

# 【Stock Connect Scheme between Shanghai and London Stock Exchanges Report II】

the analysis of the requirement for Stock Connect Scheme between Shanghai and London Stock Exchanges



## Background of regulatory provisions

The China Securities Regulatory Commission (CSRC) announced new regulations that will further expand the two-way liberalization of capital markets and open up China's domestic market globally. The CSRC recently issued the Provisions on the Supervision and Administration of Depositary Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (for trial implementation) (《关于上海证券交易所与伦敦证券交易所互联互通存托凭证业务的监管规定(试行)》, hereinafter referred to as "Regulatory Provisions") on 12 October 2018, following the Notice forwarded from the State Council General Office on 22 March 2018 regarding Several Opinions on Piloting the Issuance of Stocks or Depositary Receipts for Innovative Enterprises (《证监会关于开展创新企业境内发行股票或存托凭证试点若干意见》). The Regulatory Provisions are effective immediately.

The Shanghai Stock Exchange (SSE) has issued complementary business rules (hereinafter referred to as "1+3 Rules")<sup>1</sup> to regulate the issue, cross-border conversion and information disclosure in the depositary receipt business carried under the Stock Connect mechanism between the SSE and the London Stock Exchange (LSE) (hereinafter referred to as "Shanghai-London Stock Connect"). These measures aim to protect the legitimate rights and interests of investors, maintain the order of securities markets and ensure the seamless implementation of Shanghai-London Stock Connect depositary receipt business.

In this issue, we will summarise the relevant requirements and structure of Shanghai-London Stock Connect.

## Introduction of Shanghai-London Stock Connect Depositary Receipt Business

The Shanghai-London Stock Connect Depositary Receipt Business refers to:

- the issuance of China depositary receipts by the LSE-listed issuers of overseas underlying securities<sup>2</sup> on the SSE (hereinafter referred to as "China CDRs" or "Eastbound Transactions")
- the issuance of global depositary receipts on the LSE by the A-Share companies listed on SSE (hereinafter referred to as "GDRs" or "Westbound Transactions").

## Regulatory requirements of China CDRs

### Listing criteria of China CDRs

Where a CDR is issued with existing securities as its underlying securities, the overseas issuer shall comply with the relevant requirements for the public issue of depositary receipts stipulated in the Chinese Depositary Receipt Issuance and Trading Administrative Measures (for Trial Implementation) (《存托凭证发行与交易管理办法(试行)》, hereinafter referred to as "Administrative Measures for Depositary Receipts") and undertake the obligations of the issuer and the listed company to bear the corresponding legal responsibilities. These responsibilities include having a three-year track record, no significant disputes over the ownership of assets, no change in the actual controller for the last three financial years and no significant non-compliance issues.

\* The 1+3 Rules further clarify the criteria for the listing of China CDRs: when applying for CDRs, the issuer of overseas underlying securities should meet the following requirements: 1) have an average market capitalisation of no less than RMB 20 billion, per the closing price of the underlying shares, over the 120 trading days prior to the offering application date; 2) have been listed on the LSE for at least three years and have obtained the premium listing for at least one year; and 3) seek the listing of no less than 50 million units of CDRs with a market value of no less than RMB 500 million.

<sup>1</sup> On 2 November 2018, the SSE issued an exposure draft of business rules, which includes the Interim Measures for the Listing and Trading of Depositary Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所互联互通存托凭证上市交易暂行办法》), the Guidelines for the Pre-Listing Review of Chinese Depositary Receipts under the Stock Connection Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所互联互通中国存托凭证上市预审业务指引》), the Guidelines for the Cross-Border Conversion of Depositary Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所互联互通存托凭证跨境转换业务指引》) and the Guidelines for the Market Making for Chinese Depositary Receipts under the Stock Connect Scheme between Shanghai Stock Exchange and London Stock Exchange (《上海证券交易所与伦敦证券交易所互联互通中国存托凭证做市业务指引》).

<sup>2</sup> The issuer of overseas underlying securities must be a company listed on the LSE and approved by the CSRC.

## Review System of China CDRs

- Under the review procedures:
  - The SSE assesses whether the issuer of overseas underlying securities meets the listing conditions of CDRs in accordance with its business rules.
  - The CSRC approves the application to issue overseas underlying securities without having to submit to the Issuance and Review Committee for review.
- Under the mutual recognition arrangement of accounting and auditing:
  - The issuer of overseas underlying securities shall prepare the financial statements in accordance with the Chinese Accounting Standards for Business Enterprises or other accounting standards recognised by the Ministry of Finance.
  - The financial statements shall be audited by an accounting firm with domestic securities and futures-related business qualifications or an overseas accounting firm recognised by the CSRC and the Ministry of Finance in accordance with China's auditing standards or other auditing standards recognised by the Ministry of Finance.

\*1+3 Rules refine the review pre-listing review system: the issuer of overseas underlying securities should submit its pre-listing review application to the SSE, which will then submit the application document of the public offering to the CSRC on behalf of the issuer.

## Cross-border conversion of China CDRs

Qualified domestic brokerage companies may convert overseas underlying securities into CDRs or convert CDRs into overseas underlying securities as required.

For cross-border conversion or risk-hedging purposes, the domestic brokerage company that engages in cross-border conversion business may purchase and sell the underlying stock corresponding to the CDRs and certain investment products, complying with the rules set out by the relevant competent authority. The balance of assets of a cross-border conversion agency in an overseas market shall not exceed the upper limit prescribed by the CSRC.

\*1+3 Rules define the operational and regulatory requirements of cross-border conversion. They list out specific requirements of the cross-border conversion business process, including management filings and compliance requirements of the cross-border conversion agency and rectification system.

## Ongoing regulatory supervision of China CDRs

The **Regulatory Provisions** shall apply to the ongoing supervision after the listing of Shanghai-London Stock Connect CDRs. If there are no additional obvious regulations under these **Provisions**, the provisions on red-chip companies listed overseas, other relevant provisions of the CSRC and the relevant business rules of the SSE under the Measures for the Implementation of Ongoing Supervision of the Issuance of Stocks or Depositary Receipts for Innovative Enterprises after Listing (Trial) shall be applied.

- The overseas issuer should disclose the following periodic reports:
  - the annual report and an interim report
  - in accordance with the requirements for overseas listing or voluntary disclosure of quarterly reports, etc., disclose the same simultaneously within the territory.
- Disclosure of major asset transactions: If the issuer of underlying securities conducts a major asset transaction, which does not involve the purchase of assets through issuance of domestic depositary receipts, it can disclose the transaction to domestic investors simultaneously.

\*1+3 Rules provide more specific requirements of ongoing information disclosure of China CDRs, such as defining the disclosure exemption of objective reasons, disclosure of material transactions and a disclosure threshold for related party transactions, as well as disclosure of other non-transactional material events.

## Regulatory requirements of GDRs

Domestic listed companies issue GDRs with underlying securities based on **new stock issued or existing** stocks.

The **Regulatory Provisions** allow GDRs to perform cross-border conversions with their corresponding domestic stocks. To prevent regulatory arbitrage, while taking commercial viability into account, the Regulatory Provisions have laid down the issuance criteria, issuance price, issuance procedure and restriction on cross-border conversion for GDRs.

\*1+3 Rules clarify the requirement of the listing of underlying stocks of domestic listed companies and the issues to be disclosed to the SSE.

## Strengthened enforcement and clarification of legal responsibility of relevant market participants

If the market participants violate these **Regulatory Provisions**, the CSRC will use the Securities Law, the Administrative Measures for Information Disclosure of Listed Companies, the Administrative Measures for Depositary Receipts and other relevant provisions of the CSRC to enforce the regulations.

## Conclusion

The market responded favorably to the promulgation of the **Regulatory Provisions** and the release of a series of complementary rules. Huatai Securities has announced that its board of directors has voted to pass a number of resolutions on “issuing GDRs and applying for listing on the LSE.” HSBC has also announced that it is preparing to issue CDRs through Shanghai-London Stock Connect to become the first foreign company listed in China. As the market progresses, there may be more regulations to optimise and support the new structure. The new provisions offer domestic investors with more convenient opportunities to invest in overseas high-quality listed companies and provide more support for domestic listed companies to expand their international businesses and gain international trust in their brands.

KPMG will continue to pay attention to the implementation and practical issues of the Regulatory Provisions and complementary rules of Shanghai-London Stock Connect and work with enterprises to meet any opportunities and challenges.

This paper also provides a summary comparison of relevant requirements of the issued depositary receipts (hereinafter referred to as “CDR”), the domestically issued depositary receipts of the pilot innovative enterprises (hereinafter referred to as “innovative enterprise CDR”) and CDRs of Shanghai-London Stock Connect. See Appendix I for details.

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## Appendix I: Comparison of requirements of CDR, innovative enterprise CDR and CDRs of Shanghai-London Stock Connect

Item	CDR	innovative enterprises CDR	CDRs of Shanghai-London Stock Connect
<b>Scope of regulation</b>	Depository receipts refer to securities issued by depository in China on the basis of overseas securities, representing the interests of overseas underlying securities.	Pilot innovative enterprises publicly issue stocks or depository receipts in China.  The pilot enterprises may be red-chip companies that have already been listed overseas, or enterprises that have not been listed overseas (including red-chip companies and domestic registered enterprises).	The CDRs of Shanghai-London China Depository Receipt refer to the depository receipts publicly issued by the issuer of an overseas underlying securities listed on the LSE that is eligible to be listed on the SSE.
<b>Compliance of issuance</b>	Securities Law of the People's Republic of China, Several Opinions on Piloting the Issuance of Stocks or Depository Receipts for Innovative Enterprises, and Administrative Measures for Depository Receipts and other provisions of the CSRC	Securities Law of the People's Republic of China, Several Opinions on Piloting the Issuance of Stocks or Depository Receipts for Innovative Enterprises, and Administrative Measures for Depository Receipts	Administrative Measures for Depository Receipts
<b>Conditions of issuance</b>	(1) The basic conditions for the public offering of shares in Article 13(1) to (3) of the Securities Law; (2) For a company established according to law and operating for more than three years, there is no major ownership dispute in the company's main assets; (3) In the past three years, the actual controller has not changed, and there is no significant ownership dispute in the shares of overseas underlying securities held by controlling shareholders, controlled shareholders and shareholders controlled by actual controller; (4) The issuer of overseas underlying securities and its controlling shareholder and actual controller have no major illegal acts that have harmed the legitimate rights and interests of investors and the public interest of the public in the past three years; (5) The accounting basic work norms and internal control system are sound; (6) Directors, supervisors and senior management personnel shall be in good standing and in accordance with the requirements of the company's place of registration, and there is no recent record of major violations of law and trust; (7) Other conditions stipulated by the CSRC	(1) The pilot red-chip enterprises listed overseas shall have a market value of not less than RMB200 billion.  (2) Pilot enterprises that have not yet been listed overseas should meet one of the following criteria:  1. In the most recent year, the audited main business income is not less than RMB 3 billion, and the company's valuation is not less than RMB 20 billion. The valuation of the company should refer to the latest three rounds of financing valuation and the corresponding investors, investment amount, the proportion of investment shares in total share capital, coupled with valuation methods such as income method, cost method and market multiplier method. If there are less than three rounds of financing, judgement should be made on all financing valuations.  2. High-tech enterprises with independent research and development, international leading position, intellectual property or proprietary technology that can lead the development of important domestic fields and obvious technical advantages, R&D personnel accounting for more than 30% of total staff, over 100 invention patents related to the main business, or at least one type of new drug approval related to the main business, or a core technology recognised by the competent authority to have international leading role, technological innovation and intellectual property to participate in market competition, relatively higher competitive position, the top three market share of main products, more than 30% of the compound annual growth rate of operating income in the last three years, not less than RMB1 billions of audited main business income in the most recent year, more than 10% of R&D investment in the last three years to the total proportion of the main business income. Enterprises with great significance to the national innovation-driven development strategy, with strong development potential and market prospects are exceptional cases.	*The 1+3 Rules further clarify the conditions for the issuance of CDRs: when applying for CDRs, the issuer of overseas underlying securities should meet the following requirements: 1) the average market value of the underlying stock for 120 trading days before the issuance date should not be less than RMB20 billion; 2) it should be listed on the LSE for over three years and on the main board for over one year; and 3) the number of CDRs applied for listing is not less than 50 million and the market value is not less than RMB500 million.
<b>Authority of review</b>	As approved by the CSRC.	The CSRC must make approval in line with the advisory opinion of the advisory committee.	Reviewed by the SSE. As approved by the CSRC, no need to submit for the review of Issuance and Review Committee.
<b>Information disclosure</b>	Periodic reports and interim reports on major event disclosures, information disclosed in overseas markets are simultaneously disclosed in the domestic market.	Annual and interim reports, and interim reports on major event disclosures, information disclosed in overseas markets is simultaneously disclosed in the domestic market.  Overseas listed red chip companies shall disclose quarterly reports within 45 days from the end of the third and ninth month of each fiscal year, which shall at least include the disclosure required by the Disclosure Measures.	Annual and interim reports, information disclosed in overseas markets is simultaneously disclosed in the domestic market.  If the issuer of the underlying securities conducts a major asset transaction that does not involve the issuance of assets in the domestic depository receipts, it may be disclosed to the domestic investors in accordance with the overseas rules.  *1+3 Rules define the exempted disclosure of objective causes, major transactions and disclosure of related party transactions, as well as list out non-transactional major events.
<b>Mutual recognition of accounting audit</b>	Not clearly defined.	Pilot red-chip companies may prepare financial reports in accordance with the Chinese Accounting Standards for Business Enterprises or the accounting standards recognised by the Ministry of Finance; if the pilot red-chip companies are listed overseas, the notes to the financial statements shall disclose the adjustment of domestic and foreign differences.  If the pilot red chip company prepares financial reports in accordance with International Financial Reporting Standards or US Accounting Standards, it shall disclose the difference adjustment revised in accordance with the Chinese Accounting Standards for Business Enterprises.  The financial report and revised difference adjustment (if any) above shall be audited by domestic securities accounting firms qualified for auditing futures securities in accordance with the Chinese CPA Auditing Standards.	The issuer of the overseas underlying securities shall prepare the financial report in accordance with the Chinese Accounting Standards for Business Enterprises or other accounting standards recognised by the Ministry of Finance.  The relevant regulations of depository receipts under the Shanghai-London Stock Connect do not clearly stipulate whether the difference in standards should be disclosed.  The financial report shall be audited by an accounting firm with domestic securities and futures-related business qualifications or an overseas accounting firm recognised by the CSRC and the Ministry of Finance in accordance with China's auditing standards or other auditing standards recognised by the Ministry of Finance.