

Bond Connect

Frequently Asked Questions on Settlement Link

August 2018

Disclaimer: These Frequently Asked Questions (FAQs) are prepared for general information purposes only and do not bind the Hong Kong Monetary Authority. They do not necessarily reflect the views of the Hong Kong Monetary Authority. The information set out in the FAQs is provided on an “as is” and “as available” basis and may be amended or changed in the course of implementation of Bond Connect. It is, therefore, not intended and should not be construed to constitute any advice of the Hong Kong Monetary Authority. Investors, potential investors and other relevant persons are expected to seek their independent professional advisors to advise them on all aspects and requirements of the Bond Connect and all applicable laws, rules and regulations. The Hong Kong Monetary Authority and any of its affiliates shall not be responsible or liable for any loss or damage, directly or indirectly, arising from the use of or reliance upon any information contained in this document.

Bond Connect FAQ on Settlement Link

Table of Contents

Part One: General

1. What is Bond Connect?
2. Role of the HKMA's CMU as an Offshore Depository
3. Requirements under UCITS V Directive and AIFM Directive

Part Two: Investor Rights

4. Overseas Investors' Beneficial Rights in the CIBM Bonds
5. Enforcement of Legal Rights over the CIBM Bonds by Beneficial Owners
6. Asset Segregation
7. Asset Reconciliation

Part Three: Clearing and Settlement of Bond Connect Debt Securities Transactions

8. Delivery vs Payment Arrangements
9. Transfer of CIBM Bonds and Change of Local Custodian (CMU Member)
10. Investment Currency and Hong Kong Settlement Bank Arrangement
11. Settlement Cycles Supported under Bond Connect
12. Procedure for Reporting Failed Settlements
13. Corporate Actions

Part Four: Other Issues

14. Holidays and Severe Weather Conditions
15. Insolvency of CMU
16. CMU Fee Schedules for Bond Connect

Annex 1: High-Level CIPS II DvP Flow

Annex 2: Frequently asked questions in relation to the responsibilities of Hong Kong Settlement Banks under Bond Connect

Annex 3: CMU Form T.6 (Reporting on Bond Connect Failed Trades)

Part One: General

1 What is Bond Connect?¹

In order to promote the development of the bond markets in Hong Kong and Mainland China, the People's Bank of China (**PBoC**) has approved China Foreign Exchange Trade System & National Interbank Funding Centre (**CFETS**), China Central Depository & Clearing Co., Ltd (**CCDC**), and Shanghai Clearing House (**SHCH**) (collectively the "**Mainland Financial Infrastructure Institutions**"), to collaborate with Hong Kong Exchanges and Clearing Limited and Central Moneymarkets Unit (**CMU**) of the Hong Kong Monetary Authority (**HKMA**) (collectively the "**Hong Kong Financial Infrastructure Institutions**"), in establishing mutual bond market access between Mainland China and Hong Kong under a scheme known as "Bond Connect".

Bond Connect is implemented in phases. The initial phase of Bond Connect, which offers Northbound Trading, commenced on 3 July 2017, i.e. overseas investors from Hong Kong and other countries and areas ("**Overseas Investors**") are able to trade, settle and hold debt securities (**CIBM Bonds**) tradable in the China Interbank Bond Market (**CIBM**) through mutual access between the Mainland Financial Infrastructure Institutions and Hong Kong Financial Infrastructure Institutions. Southbound Trading (i.e. Mainland investors to invest in the Hong Kong bond market through the Bond Connect) will be explored in due course.

Bond Connect abides by the relevant laws and regulations of both Mainland China and Hong Kong. Northbound Trading follows Mainland China's current policy framework governing overseas participation in the CIBM and at the same time respects international norms and practices. Under Bond Connect, Overseas Investors are not required to open onshore accounts in the Mainland to hold their CIBM Bonds. Instead, Overseas Investors hold their CIBM Bonds, through their global custodians and CMU Members (being investors' local custodians), via CMU's nominee holder accounts maintained with each of the two Mainland central securities depositaries (**CSDs**) namely, CCDC and SHCH. There is no investment quota for Northbound Trading.

¹ Reference: Hong Kong Monetary Authority Press Release
<http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170516-5.shtml>
<http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170516-6.shtml>

2 Role of CMU under Bond Connect: is CMU a Central Securities Depository (CSD) under Bond Connect?

CMU is a CSD for the purpose of Bond Connect.

CMU 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 regarding transactions effected through CMU. Established in 1990, CMU is a financial market infrastructure (**FMI**) with the role of a CSD and a Securities Settlement System (**SSS**) which complies with the Principles for Financial Market Infrastructures to Designated Clearing and Settlement Systems (**PFMI**) issued jointly by the Committee on Payments and Market Infrastructures (**CPMI**) and the International Organization of Securities Commissions (**IOSCO**). CMU is subject to the statutory oversight of the HKMA (via the Financial Market Infrastructure Oversight team). A report on the assessment of CMU's compliance with the PFMI and self-assessment as a CSD and SSS was published by HKMA in 2016 and available at the HKMA's website². Furthermore, it is important to note that CMU, being a FMI, is not a custodian appointed by any of its members or participants (**CMU Members**), in particular, it does not take on such a role in respect of any debt securities, including CIBM Bonds under Bond Connect.

The following documents published by PBoC (either solely or jointly with HKMA) in respect of Bond Connect further elaborate CMU's role as a CSD for Bond Connect:

- (1) CMU is referred to as the offshore financial infrastructure institution for Bond Connect in the announcement jointly made by PBoC and HKMA on 16 May 2017³.

² HKMA's assessment of Central Moneymarkets Unit against the Principles of Financial Market Infrastructures:

http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/oversight/CMU_assessment_2016.pdf

Disclosure Framework for Central Moneymarkets Unit:

http://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/cmu_disclosure_framework.pdf

³ <http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170516-5.shtml>

- (2) CMU's role as a CSD is further specified in Article 5 of the Interim Measures for the Administration of Mutual Bond Market Access between Mainland China and Hong Kong SAR (PBoC No.1 (2017) document issued on 21 June 2017) (**Interim Measures for Bond Connect**)⁴ where PBoC mandated CMU (being the bond registration and depository institution in Hong Kong (i.e. **Offshore Depository**) and an onshore bond registration and depository institution recognised by the PBoC (i.e. **Onshore Depository**) to perform depository services including bond registration and depository services under Bond Connect. CMU is then required to open respective 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.
- (3) In its Frequently Asked Questions on Bond Connect issued on 22 June 2017 (**PBoC's FAQ on Bond Connect**)⁵, PBoC further named HKMA's CMU as the Offshore Depository, while CCDC and SHCH are the Onshore Depositories (please refer to Question 4 of PBoC's FAQ on Bond Connect for details).
- (4) Under Bond Connect, CMU acts as a CSD and holds CIBM Bonds on behalf of CMU Members through the CMU's nominee holder accounts maintained with the Onshore Depositories (i.e. CCDC and SHCH) respectively. The HKMA/CMU has entered into separate agreements with the two Onshore Depositories on a CSD to CSD basis for the purpose of Bond Connect, which involves a completely new set of arrangements and legal documentation which are different from those entered into between the two Onshore Depositories' and their usual members and participants. The CMU omnibus account maintained by HKMA/CMU with each of CCDC and SHCH is separate from the accounts of the other participants of CCDC or SHCH and is under a different direct holding structure. By virtue of its accounts with these two Onshore Depositories, CMU can settle Bond Connect transactions and hold CIBM Bonds on behalf of CMU Members, which in turn provide services directly or indirectly to Overseas Investors who have invested in CIBM Bonds through Bond Connect.

⁴ <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3330621/index.html>
and its English translation for reference:

http://www.chinabondconnect.com/documents/PBCInterimMeasures_E.pdf

⁵ <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3331208/index.html>

3 Does CMU, being a CSD and a SSS, have to be appointed as a delegate of the custody functions for the purpose of the UCITS V Directive⁶ and AIFM Directive⁷ or does any exclusion apply to CMU?

3.1 It is CMU's understanding that it may qualify 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.

3.1.1 *UCITS V Directive* - Article 22 of this Directive 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 securities settlement systems (SSS) shall not be considered to be a delegation of custody functions, hence excluded from the requirements applicable to delegations / sub-custodians.

3.1.2 *AIFM Directive* - Article 21(8) of this Directive 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 Directive (defined in paragraph 3.1.4 below) by SSS as designated for the purposes of that Directive or the provision of similar services by third-country SSS shall not be considered to

⁶ "UCITS" means Undertakings for Collective Investment in Transferable Securities regulated in the European Union. "UCITS V Directive" refers to Directive 2014/91/EC of the European Parliament and the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities as regards depositary functions, remuneration policies and sanctions.

⁷ "AIFM Directive" refers to Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

be a delegation of custody functions, hence, excluded from the requirements applicable to sub-custodians.

3.1.3 As mentioned in paragraph 2 above, CMU is an SSS as defined in PFMI and observes all relevant PFMI in the HKMA's assessment conducted in 2016.

3.1.4 In Article 2 of Directive 98/26/EC (**SSS Directive**), a "system" means, among other things, a formal arrangement between three or more participants with common rules and standardised arrangements for the execution of transfer orders between the participants. "Transfer order" means either an instruction by a participant to transfer a sum of money to another participant for the discharge of its payment obligation by means of book entry on the accounts of a bank or a settlement agent as provided in the system's rules, or an instruction by a participant to transfer the title or interest in securities by means of a book entry on a register, or otherwise.⁸ It is CMU's understanding that the payment and settlement services performed by CMU in relation to the execution of transfer orders between CMU Members may qualify CMU to be covered under the relevant exclusions of UCITS V Directive and AIFM Directive referred to in paragraphs 3.1.1 and 3.1.2 above.

3.2 For the reasons below, it is CMU's understanding that it may qualify for the exclusion of CSD from the delegation of custody functions as specified under Recital (21) of the Preamble of the UCITS V Directive.

3.2.1 Recital (21) of the UCITS V Directive provides as follows:

"When a Central Securities Depository (CSD) as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council⁹ [the (CSD Directive)], or a third-country CSD provides the services of operating a securities settlement system as well as at least either the initial recording of securities in a book-entry system through initial

⁸ "Pursuant to Article 2(i) of the SSS Directive, "transfer order" is defined as follows:

"- any instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit institution, a central bank or a settlement agent or any instruction which results in the assumption or discharge of a payment obligation as defined by the rules of the system; or
- an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise."

⁹ Regulation (EU) No 909/2014 of the European Parliament And of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012

crediting or providing and maintaining securities accounts at the top tier level, as specified in Section A of the Annex to that Regulation, the provision of those services by that CSD with respect to the securities of the UCITS that are initially recorded in a book-entry system through initial crediting by that CSD should not be considered to be a delegation of custody functions. However, entrusting the custody of securities of the UCITS to any CSD, or to any third-country CSD should be considered to be a delegation of custody functions.”

- 3.2.2 CMU would be a third-country CSD that provides services of an SSS, as explained in response to Question 2 and paragraph 3.1 above. Furthermore, CMU provides and maintains nominee holder accounts “at the top tier level” when acting as the offshore CSD for Bond Connect. Therefore, it is believed that CMU is likely to qualify for the exclusion of CSD from the delegation of custody functions as specified under Recital (21) of the Preamble of the UCITS V Directive.

In Article 5 of the Interim Measures for Bond Connect, it is our understanding that PBoC acknowledges that the responsibilities of both CMU as the Offshore CSD and CCDC and SHCH as Onshore Depositories are “at the top tier level” under the custodian arrangement under Bond Connect:

“The Hong Kong SAR bond registration and depository institution (“Offshore Depository”) recognized by the Hong Kong Monetary Authority shall open a nominee holder account with onshore bond registration and depository institutions (each an “Onshore Depository”) recognised by the PBoC for the purpose of recording the outstanding amount of all bonds it is holding as the nominee holder.

The Onshore Depository shall provide bond registration and depository services to the Offshore Depository, and the Offshore Depository shall provide bond registration and depository services to bondholders that have opened nominee holder bond accounts and proprietary bond accounts with such Offshore Depository.

The aggregate amount of bonds as registered by the Offshore Depository for bondholders who have opened bond accounts with it shall equal to the

outstanding amount of bonds registered by the Onshore Depository in the nominee holder account opened with such Onshore Depository.

Bonds purchased by Overseas Investors through the Northbound Trading shall be registered under the name of the Offshore Depository, and Overseas Investors shall be entitled to the rights and interests of the bonds according to law. The “nominee holder” as referred to in this Article refers to an institution which is appointed by another party and which holds bonds on behalf of such party. ”

Article 9 of the Interim Measures for Bond Connect further requires, among other things, “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*”.

In view of the above, CMU has been working with CCDC and SHCH together to perform the settlement and clearing for the investors using Bond Connect. This arrangement seems to enable CMU to comply with the UCITS exclusion requirement as a third-country CSD from the delegation of custody functions.

Part Two: Investor Rights

4 Do Overseas Investors enjoy beneficial rights in the bonds held through Bond Connect in the Mainland?

Bond Connect recognises Overseas Investor’s beneficial ownership in the CIBM Bonds held through a nominee holder account structure, which is similar to the arrangement under the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect (collectively, the Stock Connect). Under the Stock Connect, the concepts of “nominee holder” and “beneficial owner” are recognized in Mainland China¹⁰.

It is noted that Article 5 of the Interim Measures for Bond Connect provides that

¹⁰ The China Securities Regulatory Commission issued circulars to confirm beneficial ownership under the nominee structure for Stock Connect in 2015 - http://www.csrc.gov.cn/pub/newsite/tzzbh1/tbjtbzt/hgttzzbh/hgthgtwd/201508/t20150803_282335.html

Overseas Investors who purchased CIBM Bonds through Bond Connect shall be entitled to the rights and interests of the CIBM Bonds pursuant to Mainland China law.

In its response to Question 5 in the PBoC's FAQ on Bond Connect, PBoC confirmed that Bond Connect adopts the internationally accepted nominee holding arrangement and recognizes the beneficial ownership of the offshore investors in the CIBM Bonds that are held through the nominee holding arrangement. PBoC expressly indicated that the meanings of the terms "nominee holder" and "beneficial owner" of CIBM Bonds under Bond Connect follow international rules and are the same as those under the Stock Connect¹¹.

It is our understanding that the "overseas investors" mentioned in the PBoC's FAQ on Bond Connect referred to the beneficial owners in Hong Kong or overseas who ultimately own the CIBM Bonds under the nominee holding arrangement in respect of Bond Connect; and the "nominee holder" under Bond Connect includes those who hold CIBM Bonds for their own accounts and those who hold CIBM Bonds in their names but for the account of others. The nominee holders should be central securities depositories or custodian banks. HKMA/CMU is currently the only Offshore Depositary recognized by PBoC to hold an omnibus nominee holder account with CCDC and SHCH respectively under Bond Connect.

The HKMA/CMU holds the CIBM Bonds in the nominee holder accounts on behalf of CMU Members (which in turn hold the CIBM Bonds on behalf of Overseas Investors) in accordance with the CMU Membership Agreement, the CMU Reference Manuals and other relevant documents. The legal relationship between the HKMA and the CMU Members are governed by Hong Kong law. In this connection, any Overseas Investor whose CIBM Bonds are held by the HKMA/CMU in the nominee holder account(s) would be identified as beneficial owner of those CIBM Bonds in accordance with the relevant documents as mentioned above. In the respective agreements between the MA and CCDC and SHCH, there are relevant provisions to ensure that nothing contained in the agreements would have a misleading effect that the HKMA would be deemed to have beneficial ownership over the CIBM Bonds held in the HKMA/CMU's nominee holder accounts.

In its response to Question 6 in the PBoC's FAQ on Bond Connect, PBoC confirmed that an eligible offshore investor (as the beneficial owner of the CIBM Bonds) should

¹¹ <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3331208/index.html>

be able to exercise its rights as beneficial owner of the CIBM Bonds (see paragraph 5 below for further details). CMU will attend to receipts of interest payments and repayments of principal, etc. 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.

5 Enforcement of legal rights: How do beneficial owners exercise their legal rights over the CIBM Bonds acquired through Bond Connect?

Whilst CSDs (including the CMU) will generally attend to receipts of interest payments and repayments of principal as noted above, they will not generally take enforcement actions against issuers of debt securities.

In the answers to questions related to nominee structure and related beneficial ownership rights (Questions 5-7) in the PBoC's FAQ on Bond Connect, PBoC made references to the Stock Connect and indicated that the position for Bond Connect is essentially the same. On this basis, investors' beneficial ownership in CIBM Bonds held through Bond Connect will be similarly respected by Mainland regulators and Chinese courts.

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 stated that there is no express provision in Mainland China law which prohibited a beneficial owner from taking legal action directly in the Mainland courts.

More specifically, it appears that PBoC recognises 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. 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..

The issuance of certificates of bond holding is part of CMU's corporate action services, which may facilitate beneficial owners to take legal action in the Mainland. Clause

5.5.5 of Part II Chapter 5 of the CMU Reference Manual (whilst noting that the HKMA, as operator of the CMU, will not take legal action to enforce a participant's rights) authorises participants/beneficial owners to maintain proceedings against issuers, where the HKMA as operator of the CMU acts as the "registered owner" of any securities held in the CMU. This is on the basis that such a certificate may be used as evidence of securities entitlement.

In light of the above, 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. CMU is prepared to issue such certificate and the CMU Reference Manual has been updated to reflect this.

6 Asset segregation: How are assets segregated at various levels among CSDs and custodians?

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:

(1) 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 HKMA CMU, which holds the CIBM Bonds as nominee holder for CMU Members and their underlying clients.

(2) 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.

Furthermore, 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 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.

- (3) **At the CMU Member level:** CMU requires each of the CMU Members to keep proper records for each of its client's holdings under Bond Connect¹².

7 Asset Reconciliation: What are the requirements under Bond Connect's multi-layer nominee holding structure to ensure holdings are reflected correctly and in a timely manner?

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

According to Article 9 of the Interim Measure for Bond Connect:

- onshore and offshore depositories *"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 Depositories 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*

¹² Reference is made to section 3 of the CMU Bond Connect Linkage Service – Operational Information for CMU Members v.1.1

platforms and depositories shall set up a mechanism for information sharing and communication”.

As far as settlement and holding reconciliations are concerned, 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 clients (i.e. CMU Members).

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 would provide 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 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.

Part Three: Clearing and Settlement of Bond Connect transactions

8 Is the settlement under Bond Connect on a Delivery vs Payment (DvP) basis?

On 20 August 2018, PBoC issued a new guideline (issue no, 150 – 2018) to require full migration of Bond Connect settlement to Delivery versus Payment (**DvP**) mode as specified under the new phase of the Cross-Border Interbank Payment System, i.e. **CIPS 2.0**. To implement this new guideline, CMU has worked with the two Mainland CSDs and updated its Reference Manual which takes effect on 24 August 2018. As a result, DvP settlement has been fully implemented in Bond Connect starting from the same day and all trades under Bond Connect have begun to be settled on a DvP basis. This increases settlement efficiency and reduces settlement risks, affording greater convenience to international investors investing through Bond Connect .

Once a transaction is completed in the trading system and the transaction information is passed to CCDC's or SHCH's system as appropriate and confirmed by the CMU for settlement purposes, the respective Mainland CSDs will lock up the relevant CIBM Bonds in their respective systems and at the same time initiate payment instructions to the CMU via the 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 DvP basis. In the event that CMU's account has insufficient funds, the payment instructions will be placed in a queue in the system pending for payment until sufficient funds are available.

Please refer to **Annex 1** for high-level DvP flow.

9 Can the CIBM Bonds be transferred offshore among Overseas Investors? How about non-trade transfer when an Overseas Investor has to change its local custodian (i.e. a CMU Member)?

At present, CIBM Bonds can only be transferred under Bond Connect through trades concluded through the approved trading platform under Bond Connect. No transfer between two CMU Members or two sub-accounts under one CMU Member is allowed, except where such transfer is a “non-trade” transfer arising from a switch in local custodian by an Overseas Investor. The new custodian must also be a CMU Member.

Transfer of CIBM Bonds between two CMU Members in free of payment (FOP) mode

is allowed under certain circumstances, such as when an investor wishes to change its local and/or global custodian and the investor has no outstanding CNY position with the relevant settlement bank(s) (**Settlement Bank**)(please refer to paragraph 10.1 below for details of the Settlement Banks). Moreover, historical transaction records are also required to be transferred from the former custodian to the new custodian. Both the former and new custodians are required to keep proper and complete records of the data transferred between them.

10 Investment currency and settlement bank arrangements

10.1 When do Overseas Investors need to engage their Settlement Banks in Hong Kong for investing in the CIBM Bond through Bond Connect?

Eligible Overseas Investors are allowed to use their own sources of RMB in the offshore market (**CNH Channel**), or convert foreign currencies into RMB at the onshore conversion rate of RMB (**CNY Channel**) to invest in the CIBM Bonds.

For those investors that wish to invest through the CNY Channel (whether in combination with the CNH Channel or not), the investor should contact its local custodian (which is a CMU Member). The local custodian/CMU Member should engage one of the settlement banks (**Settlement Banks**), which are banks in Hong Kong approved by CFETS to access the Mainland FX market as RMB participation banks (a list of the Settlement Banks is available at the website of CFETS)¹³, to provide the relevant currency conversion and hedging services, as well as to conduct the subsequent cross-border payments and remittances. It is our understanding that investors with genuine and reasonable hedging needs arising from Bond Connect investments may obtain hedging services at the CNY rate.

10.2 Can a CMU Member engage more than one Settlement Bank for currency conversion and hedging services?

At present, our understanding is that a CMU Member may only engage one Settlement

¹³ <http://www.chinamoney.com.cn/english/mdtmmbfmm/> (The list of the Settlement Banks is available under “Bond Connect Hong Kong SAR Settlement Banks” which is under the section named “RMB/FX Market Members”).

Bank to perform FX conversion and it is required to engage the same Settlement Bank to perform its cross-border remittance for Bond Connect settlement in accordance with the Interim Measures for Bond Connect and the PBoC's FAQ on Bond Connect.

10.3 What are the procedures for changing a Settlement Bank?

According to our understanding of the PBoC's requirements, Settlement Banks have an obligation to ensure that foreign currencies converted through the CNY Channel are only used for Bond Connect investments and that a similar proportion of CNY, after maturity of the investments, is required to be converted back into the foreign currencies if not re-invested. Prior to handling any hedging request, Settlement Banks are required to ensure that the hedging arises from genuine and reasonable needs from Bond Connect investments. A list of frequently asked questions was issued to the Settlement Banks (which are banks in Hong Kong) in December 2017 in which guidance was provided on their responsibilities as a Settlement Bank under Bond Connect. Such list of frequently asked questions is attached at **Annex 2.**

When a CMU Member changes its Settlement Bank, historical transaction records are required to be transferred from the former Settlement Bank to the newly appointed Settlement Bank. CMU will publish guidelines on the relevant procedures in due course.

10.4 Are the CMU Members responsible for monitoring the currency conversion and hedging activities?

CMU Members have the responsibility to ensure that their client investors' currency conversion and hedging transactions are genuine and reasonable based on the settlement and holding information of their client investors. If Hong Kong Settlement Banks consider that there is cause for suspicion, and that it is necessary, they may request reasonable ex post clarification or information from CMU Members.

11 What are the Settlement cycles supported by Bond Connect?

The Overseas Investors should agree with their Mainland dealers on the settlement cycle at the time of placing the order. The investors may select a T+0, T+1 or T+2 settlement cycle.

12 Who is responsible for failed settlement reporting?

According to our understanding of the respective operating rules of CCDC and SHCH, any trade that cannot be settled on the intended settlement date must be reported to the relevant Mainland CSD. Both the investor and the Mainland dealer concerned are required to file a failed trade report to CCDC or SHCH, as appropriate.

Starting from 24 August 2018, to streamline the reporting of failed trade(s) to the two Mainland CSDs, CMU and the two Mainland CSDs agreed to use the same reporting steps.

If a trade has not been affirmed by CMU, the end investor and the Mainland dealer are required to report the failed settlement for this trade directly to SHCH or CCDC using the form designated by SHCH¹⁴ and CCDC¹⁵ respectively as it is appropriate. The investor can work with its Mainland dealer to report the failed trade.

If the trade has been affirmed by CMU, CMU will report the failed settlement for this trade to SHCH or CCDC directly. In order to facilitate CMU's reporting of failed settlement cases to the Mainland CSDs, the CMU Member is required to (i) complete and return the relevant CMU form¹⁶ to CMU; and (ii) submit to CMU the failed reports using the CSDs' designated forms signed by the Mainland dealer. The cut-off time for participants to send the designated failed reports and Appendix T.6 to the CMU will be extended from 12:00 noon to 2:00 p.m. on the working day immediately following the intended settlement date.

13 How are corporate action events handled and how would CMU Members be notified?

CMU provides corporate action service to CMU Members. CMU will notify CMU Members of corporate action events according to the established communication channel, as soon as CMU receives notification(s) from the Mainland CSDs.

For corporate action events that do not require any instruction for execution, such as coupon payments, interest payments, etc., CMU will credit the entitlements into CMU Members' cash and/or securities accounts on the payable date upon receipt of the entitlements from the Mainland CSDs. The corporate action credit advice will be sent

¹⁴ <https://www.shclearing.com/cpyyw/djtgsjyw/ywcz/yjyhcl/>

¹⁵ <http://www.chinabond.com.cn/cb/cn/zqsc/fwzc/zlzx/cyywbqgz/jsl/list.shtml>

¹⁶ Please refer to the sample form in Annex 3 to these FAQs, which is identical to Appendix T.6 of the latest CMU Reference Manual issued by the CMU.

via the established communication channel.

For corporate action events that require an instruction for execution, CMU Members are required to send their instructions to CMU via the established communication channel before the input deadline as specified in the relevant notice. CMU will then forward the instructions to the relevant Onshore Depository. If a CMU Member does not send its corporate action instruction to CMU by the input deadline, CMU shall be deemed authorised to take the default action specified in the relevant notice issued by the relevant agent.

Some corporate actions may require security holders to directly participate in a custody operation (e.g. attendance of a meeting). Upon request by CMU Members, CMU will issue a certificate to the CMU Member setting out the quantity of the CIBM Bond(s) concerned held by that CMU Members to facilitate the investors or the CMU Member's direct participation in the custody operation.

Part Four: Other issues

14 Holidays and severe weather conditions

Settlement calendar (including working Saturdays/Sundays) and holiday arrangements will generally follow the CIBM schedule. Settlement of Bond Connect transactions is available on a day when the CCDC/SHCH system, CIPS and the RMB CHATS are all open for business, regardless of whether it is a holiday in Hong Kong. Public holiday arrangements in Mainland China are announced by the Government of Mainland China from time to time and are available at the following website: <http://www.gov.cn/zhengce>.

Given the public holidays are announced at the start of each year, relevant Mainland authorities and/or CSDs may also announce special working days, including Saturdays and/or Sundays, as ad hoc working days for CIBM and/or Bond Connect settlement days.

Settlement arrangements under severe weather conditions will follow CMU and CIBM markets arrangements. Bond Connect settlement service continues to be available on typhoon and black rainstorm days in Hong Kong.

15 On the insolvency of CMU, what will happen to the bonds held by CMU through the nominee holder accounts under Bond Connect?

As mentioned in our response to paragraph 4 above, CMU is currently the only approved Offshore CSD acting as the nominee holder of CIBM Bonds under Bond Connect scheme. CMU is not the beneficial owner of the CIBM Bonds. Therefore, the CIBM Bonds would not be treated as assets of HKMA/CMU. CMU is owned and operated by the HKMA which is an integral part of the Hong Kong Special Administrative Region Government.

16 CMU tariff schedules for Bond Connect

The current CMU tariff schedules for Bond Connect in relation to CCDC and SHCH can be found in sections 3.1 and 3.2 respectively of the CMU Fee Schedule which can be accessed using the following link:

http://www.hkma.gov.hk/media/eng/doc/key-functions/financial-infrastructure/infrastructure/CMU_fee_schedule.pdf