Shanghai-Hong Kong Stock Connect to Boost Reciprocal Investment in RMB Securities

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I. Plans for Shanghai-Hong Kong Stock Connect announced

In a speech on 10 April 2014 at the Boao Forum for Asia held on Hainan island, China's State Council (equivalent to a ministerial cabinet) and Premier Li Keqiang unveiled plans to manage the economy based on three main drivers: reforms, structural adjustments, and public welfare improvements.[1]

Speaking on reforms, Mr. Li noted that "opening-up is a kind of reform, and opening-up can boost reform," and outlined plans for opening as follows. First, he said that China would carry out a new round of opening-up at a high level. Second, he noted that a key element of opening is to extend it to the services sector, including capital markets. And third, he cited the example of proactively creating conditions to enable the establishment of a mechanism to link the Shanghai and Hong Kong stock exchanges so as to further promote the mutual opening and sound development of capital markets on the mainland and in Hong Kong. Fourth, he said China would continue to raise the quality and level of this opening-up process through deeper integration with international markets.

An example he cited as one of China's opening-up policies, the Shanghai-Hong Kong Stock Connect, is attracting interest among both domestic and nonresident market participants as a new driving force for opening up China's capital markets.

II. Overview of Shanghai-Hong Kong Stock Connect

1. Basic design of the mechanism is announced

On 10 April, the same day that Premier Li Keqiang announced the Shanghai-Hong Kong Stock Connect, the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities & Futures Commission (SFC) jointly issued a public notice clarifying the new mechanism's basic design (Figure 1).[2]

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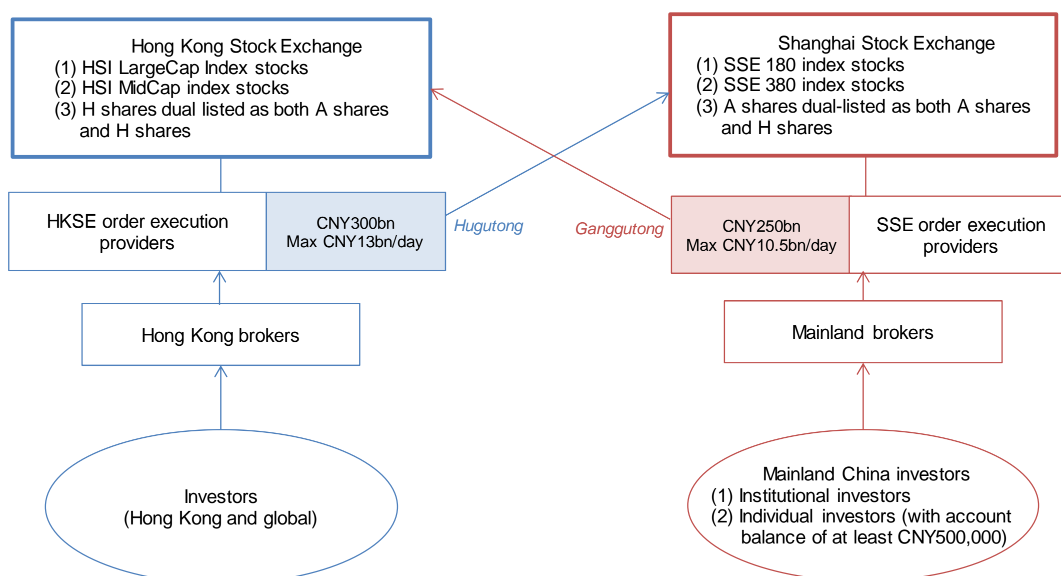
1 http://www.gov.cn/guowuyuan/2014-04/11/content_2656979.htm (in Chinese)
2 http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201404/t20140410_246762.html (in Chinese)

Figure 1: Flowchart for Shanghai-Hong Kong Stock Connect (*Hugangtong*)



Notes: Announced jointly with the Hong Kong Securities & Futures Commission on 10 April 2014.
Source: Nomura Institute of Capital Markets Research, based on materials from the China Securities Regulatory Commission.

Then on 29 April, the Shanghai Stock Exchange announced a consultation draft of implementing rules for its Shanghai-Hong Kong Stock Connect Pilot Scheme and asked for public comments (with a deadline of 16 May),[3] and on 9 May the CRSC announced its draft set of rules on the Pilot Scheme asking for public comments by 23 May.[4]

These notices can be summarized with an outline of the pilot scheme, as follows.

2. Trading entities

1) General rules

The Shanghai Stock Exchange and the Hong Kong Stock Exchange will allow investors in both mainland China and Hong Kong to use securities brokers in their respective territories to trade stocks listed on the other exchange within certain parameters. The joint public notice in the Chinese language uses three Chinese characters pronounced *hugangtong* as the name of the mechanism, with the first character representing Shanghai, the second Hong Kong, and the third recent reciprocal stock market trading route.

3 http://www.sse.com.cn/disclosure/announcement/general/c/c_20140429_3803206.shtml (in Chinese)
4 http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201405/t20140509_248743.html (in Chinese)

2) Trading Shanghai stocks (*hugutong*)

The joint public notice uses the Chinese word *hugutong* to denote the process of trading Shanghai stocks on the Hong Kong side, as follows.

First, a stock trading services company is established under the Hong Kong Stock Exchange (HKSE).

Second, investors on the Hong Kong side rely on a Hong Kong broker to place a trading order on the Shanghai Stock Exchange (SSE) via the orders execution company in order to trade SSE-listed stocks within certain parameters.

3) Trading Hong Kong stocks (*ganggutong*)

The joint public notice uses the Chinese word *ganggutong* to denote the process of trading Hong Kong stocks on the Shanghai side, as follows.

First, a stock trading services company is established under the SSE.

Second, investors on the Shanghai side rely on a mainland China broker to place a trading order on the HKSE via the orders execution company in order to trade HKSE-listed stocks within certain parameters.

3. Trading method

1) Rules that are applicable for trades, settlement, and listing criteria

First, for trades and settlement, the applicable rules are those for the market where the trade/settlement occurs. Accordingly, when trading Shanghai stocks from the Hong Kong side, Shanghai market rules apply, and when trading Hong Kong stocks from the Shanghai side, Hong Kong market rules apply.

Second, listed companies are subject to regulatory oversight based on the listing criteria and other regulations of the market on which they are listed. Thus Shanghai-Hong Kong Stock Connect will not necessitate any change in listing criteria.

Third, reciprocal trading can begin when both the SSE and HKSE are open for business and clearing/settlement arrangements are in place.

Although there is no time zone difference between Shanghai and Hong Kong, trading hours and market holidays are different, and it will be a challenge to work these differences out. Taking trading hours, for example, the SSE's are 09:15–09:25 for the pre-opening session, 09:30–11:30 for the morning session and 13:00–15:00 for the afternoon session, while HKSE trading hours are 09:00–09:30 for the pre-opening session, 09:30–12:00 for the morning session and 13:00–16:00 for the afternoon session.

2) Clearing/settlement method

The clearing/settlement of reciprocal trades will be of the direct, cross-border type between China Securities Depository and Clearing (CSDC) on the Shanghai side and Hong Kong Securities Clearing (HKSCC) on the Hong Kong side. Each side will serve as the other's counterparty and provide clearing/settlement services for reciprocal trades.

Because Shanghai's settlement date is T+1 and Hong Kong's is T+2, future adjustments will be an issue.

4. Eligible investments and trading quotas

1) Eligible investments

Trading will be limited to blue-chip stocks listed on the SSE or HKSE, with plans to revise eligibility after watching how the test progresses.

(1) *Hugutong* (Shanghai stocks)

The Shanghai stocks eligible for investment from the Hong Kong side are (1) the constituents of the SSE 180 and SSE 380 indices and (2) the A shares that are dual-listed on the SSE as A shares and H shares. The term "A shares" refers to RMB-denominated stock listed on a mainland China market and H shares refers to Chinese stocks listed in Hong Kong.

The detailed proposal includes prohibitions against margin trading (Article 24), short-selling (Article 25), and insider trading (Article 26) through the Connect mechanism.

(2) *Ganggutong* (Hong Kong stocks)

The Hong Kong stocks eligible for investment from the Shanghai side are (1) the constituents of the HSI LargeCap and HSI MidCap indices and (2) the H shares that are dual-listed on the HKSE as A shares and H shares.

The detailed proposal also includes the same prohibitions against margin trading, short-selling, and insider trading of Hong Kong stocks as with Shanghai stocks.

2) Trading quotas

Reciprocal trading is to be denominated in RMB, and in the initial stage of the test, an aggregate trading balance quota is established. There is also a daily trading quota, and trades will be monitored in real time.

(1) *Hugutong* (Shanghai stocks)

The aggregate quota for trading in Shanghai stocks from the Hong Kong side is CNY300 billion, and the daily quota is CNY13 billion. Total trading value for the SSE in April 2014 was RMB1.699 trillion, which converts to a daily volume of CNY80.9 billion (based on the 21 trading days in April), and thus the daily quota on Shanghai stocks is about 16.1% of market volume. Clearing and settlement will be denominated in RMB and handled between the HKSCC and the CSDC, while that between the CSDC and mainland Chinese clearing participants will also be denominated in RMB.[5]

Additionally, according to Articles 30–33 in the proposed detailed rules, the aggregate quota on trading in Shanghai stocks from the Hong Kong side will be managed as follows.

① Management of overall trading quota

First, aggregate trading quotas will be managed on a trades outstanding basis. The aggregate quota balance is equal to the aggregate quota less committed purchase orders plus committed sales orders.

Second, if the aggregate quota balance drops below this daily trading quota, the order execution provider on the Hong Kong side must suspend purchase orders the next trading day, but it can accept sales orders.

Third, once the aggregate quota balance reaches the daily quota, the order execution provider can resume accepting purchase orders the next trading day.

② Managing the daily quota

First, daily trading quotas will be managed on a trades outstanding basis. Specifically, the daily trades outstanding equals the daily trading quota minus the amount of buy orders + the amount of sales transactions + buy order cancellations + (the difference between the transacted price and the buy order price).

Second, if the daily trades outstanding is maxed out at the auction stage, the order execution provider on the Hong Kong side must suspend subsequent purchase orders that trading day,[6] but it can accept sales orders.

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[5] http://finance.sina.com.cn/stock/hkstock/hkstocknews/20140429/204518964613.shtml (in Chinese)

[6] Article 21 of the detailed rules proposal states that trading in Shanghai stocks must be based on the auction method, and large-lot trades are not allowed for the time being. Article 22 states that only limit orders can be used to trade Shanghai stocks, and market orders are not allowed for the time being.

(2) *Ganggutong* (Hong Kong stocks)

The overall quota for trading Hong Kong stocks from the Shanghai side is CNY250 billion, and the daily quota is CNY10.5 billion. Total trading value for the HKSE in April 2014 (including the venture market) was RMB1.3087 trillion, which converts to a daily volume of CNY65.4 billion (based on the 20 trading days in April), and thus the limit on Shanghai stocks is about 16.1% of market activity. Clearance between mainland China investors and the CSDC is denominated in RMB and clearance between the CSDC and the HKSCC is denominated in HKD.

The approach to managing overall and daily quotas for trading Hong Kong stocks is the same as that for Shanghai stocks.

5. Investors

The mainland Chinese investors allowed to invest in Hong Kong stocks from the Shanghai side are limited to (1) institutional investors and (2) individual investors with a total of at least CNY500,000 in brokerage or deposit accounts, per the SFC's request. Article 74-2 of the subsequently published detailed rules proposal stipulates that individual investors must have a basic awareness of trading Hong Kong stocks and managing forex risk, and must pass the HKSE's membership test.

In contrast, there is no mention of any qualifications for investors who want to invest in Shanghai stocks from the Hong Kong side, which suggests that investors from any global market, including Hong Kong , are able to do so as long as they open an account with a Hong Kong broker.

6. Launch date

The joint public notice issued by mainland China and Hong Kong on 10 April 2014 stated that six months of preparation time would be necessary. Accordingly, reciprocal trading is expected to begin around October 2014.

III. Differences with existing cross-border securities trading mechanisms

1. Existing cross-border securities trading mechanisms

China already has mechanisms for inbound and outbound securities investment, and the relationship between these existing systems and the newly proposed reciprocal trading mechanism is an issue to be dealt with. Before explaining the differences between the new and existing mechanisms, it makes sense to begin with an outline of the existing cross-border systems for trading securities on the open market.

1) Inbound securities investment

(1) Qualified Foreign Institutional Investors (QFII)

In November 2002, China introduced its Qualified Foreign Institutional Investors (QFII) program to allow nonresident investors to invest in mainland China's securities markets. Under the QFII, foreign asset management companies, insurance companies, securities companies, commercial banks, pension funds, and other institutions approved by the CRSC are able to invest in Chinese domestic securities (including listed stocks, listed bonds, and investment trusts) within limits set by the State Administration of Foreign Exchange (SAFE).

China's overall investment quota under QFII was expanded from the initial quota of US$10 billion to US$30 billion as a result of the Second US-China Strategic & Economic Dialogue of May 2007, and in April 2012 the CRSC added another US$50 billion to bring the quota up to US$80 billion. The CRSC further increased the quota from US$80 billion to US$150 billion in July 2013. As of 30 May 2014, 249 companies have been approved for investments totaling US$55.718 billion.

(2) RMB Qualified Foreign Institutional Investors (RQFII)

Cumulative yuan-denominated trade settlement since begun by mainland China in July 2009 had totaled CNY10.1599 trillion by end-2013, at which point yuan deposits in Hong Kong, a key trade partner with the mainland, totaled CNY860.5 billion. The RMB Qualified Foreign Institutional Investors (RQFII) program was implemented in December 2011 to provide a mechanism for yuan deposits accumulated in Hong Kong as a result of yuan-denominated trade to be invested in the mainland.

The RQFII investment quota was initially set at CNY20 billion, but was increased by CNY50 billion in April 2012 and then by another CNY200 billion yuan in November 2012, bringing the total quota to CNY270 billion. In March 2013, restrictions on obtaining the RQFII qualification were relaxed (it was initially limited to mainland Chinese securities companies and asset management companies with a Hong Kong branch or subsidiary) to allow the qualification for (1) mainland Chinese commercial banks and insurance companies with a Hong Kong branch or subsidiary and (2) foreign financial institutions registered and doing business in Hong Kong, while restrictions on eligible investments were eliminated.

Then in October 2013, it established new RQFII quotas outside of Hong Kong, CNY80 billion in London and CNY50 billion in Singapore. As of 30 May 2014, 66 companies have been approved for investments totaling CNY238.2 billion.

2) Outbound securities investment: Qualified Domestic Institutional Investors (QDII)

The prohibition against outbound securities investment by China's domestic financial institutions was lifted in April 2006 with implementation of the Qualified

Domestic Institutional Investors (QDII) program. Under QDII, each financial institution must first obtain a license from regulators and then be granted an actual investment quota from the State Administration of Foreign Exchange (SAFE), after which it can make outbound security investments within that quota.

As of 30 May 2014 , 120 companies have been approved for investments totaling US CNY76.793 billion.

2. Differences between the current and new systems

At a regularly scheduled press conference on 11 April 2014, the CRSC explained how Shanghai-Hong Kong Stock Connect differs from the existing cross-border securities investment programs in five respects (Figure 2).[7] Initially, the two systems are expected to complement each other as they operate in parallel.

Figure 2: Differences between Shanghai-Hong Kong Stock Connect and existing programs

Item	Shanghai-Hong Kong Stock Connect	QFII, QDII, RQFII
Brokers	• SSE and HKSE	• Asset management companies
	• The two exchanges reciprocally connect their markets to open an investment route to orders and allow investments to transcend markets	• Structure and sell financial products to investors, using the proceeds to invest
Investment route	• Two-way	• One-way
	• Mainland investors invest in Hong Kong stocks in the Hong Kong market (*ganggutong*)	• QFII and RQFII are one-way investments into mainland China from outside the mainland
	• Hong Kong investors invest in Shanghai stocks on the SSE (*hugutong*)	• QDII is a one-way investment from mainland China to outside the mainland
Transaction currency	• Yuan is the only currency used for transactions	• Under QFII, investments were made in US dollars and other foreign currencies
Fund management	• Managed in a closed loop	• Under QFII, proceeds from selling securities can be left in the invested market
	• Any proceeds from selling securities must always be returned through the same route, and cannot be left in the market where they were invested	
Investor discretion	• By establishing an investment route to the other market for both mainland and Hong Kong investors, those investors can freely select from among stocks eligible for the test and invest in them directly.	• Under QFII, the asset management companies request the investment quota, set investment policy, and disclose information, and investors invest indirectly in the other market, without any way to freely choose from among eligible investments.

Note: From the regularly scheduled press conference held on 11 April 2014.
Source: Nomura Institute of Capital Markets Research, based on materials from the China Securities Regulatory Commission.

1) Brokers

Under the new system, the brokerage of transactions with investors will be handled by the SSE and HKSE (and their affiliated order execution providers).

Under existing programs, institutional investors (asset management companies) structure and sell financial products to investors and use the proceeds to make investments.

7 http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwfbh/201404/t20140411_246800.html (in Chinese)

2) Investment route

Under the new program, the investment route is designed to operate in both directions.

Under the existing programs, there are two one-way investment routes, inbound securities investment into mainland China under QFII and RQFII and outbound securities investment from mainland China under QDII. SAFE did propose its "through-train" program in 2007 as a way to allow mainland Chinese individual investors to invest directly in Hong Kong stocks (the relevant rules expired at end-2009 without the program ever being implemented), but this was also designed as a one-way route.

3) Transaction currency

Under the new program, trades are denominated in yuan.

Under the existing programs, with QFII, funds denominated in US dollars and other foreign currencies are initially sent to mainland China, where they are converted into yuan and used to purchase securities.

4) Fund management

Under the new program, any proceeds from selling securities must always be returned through the same route, and cannot be left in the market where they were initially invested.

This contrasts with the existing programs (QFII and RQFII), where the proceeds from selling securities can be left in mainland Chinese markets.

5) Investor discretion

Although eligible investments will be restricted in the initial stages of testing the new program, the direct purchase of individual stocks will be allowed.

Under the existing programs, however, it is an asset management company, i.e., institutional investor, that must make the investment, and the end investor cannot invest directly in individual stocks.

IV. Keys to future development

1. Preparations and the potential for international development

At the above-noted press conference held on 11 April 2014, the CRSC outlined three areas requiring work to prepare for Shanghai-Hong Kong Stock Connect and explained that this preparation would take six months.

First, it needs to further refine the program's design, optimize the workflow, and publish the operational rules and related measures, all in parallel with working on the technical issues.

Second, it must have a discussion with the SFC on problems with regulatory oversight and the implementation of cross-border laws and further flesh out the current memorandum of understanding on regulatory oversight cooperation. At the same time, adjustments must be made to enable the signing of a memorandum of understanding on cooperation between the two stock exchanges.

Third, it must write detailed regulations, including on trading methods, trading hours, and disclosures, and draw up an emergency backup plan.

Once these preparations are complete, the new program is launched, and a track record is established, it is possible that the same approach can be used by Shanghai to develop relationships with overseas bourses other than Hong Kong's. If it does so, the most likely candidates would be Singapore and London, both of which have offshore markets and have already begun investing in mainland securities under the RQFII program. Other possible candidates for alliances include overseas exchanges where Chinese companies are listed. This makes it necessary to keep a close eye on the preparation process if China starts looking at extending Shanghai-Hong Kong Stock Connect globally.

2. Next move on the Hong Kong side

Although Shanghai-Hong Kong Stock Connect has yet to be launched, HKSE CEO Charles Li has already announced (1) plans to list a larger number of offshore RMB products, including bonds and futures, on the HKSE over the next 3 to 5 years, (2) plans to request a broadening of investments eligible for Shanghai-Hong Kong Stock Connect beyond stocks to include bonds and other products, and (3) the possibility of eliminating the program's investment quotas (from the Securities Times dated 23 May 2014).[8]

There is also an initiative to create a program of reciprocal sales based on mutual fund recognition between mainland China and Hong Kong. This is already included in the No. 10 supplemental memorandum (signed August 2013) of the Mainland/Hong Kong Closer Economic Partnership Arrangement (CEPA). CRSC Chairman Xiao Gang also attended the April 2014 Boao Forum for Asia noted at the start of this

[8] http://epaper.stcn.com/paper/zqsb/html/2014-05/23/content_577997.htm (in Chinese)

report, and spoke on the significance of allowing the sale in mainland China of mutual funds structured in Hong Kong as well as the sale in Hong Kong and other global markets by way of Hong Kong of mutual funds structured in mainland China through a program allowing reciprocal fund sales between mainland China and Hong Kong. This could also be referred to as the "mainland/Hong Kong funds passport concept."

3. Also a good opportunity for brokerage firms

Although Shanghai-Hong Kong Stock Connect is still in the preparatory stages and the mainland/Hong Kong reciprocal fund sales program is still at the conceptual stage, expanding access to investors in the mainland and Hong Kong (and global markets) is a practical and urgent issue for brokerage firms. Outside of their access to investors, the brokers' ability to execute orders and conduct research will also be challenged.

Regards the latter, there have been reports that some leading mainland brokerage firms, including Shenyin Wanguo Securities, Guosen Securities, and Guoxin Securities, have been expanding their research departments and strengthening their coverage (from the Securities Times dated 14 April 2014).[9] As of end-March 2014, 23 brokerage firms, 22 fund management companies, and six futures companies based in the mainland had established a subsidiary in Hong Kong.[10] Deregulation aimed at establishing investment routes outside of QFII, RQFII, and QDII should also create good opportunities for Chinese brokerage firms.

4. Conclusion

The 10 April 2014 joint public notice from the CRSC and the SFC emphasized three ways in which Shanghai-Hong Kong Stock Connect is significant: it will (1) strengthen capital markets in China (including Hong Kong) overall while expanding investment routes for both mainland and Hong Kong investors, (2) reinforce the financial center status of both Shanghai and Hong Kong, and (3) promote internationalization of the yuan. The mainland China side sees this as an opportunity to raise the Shanghai market to global standards while using the Hong Kong market's trading infrastructure.

Although the fact remains that nonresident investors own less than 2% of the shares in mainland Chinese markets through the QFII and RQFII programs, it will be interesting to see how Shanghai-Hong Kong Stock Connect is deployed toward China's goal of achieving a two-way opening up of capital markets, as outlined in the reform program[11] approved at the CCP Central Committee's 18th Third Plenum in November 2013.

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[9] http://epaper.stcn.com/paper/zqsb/html/epaper/index/content_563347.htm (in Chinese)

[10] http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201404/t20140425_247779.html (in Chinese)

[11] See Eiichi Sekine, "*Shoukenshijou kara mita Chuugoku Shinseiken no Dai Juuhachiki San Chuuzenkai*" (A securities market perspective on the new Chinese administration's 18th Third Plenum), Chinese Capital Markets Research, Winter 2014 (in Japanese).