

## Corporate & Commercial

### Bond Connect – The New Milestone

#### Introduction

Aiming to promote the growth of the bond markets in Hong Kong and Mainland China (“**PRC**”), the People’s Bank of China (“**PBC**”) and the Hong Kong Monetary Authority (“**HKMA**”) have approved several Mainland and Hong Kong Financial Infrastructure Institutions to collaborate in establishing mutual bond market access between Hong Kong and PRC (“**Bond Connect**”) on 16 May 2017.

Bond Connect offers new mutual access between the Hong Kong and Mainland bond markets through a cross-border platform that allows overseas institutional investors to trade effectively in the Mainland bond market. It is not only a milestone in China’s further opening up of its capital account, but also a milestone for The Stock Exchange of Hong Kong (“**HKEX**”) in expanding its products from stocks and commodities to bonds.

The Bond Connect consists of the Northbound Trading and the Southbound Trading. The Northbound Trading which commenced on 3 July 2017 allows overseas investors from Hong Kong and other countries to invest in the China Interbank Bond Market (“**CIBM**”) through mutual access between the Hong Kong and Mainland Financial Infrastructure Institutions. The Southbound Trading which allows Mainland investors to invest in the Hong Kong bond market will be explored in due course.

#### The infrastructure of Bond Connect

The Bond Connect established a settlement linkage that facilitates the settlement and custody of CIBM securities conducted under Bond Connect through a clearing and settlement linkage between Central Moneymarkets Unit (“**CMU**”) in Hong Kong and China Central Depository & Clearing Co., Ltd (“**CCDC**”) / Shanghai Clearing House (“**SCH**”).

CMU acts as the offshore custodian and settlement agent for eligible offshore investors while CCDC and SCH act as the onshore custodian and clearing institutions in PRC that provides bond registration, custody and clearing/settlement services to CMU in PRC. Through CMU, offshore investors can continue to settle and hold bonds using familiar practices.

To facilitate trading, trading links are established between global access platforms and the China Foreign Exchange Trading System (“**CFETS**”) to allow offshore eligible investors to input trade orders and instruction using an established international interface.

## **Eligible investors and eligible bonds under Northbound Trading**

Eligibility of overseas investors is determined by CFETS according to the criteria set out in PBC Notice No. 3 of 2016 and PBC Notice No. 220 of 2015. They include central bank institutions such as foreign central banks, international financial organizations and sovereign wealth funds as well as various types of institutional investors, including financial institutions legally established overseas and their investment products.

Eligible bonds cover all bonds tradable in the CIBM, including national bonds, local government bonds, policy bank bonds, financial institution bonds and corporate debt instruments. It is expected that the scope may expand in the future.

## **The enforcement rights of offshore investors under Bond Connect**

Similar to the arrangement under Stock Connect, the ownership of CIBM bonds under Bond Connect involves multiple levels: the holding by CMU as nominee holder and the holding by eligible offshore investors through CMU members as beneficial owners of the bonds.

After clearing and settlement with SCH or CCDC, the CIBM bonds acquired under Northbound Trading are registered in the name of CMU and held through the onshore nominee accounts opened by CMU in mainland China with SCH and/or CCDC. CMU members will settle trading in CIBM bonds through CMU on behalf of eligible offshore investors. HKMA, as the registered holder of the CIBM bonds, is entitled to exercise its rights as against issuers of the bonds through SCH/CCDC.

Meanwhile, the offshore investors could enforce their rights in the bonds in their own names. According to SCH Rules, eligible investors enjoy the rights and interests of the bonds according to the applicable laws, that are the laws of Hong Kong and China. Under Hong Kong law, beneficial interest in bonds acquired for the offshore investors are recognized, therefore, eligible offshore investors as the beneficial owners of the bonds should be able to exercise their rights in CIBM bonds in accordance with Hong Kong laws and regulations and they could enforce their rights in the bonds through HKMA/CMU or in its own names.

Under PRC law, to institute a legal claim, a person must be a citizen, legal person or any other organisation with a direct interest in the claim. Subject to some other criteria, the offshore investor should be entitled to bring a legal claim in its own name in the PRC if it is shown that he/she is the ultimate beneficial owner of the relevant CIBM bonds.

## **Conclusion**

With the establishment of Bond Connect, it is expected overseas investors will be more willing to invest in Mainland Domestic Bonds and its bond market will be further opened up. While this breakthrough after the establishment of the Stock Connect is not the first time

where foreign investors can have access to China's bond market, it is certainly one of the most significant.

Unlike the previous CIBM scheme, there is no quota or need to stipulate an intended investment amount. Foreign investors are able to buy trading on CIBM directly through the HKEX without going through the previous lengthy process. Bond Connect also allows investors to continue using offshore global custodians via the CMU through the nominee structure. Furthermore, it gives the flexibility of using offshore renminbi or foreign currencies for payment.

Yet, there are still uncertainties surrounding this new initiative, for instance, there is little clarity over the tax issues and the enforceability against the PRC issuers as there are no precedents in these areas and it is uncertain that how well the investors' interests will be safeguarded.

For enquiries, please contact our Corporate & Commercial Department:

E: [cc@onc.hk](mailto:cc@onc.hk)  
W: [www.onc.hk](http://www.onc.hk)

T: (852) 2810 1212  
F: (852) 2804 6311

19th Floor, Three Exchange Square, 8 Connaught Place, Central, Hong Kong

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**Important:** The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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