Bond Connect
Settlement Link FAQ



PBC Interim
Measures for the ad



CMU Ref Manual
_Appendix Aug 2018



CMU Ref Manual
Aug 2018 (v.1.5).pdf



cmu_disclosure_fra
network.pdf