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Growing Asia's Markets

Shenzhen-Hong Kong Stock Connect FAQ

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DEVELOPING ASIAN CAPITAL MARKETS

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TABLE OF CONTENTS

Background: *China maintains a "closed" capital account, which means investors can move money into and out of China only subject to strict rules. Over the past 15 years or so Chinese authorities have been gradually opening its capital markets, via tightly controlled programs, to allow some foreign participation in China's capital markets. In November 2014 China inaugurated Shanghai-Hong Kong Stock Connect, opening a portal to China's largest stock exchange to foreign investors. The launch of Shenzhen-Hong Kong Stock Connect on 5 December 2016 opens the same sort of channel to China's second stock exchange, home to listings of mostly smaller-cap, faster growing Chinese companies.*

1. What is the point of Stock Connect? Do other countries use similar schemes to enable offshore investors to invest in their stock markets? [Back to Top]

Stock Connect is indeed unusual, perhaps unique.[i] The typical route for investors in one country to buy stocks in another country is via a relationship between the broker in the originating country and a correspondent broker in the target country. Stock Connect, by contrast, is a direct link *between exchanges.* The original link, launched in November 2014, enabled brokers who are members of the Stock Exchange of Hong Kong (HKEX) to execute orders for customers through a link to the Shanghai Stock Exchange (SSE) itself, rather than to brokers who are members of the SSE in China. The HKEX has an omnibus account at the SSE (or to be precise, with its clearing entity Chinaclear) containing all the shares of the HKEX members who participate in the link. The link is symmetrical, allowing investors in China to trade HKEX stocks via Chinese brokers who are members of the SSE.

The key to understanding the link is to recall that China's capital account is still restricted. China doesn't allow foreign investors to move money into the country and open accounts at financial institutions except for specific, approved purposes. The Connect link enables the Chinese authorities to allow money to flow into (and out of) Chinese shares in a way they can control because it all flows through this single conduit. Crucially, when an investor who bought shares via Connect sells them, the RMB proceeds are delivered in Hong Kong. Investors wishing to buy Chinese shares have to purchase RMB in Hong Kong (technically they purchase offshore RMB, or "CNH"), not on the mainland, or have their broker arrange to purchase the RMB for dollars or other currency for them. Thus Connect forms a "closed loop", segregating RMB used to buy Chinese shares from the rest of the Chinese economy.

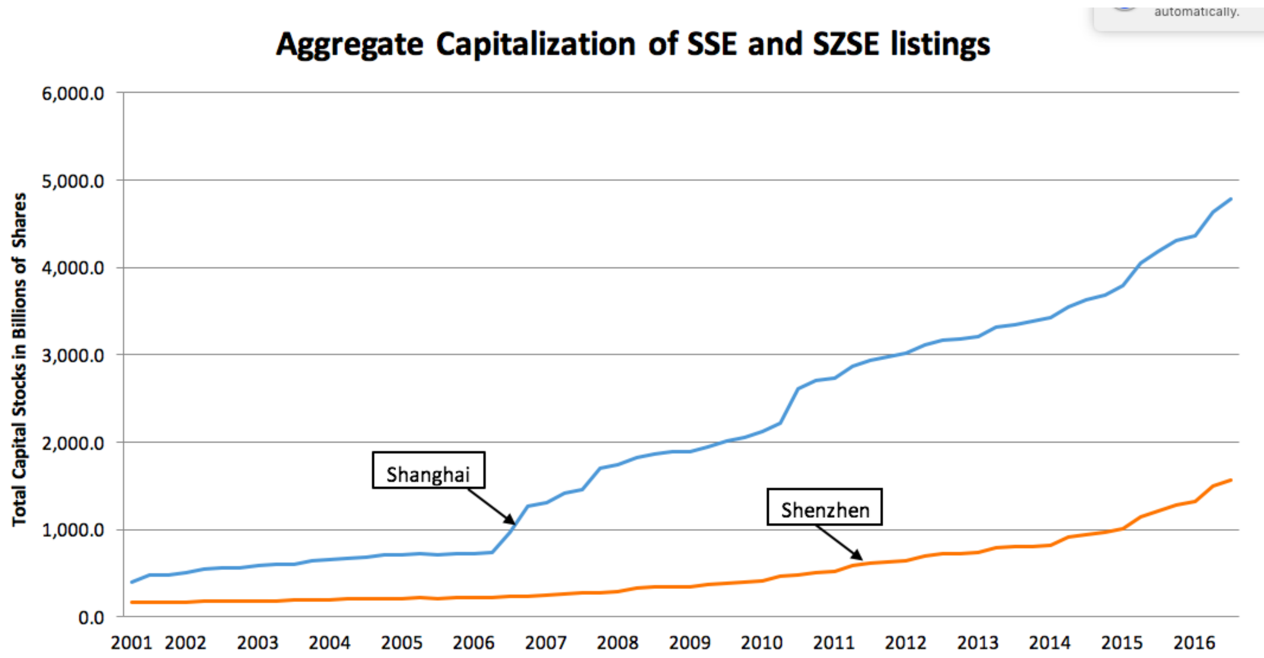
2. Haven't there been other ways to invest in China for some time? [Back to Top]

Yes. Foreign investors have been able to invest in Chinese securities through the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs. These programs allow only approved, well established institutional investors that meet a high threshold of size, experience, and other eligibility criteria set by the China Securities Regulatory Commission (CSRC) to participate. Once approved, they may invest in Chinese assets subject to specific quotas and lock-up periods and other restrictions on how much of the investment a QFII or RQFII institution may repatriate in a given month. The requirements for QFIIs have been steadily liberalized over the years but it's still restricted to institutional investors. By contrast, any investor in the world—institutional or retail—may access Chinese A-shares via Stock Connect so long as his broker has a correspondent relationship (or establishes one) with an HKEX member firm approved for Stock Connect. And there are no lock-ups or repatriation restrictions for Stock Connect.

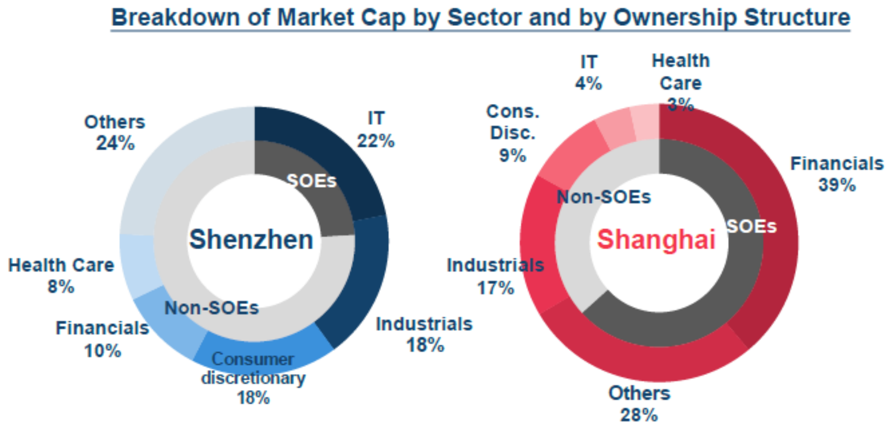
The R/QFII programs do have advantages. The main advantage is product breadth—investors can get access not just to stocks but to also fixed income products, warrants, ETFs, futures, and other approved products. As of early November 2016, there were 273 QFIIs and 171 RQFIIs with total quotas of RMB 548.8 billion and RMB 371.4 billion, respectively.

3. How does Shenzhen Connect Change things? [Back to Top]

Shenzhen Connect opens the door for foreign investors to most of the stocks listed on the Shenzhen Stock Exchange (SZSE) in exactly the same way as Shanghai Connect did for the SSE stocks. This Shenzhen leg to Stock Connect is significant, though, for investors interested in equity exposure to China, because Shenzhen makes available many new, mostly small and mid-cap "growth stocks" in fast-growing sectors such as IT, science, healthcare and technology. At the SSE, by contrast, more large (and hence large-cap), state-owned enterprises (SOEs) predominate.

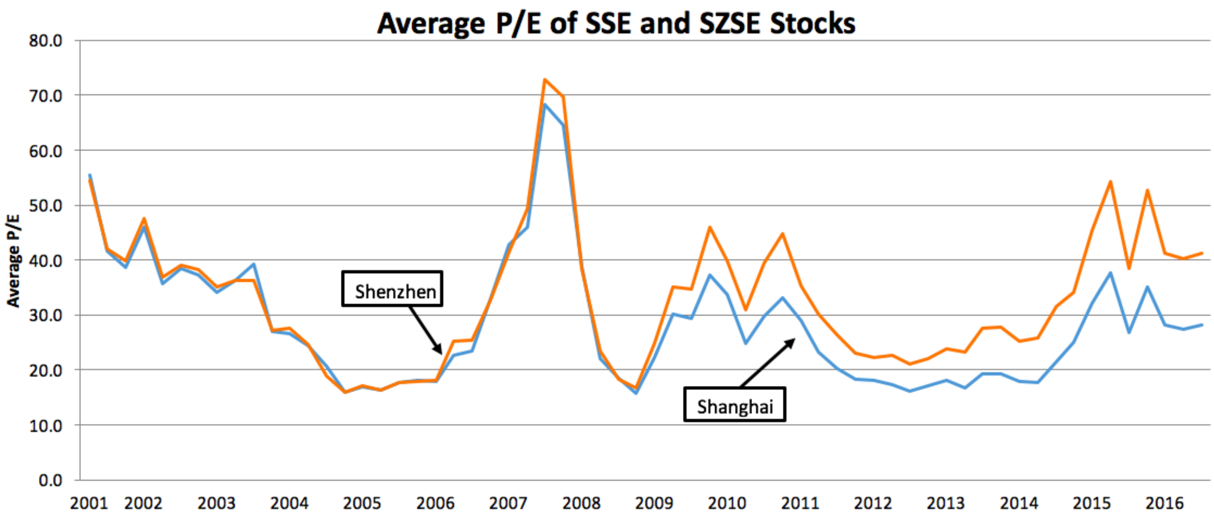


Source: Shanghai and Shenzhen Stock Exchanges



Source: HKEX

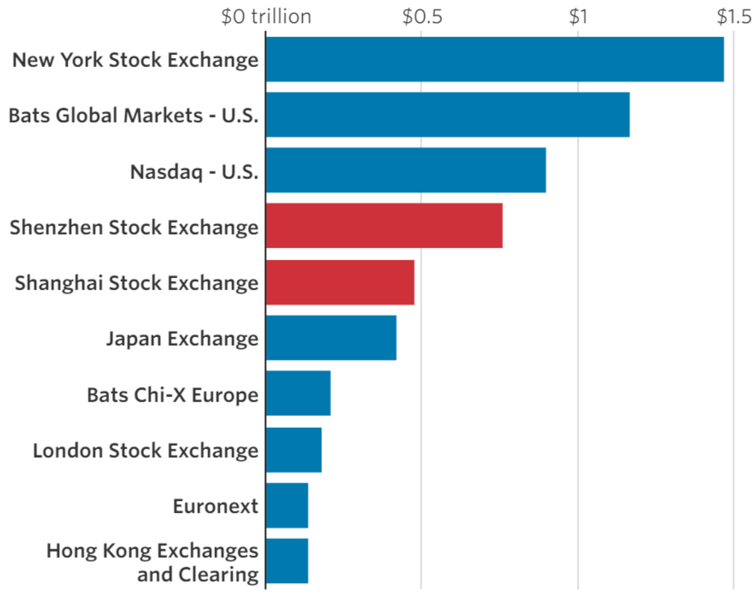
Not surprisingly, the faster growing Shenzhen companies have generated impressive returns. Over the past 10 years they returned an average of 25% a year, more than doubling in value every three years, compared to 12% a year for Shanghai stocks.[ii] Of course, the familiar disclaimer that the past isn't a reliable guide to future performance is true. Blistering growth rates end eventually. The valuations of Shenzhen stocks are also high—trailing price earnings ratios (P/Es) averaged 43 for Shenzhen stocks in early November vs. just under 16 for Shanghai. P/Es alone tell one little about a stock's prospects; a fast-growing company could have a very high P/E because cash flow is being ploughed into expansion for the sake of higher earnings in the future. Or it could reflect over-optimism on the part of investors. Nevertheless, Shenzhen-listed companies are regarded as more likely to keep growing at faster than their Shanghai counterparts, whatever the performance of their stocks.



Source: Shanghai and Shenzhen Stock Exchanges

The Shenzhen exchange is also one of the world's most active. Though it's the eight largest in the world measured by total capitalization of its listed firms, it typically ranks fourth or fifth in terms of turnover value.

Stock Exchanges ranked by value of turnover (USD trillions, July 2016)



Source: World Federation of Exchanges, via Wall Street Journal

The greatest benefit to investors from access to Shenzhen stocks is that portfolio managers can build more diversified Chinese portfolios. Diversification is one of the few free lunches in investing—a more diversified portfolio generally has less risk for the same expected return. Portfolio managers for index and other large diversified funds can deploy Shanghai and Shenzhen stocks to create portfolios that more faithfully reflect the entire Chinese economy.

4. What Shenzhen stocks will be on Connect? [Back to Top]

Not all Shenzhen stocks are part of Connect. Eligible Shenzhen stocks are those stocks in the SZSE Component Index and SZSE Small/Mid-Cap Innovation Index with a capitalization of at least RMB 6 billion as well as A-shares that have H-share counterparts trading in Hong Kong on the HKEX. The SZSE has three "boards", or classes of listings: the Main Board, of which 467 stocks are eligible, the SME board, 791, and ChiNext, 512, in order of decreasing average capitalization—and increasing risk.

5. Why are ChiNext stocks restricted? [Back to Top]

Because of the speculative nature of the small-cap ChiNext stocks, access to these will be restricted in the initial phase of Stock Connect to Institutional Professional Investors (IPIs). The purpose of the restriction is to protect retail Hong Kong and other investors from plunging into these lightly traded small-cap issues without understanding the risks that come with volatility and lower liquidity. The ChiNext restriction will be in place during Phase 1 of Shenzhen Connect but is not expected to be permanent. Given some education and appropriate risk disclosures, it's quite likely the restriction will be lifted in the not-too-distant future.

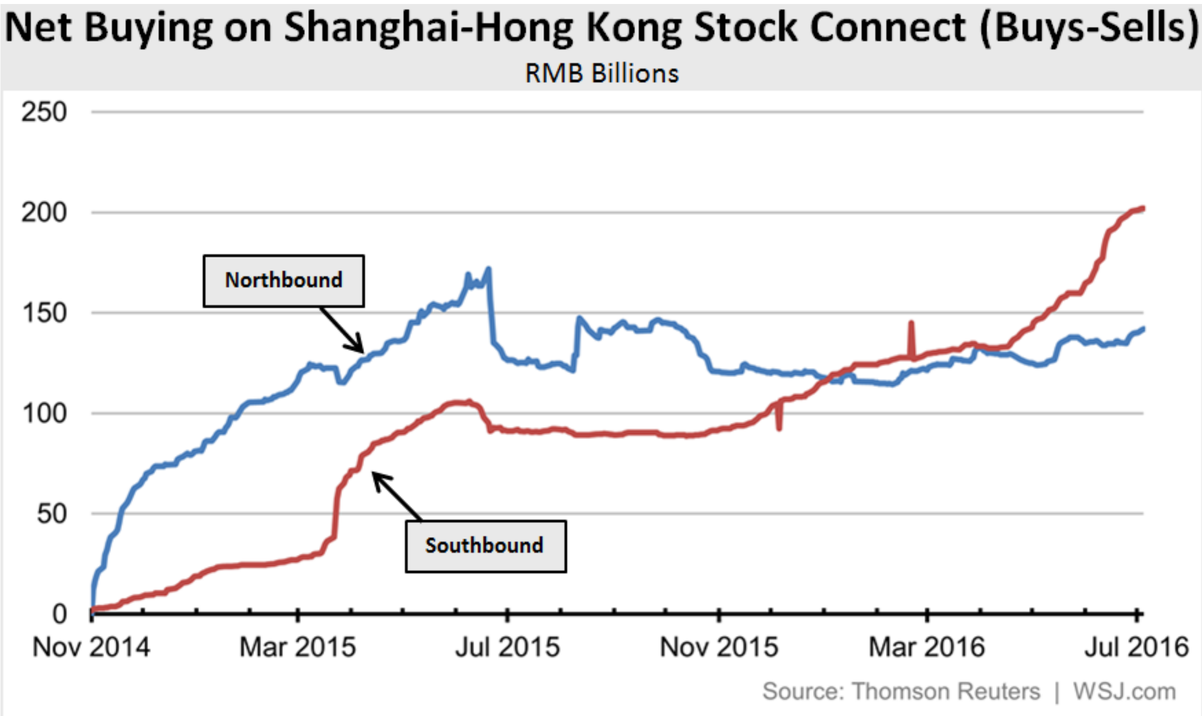
6. What about the quotas? How are they changing and why? [Back to Top]

When Hong Kong-Shanghai Stock Connect was launched, an aggregate quota of RMB 300 billion for Northbound and RMB 250 billion for Southbound trades put an upper limit on total investment allowed through Connect in either direction. (This "aggregate" is calculated as the value of net aggregate turnover, or value of total buys minus total sells.) The reason is that, like so many Chinese initiatives over the years, the program was intended to be a "pilot". That is, its size was limited initially so that the authorities and market participants could evaluate it. After two years of problem-free operation, the aggregate quotas in both directions were abolished in August 2016, when the Shenzhen Connect Link was announced.

For similar reasons there has also been a daily quota of RMB 13 billion for Shanghai Connect trading Northbound into Shanghai listed stocks and RMB 10.5 billion for Southbound Chinese investors. These quotas remain in effect. The Shenzhen leg will get its own RMB 13 billion quota, however, so that the total daily quota for the Stock Connect program will be RMB 26 billion upon launch of Shenzhen Connect. The Northbound daily quota has been fully utilized once, on its launch date November 17, 2014; the Southbound twice, both times in April 2015.

7. What are the implications of the daily quotas and the end of the aggregate quota? [Back to Top]

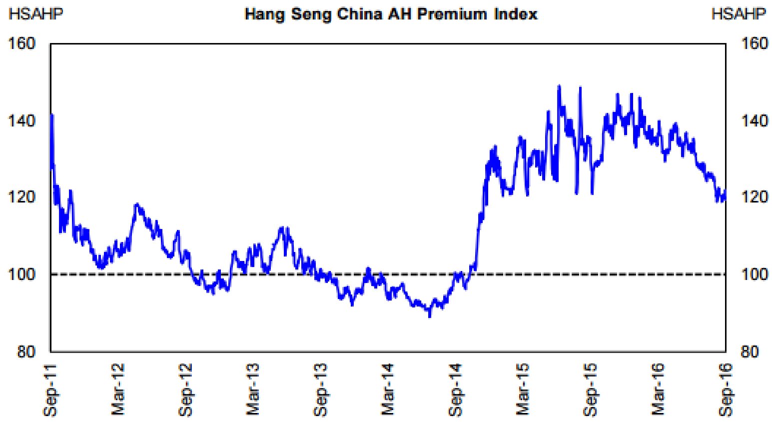
Quotas are problematic especially for institutional investors because a quota could unexpectedly prevent the execution of a buy order—and throw the portfolio out of alignment relative to its investment mandate. Straying from an investment mandate whatever the reasons creates "tracking error", the deviation of portfolio performance from its benchmark and a key measure of a fund's performance. In short, quotas are an implicit cost, and elimination of the aggregate quota gets rid of part of it. Though the Northbound daily quota was hit only once, on the day it was launched, if and when A-shares get approved for index inclusion for MSCI Emerging Markets, Northbound investment could increase substantially, along with the risk of hitting the limit. Hence they remain a concern to institutional investors.



8. Southbound buying has been on an uptrend since November of 2015. Is there a reason for that? [Back to Top]

Two reasons probably explain it. In November of 2015 the RMB was devalued 3% relative to the U.S. Dollar and it has since continued on a gradually weakening path. This created an appetite for Hong Kong Dollar assets, which are tightly linked to the appreciating U.S. currency.

Another likely motivation for Chinese investors is the "A-H anomaly". Some Chinese companies with A-shares trading on a mainland exchange also have "H" shares trading on HKEX. H-shares are equivalent in terms of ownership rights and rights to dividends as A-shares, but many of these H-shares are considerably cheaper than their A-share counterparts. Some value-minded Chinese investors have doubtless been taking advantage of this price disparity and buying H-shares at significant “discounts”.



Source: Hang Seng Indices

9. Are there any other differences in trading from other global markets? [Back to Top]

There are a few other quirks. China prohibits day-trading, so that applies to Stock Connect. Short selling is permitted in theory, but because of the way the rules are written, it’s been impracticable. A short seller has to borrow a stock in order to sell short. The rules allow only Hong Kong Exchange Participants (EPs) to lend stocks, but EPs typically don’t have inventories of stocks to lend—it’s the asset managers and custodians who do. As a result, there have been no short sales so far by Northbound Stock Connect investors since its launch two years ago. This is unfortunate not just because short selling facilitates various investment strategies but because short selling is an important element in supporting market liquidity, particularly when markets are stressed. ASIFMA and industry are hoping the Chinese authorities will amend the rules to allow affiliates of EPs such as asset managers and custodians to engage in stock borrowing and lending, and make short selling feasible.

10. What does the Shenzhen launch mean for A-share inclusion in benchmark indices such as MSCI and FTSE? [Back to Top]

Accessibility is a major criterion for the index managers and Shenzhen Connect makes a lot of new Chinese shares more accessible. The lock-ups and repatriation restrictions of QFIIs and RQFIIs are absent from Stock Connect. In short, the addition of Shenzhen Connect to the program adds weight on the positive side of the scale but is not decisive. The index managers have said that their key criteria are accessibility, implementation of the more liberalized capital mobility rules, reduction in stock suspensions, and resolution of the pre-approval requirements by Chinese exchanges on launching financial products based on indexes that include A-shares. An additional consideration is steadiness in the application of new and existing rules, with less of the sort of ad hoc changes that kept investors guessing during the turmoil in Chinese equity markets during the summer and fall of 2015.

11. What are the legal, regulatory, and operational implications of Connect? [Back to Top]

The basic principle is that home country rules apply. Hong Kong brokers and investors offering A-share products are subject to the Securities and Futures Ordinance and SFC regulations. In practice it's more nuanced and regulators on both sides of the border need to cooperate. Early on, foreign investors were concerned that their legal claims to Chinese A-shares were ambiguous because in China the shares are held in an HKEX omnibus account, lacking specific customer information. However, CSRC has issued FAQs that have largely addressed this concern. Hence, in its June 2016 conclusion of its review of possible A-share inclusion in the MSCI EM index, index manager MSCI noted the improvement in "issues regarding beneficial ownership".

Operational issues are a bit complex. The key challenge is that in China, stock is settled on the trade date, T+0, but the payment settles the following day, T+1. This contrasts to the method used in most developed markets, "delivery versus payment" (DVP) where stock and cash settle on the same day, usually on T+2. Brokers and custodians and the HKEX have devised ways that largely overcome the disconnection of settlements, though some operational and counterparty risk remains.

The European regulators who oversee the UCITS regime initially had concerns about the above issues but have been largely reassured. Regulators in Luxembourg and Ireland, where most European funds are domiciled, essentially require funds and their custodians to ensure that any investments in Chinese A-shares are consistent with their investment mandates and other regulatory obligation. Since the launch of Stock Connect over 100 UCITS funds have embraced A-shares in their investment mandates.

12. Does this complete the rollout of the Stock Connect Program, or will there be further developments down the road? [Back to Top]

Yes indeed, the HKEX has made clear there's more coming. Next on the runway are ETFs. ETFs traded in Hong Kong could be of particular interest to Southbound investors, who could use global or regional ETFs to globalize their portfolios in one step. In addition to the ETFs already trading in Hong Kong, there may be scope to create new ETFs likely to appeal to Chinese investors. For some Northbound investors Chinese ETFs might be attractive given the limited acceptance of A-shares by index managers outside China to date.

Further down the road Stock Connect could embrace exchange-traded derivatives (ETD), such as the CSI 300 contract traded at the China Financial Futures Exchange, and the Hang Seng Stock Index futures in Hong Kong. The availability of CSI futures will open numerous possibilities for improved portfolio and risk management for offshore China investors into China. HKEX also trades currency futures and has the world's most active market in warrants and structured products such as callable bull/bear contracts (CBBCs), all of which could become part of the Connect program eventually. In short, there's still plenty of room for growth in the Stock Connect program, even without looking beyond Hong Kong.

13. What about new Connects with financial centers other than Hong Kong? [Back to Top]

The Chinese authorities have held discussions with counterparts in London to explore the possibility of a London Connect. At first blush a London Connect might seem to add relatively little value to the Northbound value proposition since Shanghai and Shenzhen Connect already take offshore investors to China's equity markets. It's too soon to say, but if creatively structured a second channel to China's equity markets such as London Connect could offer added value to investors, such as lower cost or greater convenience and efficiency. For Chinese investors, on the other hand, a London Connect would likely be quite attractive because it would potentially open a rich menu of European and global equity products not available in Hong Kong.

14. How does Stock Connect affect capital outflows? [Back to Top]

As described in the first question, Stock Connect is a closed loop in both directions. Southbound Chinese investors who sell their Hong Kong holdings get their proceeds returned to them in China. For these reasons, Stock Connect limits capital outflows since investments can go only into Hong Kong stocks and nothing else. In addition, China restricts Southbound participation to investors who have no less than RMB 500,000 in their stock and cash accounts, limiting the participant universe.

In theory, there is no upper limit on Southbound flows now that the aggregate quotas are gone. In practice, Stock Connect is likely seen by authorities as an acceptably constrained outbound channel within a controlled capital account because it targets just a single asset class at a single exchange (and a Chinese exchange at that). Should market conditions nevertheless at some point in the future prompt concerns among Chinese authorities that outflows are excessive, the single-channel structure of Connect makes it easier to reimpose limits.

15. What's the future of Connect when China's capital account becomes open? [Back to Top]

As explained in the first question, Stock Connect is designed to keep foreign stock investments walled off from the rest of China. Northbound investors' proceeds come back to Hong Kong (or elsewhere depending on the location of the client) when a stock is sold. Chinese authorities have announced intentions to eliminate capital controls as early as 2020. When that happens, investors will be able to buy

RMB and invest in any Chinese assets more or less without restriction (or subject to the same restrictions as a domestic investor). Would there still be a role for Stock Connect then?

In theory, no. Given how cross-border investing works in the rest of the world, one might expect Connect to be replaced by the global model. But by then Stock Connect will be familiar to China-bound investors and it may be efficient and low cost as well. If HKEX continues to meet the demands of the market, Stock Connect could survive, uniquely quirky but working. But if the conventional model turns out to be cheaper and more efficient, Stock Connect would eventually retire into history.

[i] There are some similarities to the MILA (Mercado Integrado Latinoamerica) program integrating the stock exchanges of Chile, Columbia, Mexico, and Peru.
[ii] "China's two stock connects are a study in contrast", Kelvin Soh, UBS Market News, 22 August 2016.