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Investing in China: An ERISA Perspective

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Under the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA), fiduciaries are drawn to international opportunities with the hope of both yield and diversification. For the first time in ERISA's history, fiduciaries can easily trade in the equities of the world's second largest economy, China. Just one year ago, the Stock Exchange of Hong Kong (SEHK) and the Shanghai Stock Exchange (SSE) launched the Shanghai-Hong Kong Stock Connect (Stock Connect), which opens the doors to non-Mainland China investors to deal directly with certain equities traded on SSE, Chinese A shares (A Shares). This article examines the Stock Connect within the context of the indicia of ownership requirements applicable to investors subject to ERISA.

This article is divided into three sections. The first section describes the wiring of the Stock Connect, including how the trades are conducted, where the A Shares are stored, and the entities involved. The second section discusses the requirements for trading in non-U.S. equities under ERISA. The third section identifies the principal considerations an ERISA fiduciary should take into account when evaluating the Stock Connect for purposes of the indicia of owner-

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ship requirements. This article does not examine how the U.S. Department of Labor (DOL) or the courts could evaluate an ERISA plan's investment in A Shares over the Stock Connect under any other provision of ERISA, including the requirement that an ERISA fiduciary invest plan assets prudently.

THE STOCK CONNECT

The Stock Connect is a significant development for all investors, including ERISA fiduciaries. For the first time, all foreign investors can trade China's local renminbi (RMB)-denominated equities.² Previously, only those in Mainland China and certain institutional investors had access.³ The Stock Connect represents China's political will to open its capital markets and internationalize RMB.⁴ Since its inception last year, the Stock Connect has "enabled many investors — including hedge funds and retail investors — to access mainland equities directly, without the need for an investment license. Since then, overseas investors have added almost \$25bn to Shanghai stocks through the cross-border trading link."⁵

Nuts & Bolts

- The Stock Connect links SEHK and SSE. SEHK is the only recognized stock market in Hong Kong

² Neil Katkov & Hua Zhang, *Shanghai-Hong Kong Stock Connect: It's Just the Beginning*, at p. 4 (June 2015) (Celent, a division of Oliver Wyman, Inc.). The renminbi is the official currency of the People's Republic of China.

³ *Id.* ("Previously, international access to A shares was only available to institutional investors licensed under China's QFII (Qualified Foreign Institutional Investor) and RQFII (RMB QFII) schemes"). See also *Shanghai-Hong Kong Stock Connect FAQ for Investors (FAQ for Investors)*, pp. 8–9 (July 30, 2015), available at http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/Investor_FAQ_En.pdf.

⁴ Patrick Ho, *Shanghai-Hong Kong Stock Connect: Ignore at Your Own Risk*, available at <https://www.ubs.com/sg/en/perspectives/23/stock-connect.html>.

⁵ Josh Noble & Nicole Bullock, *China Stocks' Inclusion in Global Index Put on Hold*, Financial Times (June 10, 2015).

and it is operated by Hong Kong Exchanges and Clearing Limited (HKEx).⁶ Technically, trades will route through a SEHK subsidiary that sits in Mainland China, which happens to be a member/participant of SSE.⁷ The SEHK subsidiary will automatically match and execute the trades.⁸

- The clearing house used by SEHK for the Stock Connect is Hong Kong Securities Clearing Company Limited (HKSCC). HKSCC is also a wholly-owned subsidiary of HKEx. SSE uses China Securities Depository and Clearing Corporation Limited (ChinaClear) as its clearing house. For cross-boundary trades, “the clearing house of that market will on one hand clear and settle with its own clearing participants, and on the other hand undertake to fulfill the clearing and settlement obligations of its clearing participants with the counterparty clearing house.”⁹ Together, HKSCC and ChinaClear provide the architecture for the clearing, settlement, depository, nominee and other related services to investors using Stock Connect.
- HKSCC operates the Central Clearing and Settlement System (CCASS) for the clearing of securities listed or traded on SEHK. CCASS is a clearing and settlement system that provides book-entry settlements in securities among its participants. All China Connect securities trades are settled through CCASS.¹⁰
- Only A Shares are tradeable over the Stock Connect. Evidently, the stocks included in the SSE 180 Index and SSE 380 Index are A Shares.
- Generally, a foreign investor may only participate in the Stock Connect if it trades through an exchange participant of SEHK and a clearing participant of CCASS.¹¹ An ERISA investor is free to use any broker-dealer or bank as an intermediary, provided such bank or broker-dealer has received permission to trade on SEHK and is cleared through CCASS.

- Unless SEHK otherwise determines, Stock Connect transactions can only be conducted in RMB.¹² This means that an ERISA fiduciary will need to take into account the need to trade in and out of RMB.

Ownership Structure

A Shares are uncertificated securities. Consequently, one cannot deposit or withdraw physical A Shares under the Stock Connect.¹³ HKSCC endeavors to record an investor’s interest in A Shares digitally (i.e., book-entry) for both settlement into HKSCC’s omnibus account held with ChinaClear and then allocation to HKSCC participants’ accounts within CCASS.

The A Shares held in the HKSCC omnibus account will be registered in HKSCC’s name. This means that HKSCC will be recorded as the holder of the A Shares in ChinaClear’s books.¹⁴ HKSCC’s omnibus account with ChinaClear is segregated from the accounts of other clearing participants of ChinaClear. Once deposited in the omnibus account, HKSCC holds the A Shares in its capacity as nominee holder on behalf of HKSCC’s clients, such as an ERISA investor (albeit indirectly through an additional intermediary).¹⁵ HKSCC treats the A Shares as fungible; therefore, HKSCC will not mark or label specific A Shares for a particular client or account.¹⁶

At this point, HKSCC will credit the amount of A Shares to the accounts of the various CCASS participants (again, these are the same customers of HKSCC). The CCASS client accounts are segregated from HKSCC’s general assets, as well as the assets of other clients.¹⁷ HKSCC will utilize daily reconciliation procedures with ChinaClear and within CCASS to ensure that the appropriate credits and debits of A Shares are made with respect to each account.¹⁸

Again, HKSCC will register the A Shares in its name and in book-entry form. This is not unusual.¹⁹ In fact, the U.S. Securities and Exchange Commission (SEC) has viewed this practice as adding to the safety and efficiency of the markets:

To facilitate the clearance and settlement of securities transactions, securities held by a

⁶ Hong Kong Exchanges and Clearing Limited, Company Profile, available at <http://www.hkex.com.hk/eng/exchange/corpinfo/profile.htm>.

⁷ Rules of The Stock Exchange of Hong Kong Limited (SEHK Rules), Rule 1403(1), available at <http://www.hkex.com.hk/eng/rulesreg/traderules/sehk/exrule.htm>.

⁸ *Id.*

⁹ FAQ for Investors at p. 28.

¹⁰ SEHK Rules at Rule 1425, and The Central Clearing and Settlement System Operational Procedures (Operational Procedures), §1.2, available at <http://www.hkex.com.hk/eng/rulesreg/clearrules/ccassop/ccassoptpcd.htm>.

¹¹ SEHK Rules at Rules 1404–1406.

¹² SEHK Rules at Rule 1419.

¹³ General Rules of The Central Clearing and Settlement System (General Rules), Rule 824, available at <http://www.hkex.com.hk/eng/rulesreg/clearrules/ccassgr/ccassrule.htm>.

¹⁴ FAQ for Investors at p. 39.

¹⁵ *Id.* at pp. 40–41.

¹⁶ General Rules at Rule 809.

¹⁷ FAQ for Investors at p. 40–41.

¹⁸ General Rules at Rule 824.

¹⁹ *OCC Handbook — Custody Services*, Office of the Comptroller of the Currency, p. 16 (Jan. 2002) (“[t]he vast majority of custodial assets are held in book entry form”).

securities intermediary on behalf of its customers or another securities intermediary are commonly registered in the name of the securities intermediary or in its nominee name, which makes the securities intermediary the registered owner. This is often referred to as holding a security in “street name.” Holding securities in street name at a securities depository facilitates the transfer of negotiable certificates and obviates manually processed paperwork and physical delivery of certificates. Registered clearing agencies acting as securities depositories help to centralize and automate the settlement of securities, in part by reducing the physical movement of securities traded in the U.S. markets using book-entry movements. On occasion, other types of securities intermediaries, such as broker-dealers or banks, may perform similar functions by holding a certificate registered in its name but held on behalf of its customers.²⁰

The SEC further added:

Securities registered in the name of the securities intermediary or its nominee allows the securities to be immobilized and held in fungible bulk thereby significantly reducing the number of certificates that need to be delivered and transferred. This in turn reduces the risk and cost associated with transferring the securities. Transfers in ownership of securities held in the name of a securities intermediary are accomplished by making book-entry adjustments to the accounts on the securities intermediary’s records.²¹

The U.S. Department of Labor (DOL) has also recognized the role of holding securities in book entry:

[W]here securities owned by a plan are held in the name of a nominee or in street name, the trustee of the plan ordinarily retains exclusive control over all of the rights of ownership of such securities. For example, notwithstanding that securities are held in street name, the trustee may freely sell the securities, or pledge them, and, in the case of stock, may vote the shares. In addition, the comments received indicate that other statutes and regulations relating to such arrangements provide certain meaningful protections

²⁰ *Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries*, Sec. Exch. Act. Rel. No. 34-50755, 69 Fed. Reg. 70,852 (Dec. 7, 2004) (“Restrictions on intermediary ownership deny investors the ability to use a securities intermediary to hold their securities and to efficiently and safely clear and settle their securities transactions by book-entry movements”).

²¹ *Id.* at 70,854.

to the owners of securities (including plans) against the risks arising from the registration of the securities in the name of an entity other than their beneficial owner. Therefore, the Department has determined that the holding of securities of an employee benefit plan in nominee or street name will not, in itself, be a violation of the trust requirement of section 403(a).²²

Overseas investors can only hold A Shares through an intermediary. These intermediaries will record their clients’ interests in their books and records. The clients are considered the beneficial owners of the A Shares.²³ Beneficial owners “shall exercise their rights in relation to such securities through the nominee holder.”²⁴ In other words, it is the beneficial owners — and not HKSCC — who are intended to hold a proprietary interest in the A Shares.

This much seems to have been confirmed by the Chinese regulators. The China Securities Regulatory Commission has stated that “overseas investors shall hold SSE Securities through HKSCC and are entitled to proprietary interests in such securities as shareholders.”²⁵ Moreover, the public materials on the Stock Connect emphasize that “it is the Hong Kong and overseas investors as the ultimate investors (rather than any broker, custodian or intermediary through whom such investors hold the SSE securities) who would be recognized under the laws and regulations of Mainland China as having beneficial ownership in the SSE Securities.”²⁶ Helpfully, the A Shares “will not be regarded as the general assets of HKSCC un-

²² 47 Fed. Reg. 21,241 (May 18, 1982). The weight of this guidance is limited insofar as this article does not examine the extent to which U.S. federal law would otherwise protect an ERISA investor’s interest in the A Shares.

²³ FAQ for Investors at p. 35.

²⁴ *Id.* at p. 34.

²⁵ *FAQ on Beneficial Ownership under SH-HK Stock Connect*, China Securities Regulatory Commission (May 15, 2015), available at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201505/t20150515_277108.html.

²⁶ FAQ for Investors at p. 32. *See, e.g.*, General Rules at Rule 802 (“HKSCC has no proprietary interest in the [A Shares] deposited into CCASS, in particular, [A Shares] in the Stock Segregated Accounts of participants); FAQ for Investors at p. 39 (“HKSCC’s role as nominee holder (with its name being registered as the holder of SSE Securities in the books of ChinaClear and accordingly, the registers of members of the relevant listed companies) is consistent with its role as CSD. In fact, providing nominee services and acting as the nominee holder of the legal interest in Hong Kong listed shares for CCASS Participants and investors has been HKSCC’s role under the existing regulatory regime”), and General Rules at Rule 824 (the A Shares are “held by HKSCC as nominee holder only. HKSCC has no proprietary interest in and is not the beneficial owner of any China Connect Securities held or recorded in such accounts. All proprietary inter-

der Hong Kong and Mainland China law and will not be available to the general creditors of HKSCC on its insolvency.”

Beneficial owners of A Shares appear to enjoy the rights appurtenant to ownership. For example, beneficial owners are entitled “to exercise their rights as owners of proprietary interests in [A Shares], including the right to receive dividends and other distributions and the power to exercise voting rights.”²⁷ HKSCC serves as an intermediary between the beneficial owner and the issuer.²⁸ HKSCC will “[a]s a general principle. . .not vote in respect of [A Shares] without the specific instructions of participants.” To the extent participant directions are “incomplete, unclear or ambiguous,” then HKSCC may refuse to act on them.

Beneficial owners are expected to receive account statements and other information regarding:

- Information on receivable entitlements (and expected payable date) with respect to A Shares recorded to the respective account on the last registration date.
- Updates on entitlements already distributed and any receivables.
- Details on corporate voting activities.²⁹

HKSCC as a Central Securities Depository

HKSCC is structured to operate as a central securities depository (CSD).³⁰ In this respect, HKSCC is bound³¹ by the Principles for Financial Market Infrastructures (April 2012) (PFMI Principles),³² which defines a “central securities depository” as an entity that:

- Provides securities accounts and offers central safekeeping services and other asset services; and
- Ensures that the securities “are not accidentally or fraudulently created or destroyed or their details changed).”³³

ests in respect of China Connect Securities belong to the Participants or their clients (as the case may be”).

²⁷ General Rule at Rule 824.

²⁸ Operational Procedures at Rule 8.6.2.

²⁹ *Id.* at Rule 8.3.4.

³⁰ FAQ for Investors at p. 38.

³¹ *Id.*

³² *Principles for Financial Market Infrastructures*, Bank for International Settlements and International Organization of Securities Commissions (Apr. 2012), available on the BIS website (www.bis.org) and the IOSCO website (www.iosco.org).

³³ *Id.* at ¶1.11.

The European Central Bank has also published a glossary that similarly describes a CSD.³⁴ The Stock Connect’s public materials provide that, “the description of the role and functions of a CSD in the PFMI Principles should be helpful in demonstrating that HKSCC acts as a full-fledged CSD.”³⁵

There are two important caveats, however. First, it is unclear whether HKSCC will guarantee the safe-keeping of the A Shares. In its public materials, the Stock Connect states:

It is worth noting that HKSCC does not take on the role of and is not appointed by any CCASS Participant or investor as a typical “custodian”, “sub-custodian” or “safe-keeping agent” in respect of the [A Shares]. As a [central clearing counterparty], [central securities depository] and [securities settlement system], HKSCC acts and operates as a financial market infrastructure and is regulated by the [Securities and Futures Commission (SFC)] as such. It is required to comply with [PFMI Principles] which do not apply to typical custodians or safe-keeping agents.³⁶

This suggests that HKSCC may contend that it holds possession, but not custody, of the A Shares. Please note that this issue begs the question of what is an ERISA investor’s indicia of ownership in A Shares. That issue is discussed later in this article.

³⁴ *Glossary of Terms Related to Payment, Clearing and Settlement Systems*, European Central Bank (Dec. 2009) (defining a “central securities depository” as “an entity that: 1) enables securities transactions to be processed and settled by book entry; 2) provides custodial services (e.g. the administration of corporate actions and redemptions); and 3) plays an active role in ensuring the integrity of securities issues. Securities can be held in a physical (but immobilised) form or in a dematerialised form (whereby they exist only as electronic records).” Note that the Glossary expressly states that the definitions are not “legal definitions” and that they simply reflect how market participants currently interpret these terms.

³⁵ FAQ for Investors at p. 38. *See also* PFMI Principles at Paragraph 1.11 (“the activities of a CSD may vary depending on whether it operates in a jurisdiction with a direct or indirect holding arrangement or a combination of both”). HKSCC currently utilizes an indirect holding structure, which the PFMI Principles, n. 8, defines as “an indirect holding system employs a multi-tiered arrangement for the custody and transfer of ownership of securities (or the transfer of similar interests therein) in which investors are identified only at the level of their custodian or intermediary.”

³⁶ FAQs for Investors at p. 38. *But see* General Rules at Rule 802 (“Eligible Securities deposited into CCASS by Participants will be held in safe-custody upon the terms and subject to the provisions of the Rules. For the avoidance of doubt, HKSCC acknowledges and confirms that, save as otherwise provided in the Rules, HKSCC has no proprietary interest in the Eligible Securities deposited into CCASS, in particular, Eligible Securities in the Stock Segregated Accounts of Participants”).

The second caveat is that it does not appear that HSKCC can “maintain the definitive record of legal ownership for a security. . . .”³⁷ This would seem to be an essential role for a CSD. Changes are afoot in this category, however. According to the public materials, a bill that was recently considered by the Hong Kong Legislative Council entitled the Securities and Futures and Companies Legislation (Uncertificated Securities Market Amendment) Bill 2014. The public materials provide that, “[w]hen the Bill is enacted and becomes effective (expected to be in 2017/18), HKSCC will, in addition to its role as [central clearing counterparty], [central securities depository] and [securities settlement system], also act as the system operator to maintain the definitive records of legal ownership for Hong Kong listed uncertificated securities.”³⁸

Nevertheless, HKSCC is approved as a clearing house by the SFC, Hong Kong’s regulator for the securities market, and that HKSCC’s provision of depository, nominee and settlement services has also been approved by the SFC.³⁹

Pre-Trade Checking

The Stock Connect will have pre-trade checking procedures in place to ensure that sellers have sufficient A Shares to consummate a transaction.⁴⁰ Under the current model, an investor that utilizes multiple exchange participants (i.e., entities that are permitted to trade on SEHK) will need to ensure that each of its accounts with a particular exchange participant (held in CCASS) has enough A Shares on the day *before* the trade is to be executed (i.e., T-1, where T is the trade date). If insufficient shares are in an account held with the exchange participant, then the investor would have to transfer their A Shares to the selling eligible participant on T-1.⁴¹

Earlier this year, the Stock Connect introduced an alternative pre-trade model (Enhanced Model) “to facilitate investors whose [A Shares] are maintained with custodians to sell their [A Shares] without having to pre-deliver the [A Shares] from their custodians to their executing brokers. . . .”⁴² Basically, the overseas investor can request its custodian to open a “spe-

cial segregated account” (SPSA) within CCASS, which will be provided a unique investor identifier. CCASS will then take a snapshot of the A Shares allocated to the SPSA in order to complete the pre-trade checking (using the investor identifier).⁴³ Under this model, an investor will only need to transfer A Shares from its SPSA to its designated broker’s account *after* execution. The investor may designate at most 20 exchange participants as executing brokers that are authorized to use the particular investor identifier to execute sell orders in A Shares. As with the other model, the total number of shares held in an SPSA that are tradeable on T cannot exceed the total stock holdings of the same security held in the same SPSA immediately prior to the commencement of T.⁴⁴

Settlement occurs quickly: securities settlement occurs on T, whereas cash settlement takes place on T+1.

Restrictions

Trading in A Shares is subject to various other restrictions. First, Stock Connect participants must comply with the 10% limit on shareholding applicable to foreign investors.⁴⁵ Second, foreign investors are subject to a 30% aggregate shareholding limit. A breach of this limitation would result in the forced sale of A Shares.⁴⁶ Specifically, HKSCC has the power to force a Stock Connect participant to liquidate its holdings in an amount necessary to comply with the applicable regulations on foreign investment. HKSCC will operate with a last-in-first-out model in this regard.⁴⁷ However, Stock Connect investors can sell their A Shares even when the 30% limit has been breached.⁴⁸ Third, investors are precluded from purchasing A Shares when: (1) such securities are no longer a constituent stock of the relevant index; (2) the security is placed under a “risk alert”; and/or (3) the corresponding H Share is no longer traded on SEHK.⁴⁹ Fourth, the Stock Connect is subject to a “daily quota” and an “aggregate quota.” If either of the quotas are exceeded, then investors will be unable to purchase A Shares. However, because these quotas apply on a

³⁷ FAQ for Investors at p. 39.

³⁸ *Id.*

³⁹ *Id.* at p. 37.

⁴⁰ SEHK Rules at Rule 14A06(5).

⁴¹ SEHK Rules at Rule 14A06(8)(a).

⁴² FAQ for Investors at pp. 22–23. *See also* SEHK Rules at Rule 14A06(2A) (“a China Connect Exchange Participant who receives instructions from a client to sell China Connect Securities held in a Special Segregated Account shall, before inputting an SPSA order into the CSC, ensure that: (i) the Special Segregated Account has been designated to the client and an investor identification number has been assigned by CCASS to the Special

Segregated Account in accordance with the CCASS Rules; (ii) it has been authorized to execute on behalf of the client the sale of China Connect Securities in the specified Special Segregated Account; and (iii) it has received confirmation from the client or has advised the client to ensure that there are sufficient China Connect Securities in the Special Segregated Account to settle the delivery obligations on the settlement day. . . .”).

⁴³ SEHK Rules at Rule 14A06(7A).

⁴⁴ *Id.* at Rule 14A06(8)(b).

⁴⁵ *Id.* at Rule 14A08(2).

⁴⁶ *Id.* at Rule 14A08(3).

⁴⁷ FAQ for Investors at p. 21.

⁴⁸ *Id.*

⁴⁹ *Id.* at p. 3.

“net buy” basis, investors are always able to sell A Shares.⁵⁰

ERISA’S INDICIA OF OWNERSHIP REQUIREMENTS

Context

Before delving into ERISA’s indicia of ownership requirements, it is important to consider the context in which these rules would apply. First, we must first determine what is meant by the “indicia of ownership” of A Shares. Unfortunately, there is a paucity of guidance as to this term’s meaning. In one advisory opinion, the DOL listed stock and bond certificates as examples of indicia of ownership.⁵¹ Some practitioners consider the formal agreement that captures the ERISA investor’s interest, such as a limited partnership agreement or subscription agreement, to be the indicia of ownership. Trade confirmations are also likely to be considered indicia of ownership. Potentially, account statements or some other manifestation of the transactions and the ERISA investor’s interest in the securities would suffice. In the absence of actual stock certificates, as is the case with the A Shares, the indicia of ownership could simply be the digital entries in CCASS.

Second, some agent of the ERISA investor needs to be qualified to trade on the Stock Connect — this can be either an ERISA fiduciary or some intermediary, such as a bank or broker-dealer.

Background

As a general rule, an ERISA fiduciary may not maintain the indicia of ownership of plan assets outside the jurisdiction of the U.S. district courts. Acknowledging that investments in non-U.S. securities could be in the best interests of plan participants, the DOL promulgated a regulation under ERISA §404(b) of ERISA, 29 C.F.R. §2550.404b-1 (Regulation), which strove to strike a balance between flexibility in investing abroad while also avoiding the possible stymying of the necessary protections under ERISA as they apply to the management of plan assets.

⁵⁰ *Id.* at p. 6. The *Aggregate Quota balance = Aggregate Quota – Aggregate Buy Trades + Aggregate Sell Trades*. The *Daily Quota balance = Daily Quota – Buy Orders + Sell Trades + Adjustments*.

⁵¹ See DOL Adv. Op. 75-80 (describing ERISA §404(b) as “language [that] indicates only that the ‘indicia of ownership,’ i.e., evidence of ownership of plan assets (such as bonds or stock certificates), may not be maintained outside the United States. It does not, however, proscribe the investment of employee benefit plan assets outside the United States”).

Assuming the ERISA investor is purchasing qualifying assets under the Regulation (e.g., securities issued by a company that neither is organized in the U.S. nor has its principal place of business in the U.S.), then there are four possible tracks under the Regulation:

1. The assets are under the “management and control” of an ERISA fiduciary that is both organized, and has its principal place of business, in the U.S. (U.S. Person);
2. The indicia of ownership are in the physical possession of certain entities that are U.S. Persons;
3. The indicia of ownership are maintained by certain U.S. broker-dealers, in the custody of a “satisfactory control location,” within the meaning of Rule 15c3-3 of the U.S. Securities Exchange Act of 1934, as amended (Exchange Act); or
4. The indicia of ownership are maintained by certain banks, in the custody of a “foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank, which entity is supervised or regulated by a government agency or regulatory authority in the foreign jurisdiction having authority over such depositories, clearing agencies or banks. . . .”⁵²

Track #1: Management and Control of a U.S. Fiduciary

Context

To avail oneself of this track, the entity that is qualified to trade over the Stock Connect would possibly have to be a fiduciary by reason of being a “named fiduciary,” “trustee,” or “investment manager,” within the meaning of ERISA, and which is also a U.S. Person. The indicia of ownership would arguably be the most flexible under this track.

Requirements

Specifically, the assets held abroad must be within the “management and control” of the following types of U.S. Persons:

- A “bank” (Bank) within the meaning of §202 of the Investment Advisers Act of 1940, as amended (Advisers Act), which has, as of the last day of its most recent fiscal year, equity capital in excess of \$1,000,000;⁵³
- An insurance company that is qualified under the laws of more than one state to manage, acquire,

⁵² 29 C.F.R. §2550.404b-1.

⁵³ As set forth in §202 of the Investment Advisers Act, a “bank” is defined as: (A) a banking institution organized under the laws of the United States or a Federal savings association, as

or dispose of any asset of a plan, which has, as of the last day of its most recent fiscal year, net worth in excess of \$1,000,000, and which is also subject to the supervision and examination by the state authority having supervision over insurance companies; or

- An investment adviser registered under the Advisers Act that has, as of the last day of its most recent fiscal year, total client assets under its management and control in excess \$50,000,000 and either (1) shareholders' or partners' equity in excess of \$750,000 or (2) all of its obligations and liabilities assumed or guaranteed by certain types of entities.⁵⁴

The Regulation defines "management and control" as "the power to direct the acquisition or disposition through purchase, sale, pledging, or other means." The DOL, in at least one instance, has narrowly construed the ways in which "management and control" could be found.⁵⁵ Particularly, the DOL may require

defined in section 1462(5) of Title 12; (B) a member bank of the Federal Reserve System; (C) any other banking institution, savings association, as defined in section 1462(4) of Title 12, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this subchapter; and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

⁵⁴ 29 C.F.R. §2550.404b-1.

⁵⁵ See DOL Adv. Op. 80-73A (where the question was whether the Mitsubishi Bank of California (MBC), a "bank" organized under the laws of the State of California, exercised "management and control" of plan assets as defined in Department of Labor Regulation 29 C.F.R. §2550.404b-1(c). The DOL held that MBC had in fact exercised "management and control" because MBC had been designated as a "named fiduciary," within the meaning of ERISA §402(a)(2), to the plans in question. Under the proposed arrangement, non-U.S. investment managers were given the authority to direct trades, which MBC would be instructed to settle. MBC would settle the trades by electronic funds transfer to foreign subcustodians. However, by authority of the plans and by contractual arrangement, MBC would have the right and obligation to review, prior to settlement, the prudence and advisability of all trades it was instructed to settle. In the event MBC found a trade to be imprudent or inadvisable, MBC would "back out" or "reverse" the trade. However, MBC would not have the power, under such circumstances, to prevent settlement if the other parties involved were not willing to reverse the trade, although MBC would have the power to direct the sale by the foreign subcustodians of the securities in question subsequent to settlement. In addition, MBC would have the right and obligation to make a general review of the plan's portfolio on a monthly basis, and to di-

rect the sale of securities if an investment was considered inadvisable).

that the ERISA fiduciary constitute a "trustee,"⁵⁶ "named fiduciary"⁵⁷ or "investment manager," each as defined under ERISA, in order to demonstrate "management and control" for purposes of this track.⁵⁸

Track #2: Indicia of Ownership in the Physical Possession of U.S. Persons

Context

To meet the requirements of this track, the entity that is qualified to trade over the Stock Connect would potentially have to be a fiduciary to the ERISA investor, and that fiduciary would also have to be a U.S. Person. The indicia of ownership could *either* be the book entries of such intermediary *or* the documentation that details the transactions and holdings.

Requirements

Specifically, the indicia of ownership must be in the physical possession of:

- A Bank; or
- A broker or dealer registered under the Exchange Act that has, as of the last day of its most recent fiscal year, net worth in excess of \$750,000; or that has all of its obligations and liabilities assumed or guaranteed by certain entities.

Track #3: Indicia of Ownership Maintained by Broker-Dealer and in the Custody of a Satisfactory Control Location

Context

This track is possible where the ERISA investor's intermediary is a broker-dealer registered under the Exchange Act and HKSCC is a "satisfactory control location" under the U.S. securities laws. This would assume that only HKSCC has "custody" over the A Shares, which means that HKSCC's book-entries would constitute the indicia of ownership, unless the ERISA investor's intermediary amounted to a "satisfactory control location," in which case the indicia of ownership could be the entries on the intermediary's books or the documentation.

Requirements

This track contains five elements:

rect the sale of securities if an investment was considered inadvisable).

⁵⁶ See ERISA §403.

⁵⁷ See ERISA §402.

⁵⁸ See ERISA §3(38).

1. Indicia of ownership needs to be maintained by a broker-dealer registered under the Exchange Act;
2. The broker-dealer has, as of the last day of its most recent fiscal year, net worth in excess of \$750,000, or its obligations and liabilities are assumed or guaranteed by some other entity, subject to certain conditions;
3. Indicia of ownership is in the custody of a “satisfactory control location (SCL),” pursuant to Rule 15c3-3 under the Exchange Act;⁵⁹
4. The SCL holds the indicia of ownership as agent for the broker-dealer; and
5. The broker-dealer remains liable to its customer as if it had retained physical possession of the indicia of ownership.

Rule 15c3-3 “requires a broker or dealer promptly to obtain possession or control of all fully paid and excess margin securities carried for the account of its customers and to take action within designated time frames where possession or control has not been established.”⁶⁰ In pertinent part, a broker-dealer will be deemed to “control” the securities when they are “[a]re in the custody of a foreign depository, foreign clearing agency or foreign custodian bank which the [SEC] upon application from a broker or dealer, a registered national securities exchange or a registered national securities association, or upon its own motion shall designate as a satisfactory control location for securities. . . .”⁶¹ The SEC has established guidelines for satisfactory control locations in respect of non-U.S. securities. These guidelines generally set forth two primary conditions: (1) the “securities are not subject to any right, charge, security interest, lien or claim of any kind in favor of the foreign entity except for their safe custody or administration;” and (2) “beneficial ownership of such securities is freely transferable without the payment of money or value other than for safe custody or administration. . . .”⁶²

⁵⁹ See 17 C.F.R. §240.15c3-3.

⁶⁰ SEC Rel. No. 10429, *Guidelines for Control Locations for Foreign Securities* (Oct. 19, 1973).

⁶¹ 17 C.F.R. §240.15c3-3(c).

⁶² SEC Rel. No. 10429. See also *id.* at n. 1 (“it is the practice in many foreign countries for the foreign entity to maintain a lien, claim, or other charge on customers’ foreign securities for custody and administration charges. . .” but nevertheless “it is the broker’s or dealer’s responsibility to pay charges, claims, etc., promptly and to be certain that the amount of such charges, claims, etc., remain at all times minimal”).

Track #4: Indicia of Ownership Maintained by a Bank in the Custody of a Foreign Securities Depository, Foreign Clearing Agency Which Acts as a Securities Depository, or a Foreign Bank

Context

This track is possible where the ERISA investor’s intermediary is a Bank and HKSCC constitutes a foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank. This would assume that only HKSCC has “custody” over the A Shares, which means that HKSCC’s book-entries would constitute the indicia of ownership, unless the ERISA investor’s intermediary constituted a foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank, in which case the indicia of ownership could be the entries on the intermediary’s books or the documentation that details the ERISA investor’s holdings.

Requirements

This track requires that a Bank places the indicia of ownership in the custody of foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank, which entity is supervised or regulated by a government agency or regulatory authority in the foreign jurisdiction having authority over such depositories, clearing agencies or banks, provided that:

1. The foreign entity holds the indicia of ownership as agent for the Bank;
2. The Bank is liable to the ERISA investor as if it had retained physical possession over the indicia of ownership within the U.S.;
3. The indicia of ownership are not subject to any right, charge, security interest, lien or claim of any kind in favor of such foreign entity, except for their safe custody or administration;
4. Beneficial ownership of the assets (represented by the indicia of ownership) is freely transferable without the need for payment of money or value (other than for the safe custody or administration);⁶³ and
5. Upon request by the ERISA fiduciary who is responsible for the selection and retention of the

⁶³ The DOL has indicated in a different context that it considers the phrase “freely transferrable” to be an escape hatch for fiduciaries of an investment. See 51 Fed. Reg. 41,262, 41,267 (Nov. 13, 1986) (“The Department also believes that the “widely-held” and “freely transferable” requirements under the publicly-offered exception will provide plan investors two significant protections: (1) The ability to liquidate an unattractive investment; and (2)

Bank, the Bank identifies to such fiduciary the name, address and principal place of business of the foreign entity that acts as custodian for the plan pursuant to the foregoing, and the name and address of the governmental agency or other regulatory authority that supervises or regulates that foreign entity.

The Regulation defines “depository” as “any company, or agency or instrumentality of government, that acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates.”⁶⁴

The Exchange Act defines “clearing agency” as “any person, such as a securities depository, who: (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates; or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.”⁶⁵ This, it would be necessary for the foreign securities to be “fungible.”⁶⁶

The DOL has described the contours of the meaning of “foreign clearing agency which acts as a secu-

diminution of concentration of ownership in any one investor due to the large number of investors in the entity so that it will be less likely that the entity’s managers will engage in transactions for the benefit of persons related to any particular investor”).

⁶⁴ 29 C.F.R. §2550.404b-1(c)(2).

⁶⁵ 15 U.S.C. §78c(a)(23). The DOL has endorsed this definition. *See also* 5 Law Sec. Reg. §14.2, n. 85 (citing Louis Loss & Joel Seligman, *Securities Regulation* §7-E-2 (3d ed. 2004), relying on *Report of the Presidential Task Force on Market Mechanisms* VI-15 (1988)) (“‘Clearing,’ ‘clearance,’ or ‘trade comparison’ refers to the comparison or reconciliation of what a trade was; that is, a post-trade comparison by the involved parties confirming: (1) that the trade was executed; and (2) that it was executed in accordance with the directions of the buyer and seller”).

⁶⁶ “Fungibility” means that the individual securities are indistinguishable from each other. *See* ECB Glossary (defining “fungibility” as “a characteristic of securities which are substitutable on account of their being identical”); SEC Rel. No. 34-50758, *Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries*, at n. 23 (Dec. 7, 2004) (“Fungible bulk means that no participant or customer of a participant has any claim or ownership rights to any particular certificate held by [the Depository Trust Company]. Rather, participants have a securities entitlement to obtain a certificate representing securities held in their DTC accounts”); *Morton Intern., Inc. v. A.E. Staley Mfg. Co.*, 343 F.3d 669 at n. 7 (3d. Cir. 2003) (“When money is deposited in a bank

curities depository” in various advisory opinions. For example, in DOL Adv. Op. 91-28A, the DOL considered whether S.D. Indeval, S.A. de C.V. (Indeval) constituted a “foreign clearing agency which acts as a securities depository.” As described in the opinion, Indeval was a central clearing depository for most securities traded on the Mexican Stock Exchange, and also operated as a central clearing agency. In Indeval’s agreements with brokerage firms, banks, insurance companies, mutual funds and surety companies, from whom Indeval would accept securities for deposit, it was stated that securities were considered fungible and were able to be transferred, loaned or pledged by bookkeeping entry. The DOL concluded that Indeval appeared to constitute a “foreign clearing agency which acts as a securities depository.” As to the five conditions, the agreement also contained an “ERISA Rider” that would need to be executed when a depositor maintains the indicia of ownership of ERISA assets on behalf of a plan fiduciary. The ERISA Rider provided that:

the Depositor shall remain liable to the plan to the same extent it would be if it retained the physical possession of the indicia of ownership of plan assets within the United States; the indicia of ownership shall not be subject to any right, charge, security interest, lien or claim of any kind in favor of Indeval, except for their safe custody or administration; and the Depositor upon request by a plan fiduciary who is responsible for the selection and retention of the Depositor, shall identify to such fiduciary the name, address and principal place of business of the Depositor as set forth in the Deposit Agreements and the name and address of the National Securities Commission and the Ministry of Public Finance and Credit.

The Agreement also contained a provision that established a contractual custodial relationship. ERISA fiduciaries should keep these types of terms in mind when reviewing the documentation applicable to the Stock Connect.

The DOL has also addressed whether Euroclear was a “foreign clearing agency which acts as a securities depository.”⁶⁷ In the Advisory Opinion, Euroclear was represented to be a “true central clearing system” that would allow its participants to access international markets. Each participant would enter into

the depositor does not cease owning the money because the actual dollars and cents it deposited are fungible and are used by other customers”); *Towers Charter & Marine Corp. v. Cadillac Ins. Co.*, 894 F.2d 516, 523 (2d. Cir. 1990) (“money is the quintessential fungible”).

⁶⁷ DOL Adv. Op. 84-14A.

an agreement and open a cash and securities account with the Brussels office of Morgan Guaranty Trust Company of New York, the operator (Euroclear was owned by Euroclear Clearance System Public Limited Company, which was organized in the United Kingdom). Securities accepted into the Euroclear system were permitted to be physically held at Morgan Guaranty Brussels or other offices or with other institutions, including sub-custodians. All securities deposited within the Euroclear system were to be treated as fungible and able to be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates. The DOL concluded that Euroclear was a “foreign clearing agency which acts as a securities depository.” Interestingly, with respect to the first condition, a bank (as a participant in the Euroclear system) would have a contractual custodial relationship with Morgan Guaranty Brussels, and that while the terms and conditions of that agreement did *not* use any particular label to describe the legal relationship between a Euroclear participant and Morgan Guaranty Brussels, it was represented that the relationship may properly be described as one of custodianship and agency.

Detailed documentation of the transactions and account holdings is important. In DOL Adv. Op. 2008-04A, the DOL ultimately concluded that Northern Trust Company (Northern Trust), in its role as global custodian, may permit sub-custodians that are a foreign bank, foreign securities depository or foreign clearing agency to hold the indicia of ownership of ERISA assets outside the U.S. Importantly, Northern Trust would be liable to the ERISA investor to the same extent as if it had retained physical possession of the indicia of ownership within the U.S. The DOL also noted the following reports that would be available to ERISA fiduciaries and the U.S. courts from Northern Trust:

First, appropriate account statements of each ERISA Sub-Fund would set forth the ownership interest of each investing Plan. The information contained on the Plan-level account statements would consist of a statement of the number of units of each Sub-Fund held by the Plan and the value of such units. Second, the underlying investments of each Sub-Fund in which the Plan invests would be set forth on separate account statements. The information contained in each Sub-Fund-level account statement would consist of a detailed statement listing the total position and market value of each asset owned by the Sub-Fund.

If a Plan fiduciary or other appropriate party desires to determine a Plan’s percent-

age ownership interest in an ERISA Sub-Fund, a report containing that information would be provided upon request. The information compiled in both the Plan-level account statements and Sub-Fund level account statements would be assembled in accordance with Northern Trust’s general business practices.

All of the above account statements and reports will be available to the fiduciaries of ERISA Plans and other appropriate parties (e.g., a U.S. District Court with jurisdiction over a matter relating to the Plan’s assets) from Northern Trust. Thus, Plan fiduciaries will be able to access detailed ERISA Plan-level account statements at any time. In addition, Plan fiduciaries will be provided with copies of ERISA Sub-Fund-level account statements and the Plan percentage ownership report upon request.

Based on all the representations in the Advisory Opinion, the DOL concluded that the Regulation “would permit a bank described in 29 C.F.R. §2550.404b-1(a)(2)(ii)(A)(1) (e.g., Northern Trust) to maintain the indicia of ownership of plan assets that are foreign securities or foreign currencies (as described in section 2550.404b-1(a)(1)) in the custody of an entity that is a foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank,” provided the conditions were met.

Though it is unclear the weight the DOL placed on the reporting under this Advisory Opinion, it is difficult to contemplate a scenario where more data given to an ERISA fiduciary (who is within the reach of the U.S. district courts) can be anything other than a good thing.

CONSIDERATIONS

There seems to be political will behind the Stock Connect. The Stock Connect is, simply, designed to succeed and serve as a model for other links between exchanges in Asia and elsewhere. As we have seen with the offering of the Enhanced Model, the Stock Connect will quite likely continue to morph over time to adapt to investor concerns. With this in mind, ERISA fiduciaries may wish to consider the following in respect of potentially accessing A Shares via the Stock Connect.

1. It is unclear whether HKSCC will custody the A Shares or whether it is relinquishing such responsibility to the ERISA investor’s custodian. HKSCC appears to have possession over the A

Shares, though. Because it is uncertain what constitutes the indicia of ownership of A Shares, this is an important issue that should be clarified.

2. HKSCC does not have an ability to catalog the definitive record of ownership. While this may change in the future due to legislative action, an ERISA fiduciary should carefully consider this deficiency, particularly in light of (1) above.
3. The Stock Connect has gone to great lengths to clarify that HKSCC does not have a proprietary interest in the A Shares, and that the underlying investor is the beneficial owner who enjoys all the rights appurtenant to ownership. While the clarification is helpful, it remains unclear whether the underlying investor is able to pledge, loan or hypothecate the A Shares.
4. HKSCC should clarify whether the A Shares are subject to security interests (in favor of HKSCC or otherwise). It would be important that HKSCC not have a lien over, or other interest in, the A Shares.
5. Roadshows and additional material explaining the complex ownership structure would help. This complexity is not necessarily specific to Stock Connect, though.⁶⁸
6. The reporting currently available is a good first step. Potentially, DOL may even consider this reporting to be the indicia of ownership of the A Shares. Ideally, ERISA fiduciaries would receive trade confirmations or other evidence of a transaction (which would be provided as contemporaneously with the transaction as possible). The fact that the A Shares are recorded in computerized form should not be an issue.
7. In light of this past summer's events, ERISA fiduciaries will likely take a close look at the vari-

ous restrictions related to A Shares. As much clarity on this issue as possible would be warranted. It is helpful that none of the restrictions appear to inhibit the disposition of A Shares, but rather would prevent the purchase of additional A Shares. There are instances in which an ERISA investor's holdings may be forced to liquidate (last in-first out). In these cases, an ERISA investor may be required to sell its A Shares at a depressed price.

8. The public materials for the Stock Connect suggest certain provisions be included in agreements between investors and intermediaries, such as a provision addressing the foreign holding restriction. ERISA fiduciaries should be prepared for these types of provisions and should understand their significance.

These are the early days for the Stock Connect, though. At just a year old, the Stock Connect has already undergone changes to address investor concerns. This is a prototype that could multiply elsewhere. It arguably represents the future of trading across markets. As a White Paper by Celent provides:

Market observers debate the extent to which this will be followed by links between Shanghai or Shenzhen and Taiwan, Singapore, Tokyo, New York and London. Stock Connect has also inspired a number of proposals for links between Asian markets outside of China. Chinese and Asian cross-border links for derivatives, fixed income and commodities are also being discussed. What is clear is that the key factor driving demand for use of Shanghai Hong Kong Stock Connect is that it opens up a market previously difficult to access.⁶⁹

Access to A Shares may become even more critical once A Shares are included in major global indices, such as those of MSCI. The addition of A Shares to the widely-followed MSCI index could come as early as 2017 and add up to \$50bn to China's equity markets.⁷⁰

As this article's title suggests, there will likely be many developments regarding the trading of A Shares over the Stock Connect and other non-U.S. equities over other trading links. Stay tuned.

⁶⁸ SEC Rel. No. 34-50758 at n. 21 ("The relationship between various levels of securities intermediaries and beneficial owners is complex. There may be many layers of beneficial owners (some of which may also be securities intermediaries) with all ultimately holding securities on behalf of a single beneficial owner, who is sometimes referred to as the ultimate beneficial owner. For example, an introducing broker-dealer may hold its customer's securities in its account at a clearing broker-dealer, that in turn holds the introducing broker-dealer's securities in an account at DTC. In this context, DTC or its nominee is the registered owner and DTC's participants (i.e., broker-dealers and banks) are beneficial owners, as are the participants' customers. However, DTC, the clearing broker-dealer (the DTC participant), and the introducing broker-dealer are all securities intermediaries. These distinctions may be important under both federal and state law when determining the rights and obligations of the parties holding securities on behalf of others").

⁶⁹ Neil Katkov & Hua Zhang, *Shanghai-Hong Kong Stock Connect: It's Just the Beginning*, at p. 2 (June 2015).

⁷⁰ Josh Noble & Nicole Bullock, *China Stocks' Inclusion in Global Index Put on Hold*, Financial Times (June 10, 2015).