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Practice Group:

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An Overview of the Shanghai-Hong Kong Stock Connect

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Introduction

The Shanghai-Hong Kong Stock Connect (Stock Connect Scheme), a pilot programme for establishing mutual stock market access between Mainland China and Hong Kong, was announced in April 2014 by the China Securities Regulatory Commission and the Securities and Futures Commission of Hong Kong (SFC), and is expected to go live in mid-October 2014. It is highly anticipated, as it will allow individual Hong Kong and foreign investors to invest directly in securities listed on the Shanghai Stock Exchange (Northbound Trading), and domestic investors from Mainland China to invest directly in securities listed in Hong Kong (Southbound Trading). This will be carried out via the exchange and clearing house in their respective local markets, a channel not previously accessible to non-domestic investors.

However, there are some major unresolved issues in the rules and operations of the Stock Connect Scheme that investors intending to utilize it will need to be aware of before they leap in.

Issues to Consider

Trading Limits

Day trading is not allowed on the Shanghai Stock Exchange (SSE). Under the Stock Connect Scheme, Hong Kong and foreign investors would be subject to the same prohibition. Therefore, Hong Kong and foreign investors buying shares through Northbound Trading may only sell those shares one day after the initial trading day (T), on which the shares were bought, ie T+1.

Furthermore, according to the rules of the SSE, there should be sufficient shares in the account before an investor sells any shares, otherwise the sell order will be rejected. Therefore, Hong Kong and foreign investors must ensure that they have sufficient shares in their accounts one day prior to the trading day (ie T-1) in order to sell their shares on the trading day when placing sell orders. This may create counterparty risk issues, especially for long investors that have multiple custodians, as they must transfer stock from custodians to brokers overnight at the end of T-1 in order to have it available for sale on T.

The latest update circular by The Stock Exchange of Hong Kong Limited (HKEx) on 26 September 2014, allows for the possibility of stock borrowing and lending under certain circumstances; however, the exact details have not been clarified. Additionally, requiring the transfer of stocks to a clearing account before trading may, in the case of a large sale transaction, potentially facilitate insider dealing, as third parties who are part of this transfer process would be privy to information they would previously not have had access to, or have had time to benefit from. The only way for institutions to deal with these new issues is to increase monitoring for such activities and to upgrade internal control and compliance systems, which inevitably leads to increased costs.

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Limited Access

In the initial stages of the Stock Connect Scheme, Hong Kong and foreign investors may only access certain A shares listed on the SSE. These include all of the constituent stocks of the SSE 180 Index and the SSE 380 Index, and all the SSE-listed A shares that are not included as constituent stocks of the relevant indices but which have corresponding H shares listed on the HKEx, except the following:

a) SSE-listed shares which are not traded in Renminbi (RMB); and

b) SSE-listed shares which are included in the 'risk alert board' (shares of companies which are in the process of, or run the risk of delisting).

Hong Kong and foreign investors wanting access to shares listed on other markets in Mainland China, as well as other types of onshore assets such as certain bonds, derivatives, and investment funds, will have to rely on other programs such as QFII and RQFII.

In addition, while stocks must be designated as eligible stocks for the purpose of being traded in the Stock Connect Scheme, stocks may also lose such designation, and if this happens in respect of a stock, it may only be sold but cannot be bought.

Legal Ownership Rights

There is currently uncertainty over the status of legal ownership of shares purchased under the Stock Connect Scheme. For Hong Kong and foreign investors investing in A shares on the SSE, the shares will be held by the Central Clearing and Settlement System (CCASS), the HKEx clearing entity, on behalf of the investors in an account within the SSE's clearing entity, Chinaclear. Mainland China authorities recognize the HKEx affiliate as the owner of those shares, and not the investors that actually put in the buy order.

Although it was stated in the Several Provisions on the Pilot Program of Shanghai-Hong Kong Stock Market Connect (the rules promulgated by the China Securities Regulatory Commission (CSRC) in relation to the Stock Connect Scheme) that Hong Kong and overseas investors will "enjoy the rights and interests in such SSE Shares", there is ambiguity as to the extent of the proprietary rights of the investors on the shares held by CCASS, especially in the context of litigation. It is uncertain whether the Chinese courts would recognize the ownership interest of the Hong Kong investors to allow them standing to take legal action against the Chinese entities in case disputes arise.

Closed Loop Cross Boundary Fund Flow

Under the Stock Connect Scheme, the fund and securities flows are insulated in the closed loop of the two settlement systems; once Hong Kong and foreign investors sell their A shares after Northbound Trading through the Stock Connect Scheme, the resulting funds would flow back to their bank accounts in Hong Kong. Hong Kong and foreign investors would not be able to use the resulting funds to invest in other types of onshore assets in Mainland China.

Settlement

All trades under the Stock Connect Scheme will be settled in RMB, and all conversions of RMB will happen in Hong Kong. Northbound Trading by Hong Kong and foreign investors under the Stock Connect Scheme will be settled in offshore RMB. This makes matters slightly more difficult for investors hoping to access PRC onshore securities with foreign currency, as they must now have access to a ready supply of offshore RMB.

Further, it is still unclear whether investors may purchase shares with margin financing or engage in short-selling.

Quota Limits

Both Northbound Trading and Southbound Trading under the Stock Connect Scheme would be subject to both an aggregate quota that caps the absolute amount of cross-boundary flow of funds, together with a daily quota that limits the maximum daily net purchase value of cross-boundary trades, which will be monitored in real time on a "first come, first served" basis.

Initially, Southbound Trading will be subject to a daily quota of RMB10.5 billion and an aggregate quota of RMB250 billion, while Northbound Trading will be subject to a daily quota of RMB13 billion and an aggregate quota of RMB300 billion.

Once that daily quota is reached, investors cannot buy, but can only sell, for the remainder of the day. The uncertainty as to whether or not all buy orders of an investor, particularly a large fund, can be executed will impact the fund's investment strategy. This may deter certain investment managers from participating, such as index managers that may find it difficult to track an index with such limitations. In contrast, the QFII and RQFII programs have no such limitations, making them a much more attractive option for fund managers.

Individual mainland Chinese investors will need at least RMB500,000 in their brokerage account to buy Hong Kong shares, which is a threshold that excludes most retail investors.

Tax Issues

Under existing tax laws in Mainland China, a 10% tax is normally levied on unrealized and realized capital gains. Historically, however, China has not enforced this tax against investments under the QFII or RQFII programs, although most participants in these programs make withholding tax provisions for this. It is unclear whether the same would apply to Hong Kong and foreign investors conducting Northbound Trading on the Stock Connect Scheme.

In the latest technical briefing by the HKEx regarding the Stock Connect Scheme, capital gains tax on share disposal has yet to be confirmed with the State Administration of Taxation in China. There has been no definitive statement released from the relevant Chinese tax authorities in relation to this issue.

Reduced Investor Protection

Hong Kong's Investor Compensation Fund compensates investors of any nationality for any pecuniary losses arising from the default of a licensed entity or authorized institution in relation to Exchange-traded products in Hong Kong, such as fraud or insolvency. Since Southbound Trading is conducted by Mainland securities brokers that are neither licensed nor regulated with the SFC and Northbound Trading relates to securities which are not listed on HKEx or Hong Kong's futures market, they will not be covered by the Investor Compensation Fund.

Similarly, the China Securities Investor Protection Fund (CSIPF, 中國投資者保護基金) only extends to the indemnification of investors with respect of losses arising, "in case a securities company in Mainland China is subjected to compulsory regulatory measures including dissolution, closure, bankruptcy and administrative takeover by CSRC and custodian operation" or "other functions approved by the State Council". As Hong Kong investors participating in Northbound Trading trade through their securities brokers in Hong Kong that are not Mainland brokers, they will not be entitled to any claim under the CSIPF.

Conclusion

These issues present significant limitations and uncertainties for Hong Kong and foreign investors intending to take advantage of this groundbreaking scheme. Some question the relevance of the Stock Connect Scheme in the light of the existing RQFII and QFII programs. The Stock Connect Scheme is a positive step forward in the gradual relaxation of restrictions on the RMB generally, as well as the PRC onshore securities market specifically. This may in the long term, cause a shift in the PRC domestic markets towards a more evenly-proportioned investor base that is not dominated by retail short-term buyers, but rather, is balanced between institutional and retail investors with a focus on company fundamentals instead of short-term punts.

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