

Legal Commentary

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Capital Market Law

No Shortage of Short Swing Profit Rules

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Background

The so-called short swing profit rule (“SSPR”) is originally provided in the *PRC Securities Law*. Under Article 44 of the *PRC Securities Law*, for shareholders that hold more than 5% shares of a listed company or a company whose stocks are traded on the other national securities trading venues as approved by the State Council, directors, supervisors or senior management personnel of the said company, where they buy/sell and then sell/buy within six months the stocks or other securities of equity nature in the said company, the proceeds realized from such transactions shall belong to the said company, and the board of directors of the said company shall recover the proceeds. Article 44 further provides that the China Securities Regulatory Commission (“CSRC”) may prescribe exemptions under which the SSPR shall not apply.

On July 21, 2023, CSRC issued a consultation paper of the *Several Provisions on Improving the Regulation of Covered Short-Swing Transactions* (the “**Consultation Paper**”). The consultation period will end on August 20, 2023. According to its official explanatory note, the Consultation Paper is formulated to clarify regulatory positions, provide reasonable exemptions, respond to updated market practice and facilitate trading by domestic and foreign investors.

Highlights of the Consultation Paper

I. Confirming scope of application

The Consultation Paper generally follows the current rules and regulatory practice when defining “covered investors”, “covered securities” and activities subject to SSPR.

1. Investors subject to SSPR

Articles 2 and 4 of the Consultation Paper provide that “covered investors” are subject to the SSPR. The Covered Investors are defined as shareholders that hold more than 5% shares in a listed company or a company whose stocks are traded on the other national securities trading venues as approved by

the State Council, directors, supervisors and senior management personnel of the said company. Notably, for any investor that is not a Covered Investor at the time of purchasing the Covered Securities but becomes a Covered Investor when selling the Covered Securities, it shall also comply with SSPR.

2. Securities subject to SSPR

Article 2 of the Consultation Paper provides the scope of securities subject to SSPR, which would cover stocks and other types of securities with equity nature, including without limitation depository receipts, exchangeable bonds and convertible bonds (the “**Covered Securities**”).

3. Activities subject to SSPR

Article 5 of the Consultation Paper specifies that the buying and selling activities subject to SSPR would cover any action by a Covered Investor to pay consideration that results in the increase or decrease in the number of Covered Securities.

Article 6 of the Consultation Paper further provides certain exemptions that would not be deemed as short-swing transactions, which include conversion into shares from convertible bonds, borrowing or lending Covered Securities, judicial enforcement, etc.

It is further provided that where a Covered Investor is involved in covered short swing transactions, such transactions shall be determined based on the quantity of each securities category such as stocks, depository receipts, exchangeable bonds and convertible bonds held by such Covered Investor respectively. This means that no short swing profits shall be calculated on a cross-product basis, e.g., a Covered Investor may not be deemed in violation of the SSPR rule if it buys/sells stocks and sells/buys another type of Covered Securities (such as convertible bonds) within 6 months.

II. Clarifying calculation method

Articles 9, 10 and 11 of the Consultation Paper clarify the calculation method of shareholdings for domestic and foreign investors as follows:

- A domestic entity shall aggregate the Covered Securities held in all the accounts under its own name and via any third party’s accounts.

Domestic securities/funds operating institutions (e.g., securities firms, FMCs) may calculate shareholdings per each product for collective private asset management products under their management.

Domestic private fund managers with standardized internal controls, sound governance structures, and investment management models that are basically consistent with public fund managers may apply to Asset Management Association of China to calculate the shareholdings per each product for the purpose of SSPR.

- A foreign investor shall aggregate the Covered Securities held by it through QFI, Stock Connect and strategic investment channels for SSPR purpose.

III. Leveling a play field for foreign investors

For foreign mutual fund managers, they may apply to CSRC to calculate shareholdings per each product for the purpose of SSPR, provided that they meet the requirements as specified under the Consultation Paper, such as (1) a sound governance structure, (2) separation of business and client key information with affiliates, (3) separate accounting and management for each product/fund, (4) undertaking to disclose investments through strategic investment and Stock Connect channels, and (5) compliance with information disclosure rules and monitoring of aggregate shareholdings through all channels at the manager's level and concerted parties' level.

Outstanding issues

The Consultation Paper is generally seen as a positive development, especially considering the regulator's efforts to respond to updated market practice and level a playing field between domestic and foreign investors. That said, there may still be some pending issues to be clarified or further lobbied with the regulator, such as the following:

- Availability of exemption for foreign mutual funds. In practice, certain specific requirements proposed under the Consultation Paper may be difficult for foreign mutual fund managers to meet, such as separate management of each fund, internal segregation among investment management teams which may not be consistent with the common practice among global asset managers.
- Applicability for disclosure of interest. Market players wonder whether the same exemptions in the Consultation Paper could be applied by foreign mutual fund managers and domestic private fund managers for the purpose of disclosure of interest obligations. For consistency of regulatory positions, we tend to think the same exemptions should apply for disclosure of interest purpose as well.
- Lack of "persons acting in concert" concept. For the purpose of calculating holdings by individuals and institutions, we note the relevant securities held "by using other person's accounts" shall also be aggregated. But there is not a well-defined concept of "persons acting in concert" such as that provided under the PRC Securities Law. It is worth further clarifying whether such a concept would not apply for SSPR purpose and what typical scenarios would be regarded as "using other person's accounts".
- Extraterritorial applicability. It is still questionable whether the rule is applicable to trading activities conducted through an overseas exchange (assuming the relevant jurisdiction does not have a short swing profit rule). For example, it is unclear whether the short swing profit rule applies when an overseas investor with more than a 5% interest in the issued shares of a PRC listed company sells the H shares of such dual-listed PRC company within 6 months of the last purchase. Where an overseas investor holds only H shares, it seems that such short term trading has not been challenged by either the PRC listed companies or CSRC. The position is also unclear as to whether an overseas investor, whose holdings in A shares and B shares do not exceed 5% of the shares of such company but whose aggregate holding in A Shares, B Shares and H shares is greater than 5% should be restricted by the short swing profit rule in terms of its domestic and/or overseas trading.

On the same day the Consultation Paper was issued, the Shanghai Stock Exchange, the Shenzhen Stock

Exchange and the National Equities Exchange and Quotations announced that they are formulating the implementing self-discipline rules to the Consultation Paper. It is anticipated that the Consultation Paper and relevant self-discipline rules will be issued soon. We will monitor these developments and provide updates as they occur.

We have also prepared an English translation of the Consultation Paper. Please contact us if you wish to receive a copy.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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