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China A Shares Future Outlook:

Dual Tracks Go Hand-in-Hand

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asifma
Growing Asia's Markets

QFI and Stock Connect Future State

I. Executive Summary

Since the publication of the last Asia Securities Industry & Financial Markets Association ("**ASIFMA**") China Capital Markets White Paper, The Pace of Change Accelerates (June 2019), the rate of market reforms has indeed accelerated. This is true, in spite of the recent deepening geopolitical tensions and undeterred too by the global headwinds of Covid-19. Ownership caps for foreign financial institutions setting up onshore operations were initially increased to majority stake and then eliminated altogether, along with license scope expansions. China's Securities Law has been updated, and a new China Futures Law is currently being reviewed through a public consultation, which provisions for settlement finality and closeout netting protections much welcomed by the Industry.

New QFI regulations promulgated at the end of 2020 now permit QFI investors to engage in securities lending and to participate more actively in listed financial derivatives onshore for hedging purposes. The expanded scope allows market participants to better manage their risks and will help the market improve liquidity and price discovery. Secondary market investment flows had heavily skewed towards the Stock Connect channel in 2018-19 following MSCI inclusion of A shares, but the above-mentioned reforms and the initial exclusive access for QFI investors to the STAR Board and ChiNext has reinvigorated investor interest towards the QFI channel. These are still at an early stage and the industry continues to work with exchanges and regulators to further enhance the framework, including relaxing hedging quotas, refining the operational process around SBL, and securing greater tax clarity. QFI inflows had been initially dominated more by the passive fund managers, but per earlier mention, the QFI reforms are now attracting active fund managers to invest more in China as well.

With 150 members comprising a diverse range of leading financial institutions, including banks, asset managers, index providers, accounting, tax and law firms, trading platforms and market makers, clearing and settlement entities, credit rating agencies, and other market infrastructure service providers, ASIFMA is the leading capital markets trade association in Asia with the broadest representation of stakeholders across all asset classes and markets in Asia. ASIFMA is pleased to share its perspectives and recommendations on the evolution and future state of the QFI and Stock Connect channels towards a more robust ecosystem of diverse participants in a deeper and more mature capital markets. This is in the interest of all investors (domestic and foreign) and for the continued growth of China's economy.

This paper will summarize some key reforms under the QFI and Stock Connect schemes in recent years, along with some suggested refinements proposed by the industry to allow for a more diverse range of products to be developed in an ecosystem where products across the spectrum are priced consistently with each other through efficient arbitrage.

ASIFMA's China Equities Working Group (CEWG) is a subgroup of ASIFMA and is comprised of representatives from the buyside and sell side, front and back office including compliance officers, as well as with law firms and index providers such as FTSE Russell and MSCI. The CEWG meets on a biweekly basis to discuss market structure opportunities and challenges in China's equities market. Some key industry recommendations prioritized by CEWG which are described in further detail in subsequent sections have been summarized below:

QFI Issues

1. **Delivery Versus Payment ("DVP"):** Allow DVP settlement (delivery of securities happens when and only when payment is received, and payment happens when and only when the securities is delivered) for both stock and cash to better ensure asset safety for investors and remove the pre-funding requirement; migrate to a T+1 or T+2 settlement cycle to better align with international practice; In the meantime, given the current tight T+0 settlement timeframe, it would be helpful to implement a workable stock borrowing and lending ("**SBL**") regime, which can help to facilitate stock borrow for 'fail cover' settlement purposes.

2. **Multi-broker Model, DMA, and Program Trading:** Relax current single broker restriction for investors and provide optionality to switch across multiple brokers in line with global best execution regulatory obligations. Allow brokers to provide Direct Market Access ("**DMA**") to clients and remove the drafted prerequisite that a broker must be rated grade A or higher for the past two out of three years which would be unfair for foreign brokers. Engage Industry to formulate clear rules for program trading.

3. **QFI Participation in SBL Impaired by the Long Sale Uptick Rule:** Exchange rules require that even long sales are subject to the uptick rule up to the quantity of the borrowed shares, which is unique to China's capital markets. QFI's may employ different trading strategies amongst different independent trading desks within the same entity and engaging in SBL by one trading desk may impair the ability of the other trading desks within the same QFI to trade as the long sale uptick requirement is imposed across all accounts under the same QFI's control. Request that this rule be amended to facilitate more active QFI participation in SBL. For example, to introduce the concept of

aggregation units similar to the practice in Hong Kong and Korea, so that uptick is only applied to the aggregation unit, which is actually short selling the shares.

Stock Connect Issues

4. **Expansion of Product Scope:** Current security eligibility for Northbound Connect is restricted to constituent stocks in major indices, A shares with corresponding H shares, and/or market capitalization thresholds. Foreign investors would benefit from broadening the range of Main Board, STAR and ChiNext securities allowed within the existing Connect program to include all ordinary A shares. Additionally, the Connect model should be enhanced to bring IPO issuances into scope.

5. **Holiday Trading:** Foreign investors cannot trade through Stock Connect if the China market is open, but the HK market is closed during an HK holiday as well as for the day prior. Request that the Shanghai Stock Exchange ("**SSE**"), the Shenzhen Stock Exchange ("**SZSE**"), and the Hong Kong Stock Exchange ("**HKEX**") work with the Industry to develop solutions to address this issue and market risks.

6. **Expansion of Block Trading:** Request that Stock Connect participants also be provided a mechanism to conduct block trading, a facility which is currently available only for QFI investors and only during a 30-minute window between 3pm and 3:30pm. For QFI investors, request that the block trading window be extended for matching throughout the entire trading day (similar to the block window for STAR Board names, where blocks can be reported to the exchange from 09:30 – 11:30 and 13:00 – 15:30, and matching is instant).

7. **Activate Dormant SBL Framework by Expanding Definition of Exchange Participant (EP):** Stock Connect rules allow for SBL between EPs of the Exchange. However, actual market participants are affiliates of EP's or Agent Lenders and not the EPs themselves. Request that the EP definition be expanded (to include EP affiliates and Agent Lenders) to permit securities lending between Stock Connect participants as originally intended during the initial launch.

Common Issues Across Both QFI and Stock Connect Channels

8. **Expand Listed Derivatives Access to Facilitate Better Hedging:** Increase flexibility on hedging quota calculations and diversify derivative product suite (current products limited to CSI300/500 and SSE50 index futures, one index option on CSI300 and three ETF options on CSI300 and SSE50 ETFs) to further expand the portfolio of available

hedging instruments onshore. Provide offshore investors without a QFI license, including those under the Stock Connect scheme, access to PRC onshore derivative products. Broaden offshore hedging instruments including HKEX futures products on the MSCI China-A Index. Efficient hedging capabilities critical to attract more global investment.

9. **Equity OTC Derivatives as an Important Market Access Product:** We would welcome CSRC's support for QFI license holders to launch more OTC equity derivatives products, which will support the expansion of global investor activity in the onshore market. ASIFMA appreciates if the CSRC could reconsider relaxing the hedging requirement for the trading of stock index futures to permit QFIs to hedge and expand their provision of OTC derivative products accordingly.

II. Regulatory Framework and Industry Engagement: Principles Based vs Rules Based

We would encourage China to consider gradual adoption of a principles-based regulatory regime which focuses around best practices which balance market efficiency while maintaining robust investor protection. Such an approach has been adopted by other major capital markets such as in Australia, Hong Kong, and Singapore.

A principles-based approach will protect markets while allowing the control mechanisms to continue to develop and benefit from innovation.

This approach should be considerate of risks, but the primary objective should be to encourage the participation in, and growth of, the financial market, thereby improving accessibility and liquidity.

Within the framework, regulators can decide upon the definitions of market issues, including but not limited to, the following:

- Disruptive Trading
- Wash Trades / Self-Match Prevention
- Excessive messaging
- Robust incident-handling policy and procedures
- Effective and Independent Control Functions
- Regular reviews
- Effective business continuity arrangements

In addition, by publicly consulting on proposed rules and regulations, market participants will be well-placed to identify issues and items of potential concern to China's regulators and Exchanges. In order to provide sufficient time for market participants to digest new regulations and to provide considered feedback, it would be helpful for regulators and exchanges to provide more time for such responses, briefings, and forums for meaningful dialogue – in other major capital markets, regulatory consultation periods last for a minimum of 60-90 days. Finally, timely publication of the consultation documents including responses would improve transparency, build confidence in the consultation process, and align with approaches adopted in other major capital markets.

With the regulators having established a (high-level) framework to achieve the objectives of a well-functioning, orderly, liquid, and transparent market, the Exchanges role can then be that of gatekeeper and overseer of market practices. Exchanges are uniquely positioned to apply controls uniformly to all participants trading in their market given their functional proximity to market information. Effective implementation of the regulatory framework should take into consideration market circumstances, participant behavior and market efficiency through the resulting liquidity for end-clients.

In our view as market participants, the following prescriptive set of limitations may be impeding the efficiency of China's equities market. Hence, we would propose replacing these limits with a more principles-based approach as follows:

- **Futures and Options Restrictions (Hedging and Arbitrage Trading Quotas and Intraday Position Limits):** Currently, the quotas and position limits imposed on QFI investors are too restrictive and prevent investors from fully hedging their portfolios, given the volatility in the market. We also note that QFIs are on an unlevel playing field compared to domestic investors, who are able to trade futures and options for purposes other than hedging. Please see the recommendations in the "Expand Listed Derivatives Access to Facilitate Better Hedging and Risk Management" section below.

- **Intraday Trading Restrictions (same day buy & sell restrictions):** It should be removed, to allow liquidity providers to bridge the asynchronous arrival of investor orders, to allow them to facilitate having both buy and sell quotes in the market. When an investor order arrives, a liquidity provider will have both buy quotes and sell quotes in the marketplace. If the liquidity provider buys, they are forced to cancel their sell quote. If the liquidity provider sells, they are forced to cancel their buy quote. These order cancellations reduce liquidity in the overall market. Additionally, some investors may choose to avoid trading if they are unable to manage their positions until the next day. Eliminating intraday trading restrictions could increase liquidity in the market and would also bring China in line with other major capital markets such as Australia, Hong Kong, Singapore, Japan, and Korea.

- **Order Cancellation Limits:**

  Many market participants utilize electronic trading strategies which make use of "passive order placement" (e.g., inputting limit orders). Orders at passive prices do not immediately execute and instead provide liquidity to the market and help to reduce volatility. As modern-day exchanges process messages in sub-seconds, such orders can therefore become stale, and all may not result in execution in the trading session.

  To address this, trading programs dynamically adjust to the market by placing, amending, or cancelling and replacing orders to help attain a better overall average price for investors. It is therefore common to see high levels of cancellations and amendments in other major capital markets such as the US.

  Order cancellation limits should therefore dynamically take into consideration market conditions such as volatility and available liquidity. The inability to amend orders in China results in market participants needing to cancel their orders. Additionally, the inability to amend stale orders and the limiting of cancelations risks market information that is outdated, inaccurate and/or imprecise, potentially harming investors seeking to execute at the best available price.

ASIFMA members also respectfully request Exchanges to notify all participants simultaneously about regulation and systems changes in advance and to provision for sufficient lead time for testing and implementation. The amount of lead time would depend on the degree of complexity associated with the change and risks to the market, which should be determined in consultation with the market. Robust engagement and coordination with the Industry will help better ensure stability of the market's operating environment.

III. Potential of China Stock Market and Diverse Ecosystem

1 Growth of China's Stock Market

China has become the world's second largest stock market with a combined market capitalization of roughly RMB 80 trillion as of the end of 2020. Since 2018, China A-shares have been included in several major international indices, such as MSCI, FTSE Russell, and S&P Dow

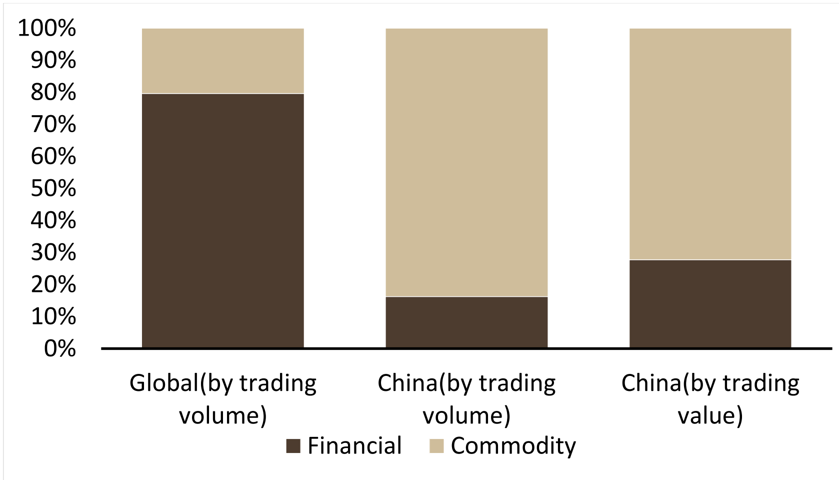
Jones indices. For example, China's weighting in the MSCI Emerging Markets index series has surpassed 40% (5% from China A-shares and the other 35% from Chinese securities listed on other exchanges (e.g., Hong Kong, United States) in terms of free float market cap. In addition, the weighting of the 10 largest constituents in the 1,400-member emerging-market benchmark has increased from below 20% at the end of 2015 to over 30% at the end of 2020, with six of them being Chinese firms. A-shares comprise 5% of the Emerging Markets Index, but their weighting is constrained by the 20% MSCI Inclusion Factor in the index. As demand for A-shares continues to increase among international investors and China continues with market reforms to facilitate easier access for global investors, under a hypothetical 100% A-shares MSCI inclusion factor scenario, China could account for around 50% of the Emerging Markets Index with 20% from China A-shares.

Retail investors still make up about 80% of average daily trading volume ("**ADTV**") in the China stock markets. In America, retail investors account for around 25% of ADTV. However, institutional investors' holdings as a share of China's market capitalization have increased from 30% in 2012 to about 50%, and at this pace, experts believe that institutions' share of daily trading volume could hit 50% within the next five years.[1]

Also, globally, exchange-traded financial derivatives account for the lion's share of trading volumes, but the balance is currently reversed in the Mainland, where commodity derivatives comprise the majority of volumes. (Ref. Figure 1 below)

Figure 1: Globally, exchange-traded financial derivatives take the lion's share, but this is reversed in mainland China

[1] "China's markets are shaking off their casino reputation", *The Economist*, 20 March 2021. https://www.economist.com/finance-and-economics/2021/03/18/chinas-markets-are-shaking-off-their-casino-reputation



Source: UBS Securities

There is still tremendous scope for growth for foreign investors in China's A share market. In the Chinese onshore stock market, foreigners hold about 5% of Chinese shares. In comparison, foreigners own about 25% of American shares. Foreigners also own 30% of American bonds but own just 4.2%[2] of Chinese bonds (of which positions are overwhelmingly concentrated in government bonds).

<u>Figure 2: Chinese Retail Investors' Shareholding Dominance is dwindling</u>

Source: Financial Times

The QFI scheme (which comprises the merged **QFII** scheme and the RMB Qualified Foreign Institutional Investor ("**RQFII**") scheme) and the Stock Connect scheme (which comprises the

[2] As of March-end 2021

Shanghai–Hong Kong Stock Connect and Shenzhen–Hong Kong Stock Connect) are collectively the primary channels for foreign investors to access the onshore Chinese stock markets.

Significant improvements have been made to facilitate capital inflows/outflows over the years. Hong Kong's Stock-Connect program, which allows trading in Chinese stocks since Nov 2014, has fueled a 40x increase in daily cross-border trading volumes in China. Repatriating profits through the QFI scheme used to take up to six months. Now it takes a few days.

2 Evolution Towards Sound Ecosystem with Diverse Market Participants

Yi Huiman, the Chairman of the CSRC, announced at the China Development Forum 2021 on March 20th that the Peoples' Republic of China ("**PRC**") regulators are committed to creating a sound ecosystem and maintaining an open and fair market environment to attract more investors. A healthy ecosystem should provision that a wide range of participants are able to buy and sell securities with confidence that the securities are priced consistently and fairly. This is important to professional investors, but even more so for individual investors that may lack comprehensive market access and ability to determine fair valuation of financial instruments.

For example, a case where a basket of stocks forms an index, there may be listed futures, options, exchange traded funds ("**ETFs**"), and warrants on this index. Additionally, the underlying stocks in the index may each have their own futures, options, and warrants. Each of these instruments has defined pricing relationships with each other. Arbitrage opportunities arise when these market prices do not closely follow these relationships.

Theoretically, these arbitrage opportunities should quickly disappear as traders aim to profit from buying the undervalued instrument and selling the overvalued one. The more effective these traders are, the more consistently and fairly priced the ecosystem of instruments are, and therefore the more confident investors can be regarding the prices of these assets.

In reality, it is observed that the financial markets are not always priced consistently. Generally, the more restrictions traders face in performing these types of trades, the larger the pricing inconsistencies can be between related products. With this inconsistency, there can be room for increased market risk. Shifting away from prescriptive limits and quotas towards more principles-based regulation as mentioned in the earlier Regulatory Framework section would help to improve market and pricing efficiencies.

IV. Overview of Key Reforms to QFI and Stock Connect Schemes

ASIFMA's Asset Management Group published a paper in January 2021 describing the access channels for foreign investors which may serve as a useful reference (Foreign Institutional Investment in China: Various Access Channels). We highlight some key recent reforms per below:

1 QFI Scheme

The QFII scheme was first introduced in 2002 and was followed by the launch of its sibling scheme, the RQFII scheme, in 2011. The QFII and RQFII schemes went through a number of substantial developments and liberalization in recent years and were officially merged on 1 November 2020 as the Qualified Foreign Investor ("**QFI**") scheme. These major developments and changes include, among others:

- In June 2020, the QFII and RQFII quota limits administrated by the State Administration of Foreign Exchange ("**SAFE**") were abolished and QFIs may now freely choose the amount of their investment and the timing and currency for their capital injection into China;
- The process for repatriation has been largely simplified to remove the requirement for a special tax audit before repatriations can be processed;
- The eligibility criteria for QFI applicants have been relaxed, among other changes, removing the hard requirements on track record and AUM; and
- The investment scope has been expanded to include, among others, private investment funds, commodity futures, financial futures, options, margin trading and securities lending, although the realization of some of these still awaits further detailed implementation rules and guidelines, formal approval, or market testing.

2 Stock Connect Scheme

The Stock Connect scheme was first launched between Hong Kong and Shanghai in 2014 and was followed by a similar scheme between Hong Kong and Shenzhen in 2016. Stock Connect enables foreign investors to invest in eligible Mainland-listed A-shares (Northbound) and Mainland investors to invest in Hong Kong-listed shares (Southbound) via connections between the respective Mainland and Hong Kong stock markets. Compared with the QFI scheme, which gives foreign investors a wider selection of investable shares (i.e., all listed shares in the Mainland), foreign investors under the Stock Connect scheme may only invest in listed shares that are constituents of certain indices or that have H-share counterparts listed in Hong Kong. However, many foreign investors prefer the Stock Connect scheme because they are more used to the funding, clearing and settlement processes in Hong Kong which are more aligned with their global processes.

The Stock Connect scheme has gone through significant reforms in recent years including, among others:

- On 30 March 2015, HKEX introduced on the Special Segregated Account (“**SPSA**”) service to facilitate pre-trade checking so that shares being sold in Stock Connect do not have to be pre-delivered to the broker, which helped to create a two-legged settlement process (Exchange vs Broker and Broker vs Client) to simulate a DVP experience for the investor;

- On 11 April 2018, the CSRC and the Hong Kong Securities and Futures Commission ("**SFC**") jointly announced to quadruple the daily quota for northbound connect from RMB 26 billion to RMB 104 billion (52 billion for each of Shanghai and Shenzhen market) which took effect from 1 May 2018;

- On 20 August 2018, SSE started to implement a closing auction mechanism which facilitates increased liquidity and better supports investors seeking to execute at the volume weighted average price ("**VWAP**") at the close;

- On 10 July 2020, the Master Special Segregated Account ("**Master SPSA**") was introduced to greatly enhance the efficiency of pre-trade checking for fund managers who manage multiple underlying funds; and

- On 25 November 2020, the People's Bank of China ("**PBOC**") and Hong Kong Monetary Authority ("**HKMA**") announced that the currency swap agreement between them has been renewed for a term of five years, with its size expanded to RMB 500 billion / HKD 590 billion from RMB 400 billion / HKD 470 billion. This increases the availability of RMB in Hong Kong ("**CNH**") to fund Stock Connect activity. The currency swap agreement was initially signed by PBOC and HKMA on 20 January 2009 and had been renewed three previous times, on 22 November 2011, 27 November 2014, and 27 November 2017, respectively.

3 Other New Developments

The Shanghai Stock Exchange launched the STAR Board for innovative companies in 2019, followed by a renovated ChiNext Board on the Shenzhen Stock Exchange the following year, with both regimes employing a registration-based framework.

On 27 November 2020, SSE, SZSE, and HKEX jointly announced an expansion of the scope of eligible securities under the Stock Connect scheme to include a limited number of securities on the STAR Board for northbound trading, and pre-revenue biotechnology companies listed in Hong Kong for southbound trading.

V. Further Refinements Proposed by the Industry

This section sets out the main refinements currently proposed by the industry. Please also refer to Annex I for a summary of the proposed refinements for both QFI and Stock Connect schemes.

QFI Issues

1 Delivery Versus Payment

For equities investing/trading, many markets around the world have been converging to a delivery versus payment ("**DVP**") settlement cycle of two days ("**T+2**") after the trade date ("**T**") which allows investors globally to simplify and standardize their operational processes and to easily shift investments from one market to another. China's equity market is unique in that regard as stocks are settled on a gross (trade-for-trade) basis on the day they are traded, i.e., T0, while cash, on the other hand, settles on a net basis the next day, on T+1 (the "**Non-standard DVP**"). Under the brokerage business, this system requires all stock trades and cash to be fully pre-delivered or pre-funded before an investor can place a buy or sell order on the market. When investing via the QFI channel, foreign investors will have to conduct Free of Payment ("**FOP**") transfers, with delivery of stock and receipt of cash separate from each other, which gives rise to several issues that DVP avoids.

By way of comparison, it is worth highlighting the successful introduction of Real-time Delivery Versus Payment ("**RDVP**") in November 2017 for the northbound trading link. This has been an important development for many foreign institutional investors, particularly those who manage public/retail funds and the custodians of funds, as they have a fiduciary or statutory duty to safeguard the assets of those funds.

As such, we find that in practice Non-standard DVP causes a number of risks and poses multiple challenges for foreign investors, some of which are highlighted below:

(i) Non-standard DVP in China's equity markets not only raise counterparty and market risks for foreign investors but also exposes China Securities Depository and Clearing Co., Ltd ("**CSDC**") to both principal and replacement cost risks. The non-simultaneous settlement between stock and cash leads to the possibility that the buyer may sell stock (which settles on T) before the payment of the purchase price and the settlement of funds (which occurs on T+1). Though the relevant regulations in China provide CSDC with a right of disposal, enabling the transfer of a defaulting party's stock into a stock disposal account (when the defaulting party fails to pay), this however is a post-default measure and may not mitigate the principal risk.

(ii) Non-standard DVP also creates additional costs and risks for foreign investors and their brokers (i.e., clearing participant under QFI scheme), especially for large long-only foreign investors who typically use multiple custodians for the many funds and client mandates that they manage. For example, it creates for foreign investors a "cash drag", which is a degradation in investment performance since the required pre-funded cash will earn little or no return. In addition, because the outcome of an order is always uncertain, the treasury of a foreign investor in another time zone cannot forecast with certainty an order's funding needs, which raises the cost of funding as they may be pre-funding more than needed, creating even more of a cash drag.

(iii) Non-standardized DVP also creates trading inefficiencies due to the need for pre-trade checking to ensure cash and stocks are available before the trade is placed. If the broker agrees to finance the sale proceeds for the client by delivering the cash to the client on T (instead of T+1) to eliminate this risk for the client, the broker incurs financing costs and takes on counterparty risk vis-a-vis the exchange clearing house such as CSDC.

(iv) Time-zone differences exacerbate some further operational challenges, as overseas market participants are only given 3.5 hours to settle their trades under the current settlement arrangement. Due to time zone differences, foreign investors in the US and Europe (which are 6 to 16 hours behind China) have to pre-fund their buy-trades and/or opt for single-sided settlement (i.e., confirmation from only one side of the transaction) for their sell-trades when trading in Chinese stocks. This is not only costly but also raises counterparty risk. When investing in China, the time zone difference and the multi-layer custodian arrangements that are associated with large numbers of foreign institutional investors require major workarounds by market participants if they are to satisfy their respective regulators and legal and compliance requirements. Brokers in general need to prefund buy trades even in the Hong Kong market, where prepayment is made by brokers early on T+2 to release the stock on-hold before clients' money is paid to brokers later on T+2 at 5:45 pm for onward delivery from brokers.

(v) In addition, standard settlement for the RMB spot market in China is T+2 which is the same as in most other foreign exchange markets. The settlement timing difference between foreign exchange and stock settlement creates another layer of costs for foreign investors who have to convert currency on a non-standard cycle of T+1 for their equity trades in China.

Most markets settle stocks and cash simultaneously with sufficient time lag following a trade for counterparties (on both sides) to confirm trades, arrange for delivery of foreign exchange as needed, transfer cash, correct problems, and settle. Europe moved to a T+2 cycle in 2015 and the US followed suit in 2017. Quite a few Asian markets such as India, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan, and Thailand have all moved to a T+2 settlement cycle to accommodate global institutional investors and better integrate their equity markets with those of the world. Harmonization around the same settlement timing for stocks and cash globally leads to greater efficiency and facilitates more investment by global investors. It should be noted that in most markets there is no pre-funding requirement; hence trades can be executed more efficiently and without the cash drag mentioned above.

Given the operational challenges of China's Non-standard DVP settlement cycle, foreign investors would like to recommend the following improvements in China:

(i) To allow DVP (i.e., contemporaneous settlement of stock and cash) to better protect investors as well as a move to T+1 or T+2 settlement for both stock and cash to align with global practice as this would help reduce counterparty and settlement risks and improve operational efficiencies. As China's move towards a T+2 settlement cycle for equities may be a longer-term solution, it is recommended that at least in the short term, China should move to T+1 DVP settlement for equities trading;

(ii) To implement a workable Stock Connect SBL regime (with not only brokers but also their affiliates, asset owners and their lending agents being allowed to engage in SBL) which would help tide foreign investors over the current tight settlement timeframe and minimize the possibility of failed settlement;

(iii) To remove the pre-funding requirement (i.e., having cash available before a buy trade) which is onerous, particularly for onshore investors, and costly and inefficient, particularly for overseas investors. A potential solution might be to not require pre-funding if funding is secured by end of T, i.e., the day prior to cash settlement on T+1; and

(iv) To allow banks to provide temporary credit solutions to investors, particularly foreign investors, to address the pre-funding requirement, if it is not removed, since currently only brokers are allowed to provide credit solutions to their clients.

Adopting one or more of the aforementioned recommendations to bring DVP to China's equity markets would significantly enhance the attractiveness of these markets to foreign investors. Although Stock Connect has simulated the DVP experience for investors through broker financing and via SPSA accounts, it remains an expensive solution. DVP is not available at all via the QFI channel which has steered many investors to prefer the Stock Connect channel over QFI owing to asset safety concerns.

ASIFMA's Recommendations: Allow DVP settlement for both stock and cash to better ensure asset safety for investors and remove the pre-funding requirement; migrate to a T+1 or T+2 settlement cycle to better align with international practice; In the meantime, given the current tight T+0 settlement timeframe, it would be helpful to implement a workable stock borrowing and lending ("SBL") regime, which can help to facilitate stock borrow for 'fail cover' settlement purposes.

2 Multi-broker Model, DMA, and Program Trading

(1) Multi-broker Model

While the new QFI Rules, namely the *Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* and *Provisions on Issues Concerning the Implementation of the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* issued by CSRC on 25 September 2020, have removed the limit on the number of brokers a QFI may engage, we are concerned that there is still a practical obstacle for a QFI to sell the shares purchased via one broker through another broker due to the following provisions:

(i) The rules promulgated by the SSE (including Article 5 of the *Guidelines No.1 on the Application of Securities Trading Rules of the Shanghai Stock Exchange for Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* ("**SSE QFI Rules**"), issued on 30 October 2020) provide that a securities account may designate only one broker and participate in securities trading via the dedicated Participant Business Unit ("**PBU**") assigned by such broker. The same securities account may place orders with another broker only after its re-designation of such broker and after fulfilling formalities and subject to restrictions provided by the SSE; and

(ii) Article 4.1.2 of the *Trading Rules of Shenzhen Stock Exchange* issued on 31 December 2020, with effect from the same day, provides that investors may sell securities through the PBU through which they have purchased such securities. They may also give an instruction to such PBU for transferring the custody of their securities to another PBU, and, upon completion of the transfer, sell the securities through the new PBU; and

(iii) Different dedicated PBUs assigned by different brokers are isolated from each other.

From a practical perspective, the above provisions have effectively hindered a QFI from selling shares through a broker different from the one through which the shares were originally purchased, as this requires re-designation of a broker or transfer of custody prescribed by the SSE/SZSE.

The resulting restriction adds to operational complexity and compliance costs for foreign investors besides the concentration risk (with just one broker) and the potential of not meeting best execution requirements. As a matter of global market practice, investors are generally free to buy and sell any of their shares through any broker they choose, which is also the case under the Stock Connect scheme. The industry would like to highlight that the aforesaid restriction is among one of the main factors that discourage foreign investors to utilise QFI scheme in comparison to the Stock Connect scheme. *We would like the Chinese regulators to consider relaxing the aforesaid restrictions to better align with global practices.*

(2) Direct Market Access

In 2015, the CSRC issued circulars, namely the *Notice on Strengthening the External Interface with Information System by Securities Companies* and the *Opinions on Clearing up and Rectifying Illegal Securities Business Activities*, to regulate/restrict the API provided by brokers to their clients. There is a grandfathering rule that the APIs provided before issuance of such circulars may continue, but strictly speaking they should not be offered to new clients. As DMA is akin to API, market participants believe that the aforementioned circulars would apply to DMA as well.

Notwithstanding the above, it is generally understood that CSRC's 2015 circulars apply in the domestic context and are not particularly applicable to QFIs. In practice, most brokers who offered their clients DMA services via APIs before the issuance of the 2015 circulars should still be able to provide DMA to new QFI clients. *It would be appreciated if regulators could confirm the above understanding is correct.*

In 2019, the CSRC issued a consultation draft of the *Interim Administrative Provisions on External Interface with Trading Information Systems of Securities Companies* (the "**API Consultation Draft**"), which was intended to standardize the API provided by brokers and seems to signal CSRC's intention to permit institutional investors to get access to brokers' trading system and route orders to the Exchanges via the brokers' API. *The industry welcomes its promulgation soon.*

The industry also has concerns around the Grade A rating for the broker. As per the API Consultation Draft, the paper sets out the requirement that securities brokers seeking to offer DMA must have received an A-class rating or higher for at least two years within the past three years. However, this requirement would mean that almost all the joint venture securities brokers or the Wholly Foreign-Owned Enterprise ("**WFOE**") securities brokers to be incorporated in future (collectively "**Foreign-invested Securities Brokers**") would fail to meet such requirements.

We are therefore concerned that the grade rating requirements will be a substantial challenge for any Foreign-invested Securities Broker seeking to provide DMA for their investors. Given that providing DMA services to clients has been a significant contributor to brokers' profitability, it will be very difficult for Foreign-invested Securities Brokers to achieve the profitability required for an A-grade rating if they are not eligible to offer DMA services. In addition, any newly incorporated Foreign-invested Securities Broker would only be eligible to provide such services after it has been in operation for more than two years. We are not aware of similar profitability prerequisites for securities brokers in other markets and as such, we are concerned that this grade rating requirement will be a substantial obstacle for foreigners seeking to establish their securities brokerage subsidiaries and develop the relevant competitive businesses in China.

(3) Program Trading

In October 2015, as one of CSRC's efforts to react to the then stock market turmoil, CSRC issued a consultation draft on the *Administrative Measures on Program Trading in the Securities and Futures Markets* (the "**Program Trading Measures**") with the intention to regulate so-called "program trading" which is broadly defined to cover any trading activities in which the trading orders are automatically generated or executed through pre-set programs or specific softwares. The draft Program Trading Measures were very controversial at the time of their issuance and discussions have gone no further.

Since then, there has been no significant development in the regulation of program trading in the securities market, except for the requirement to report with exchanges and refrain from affecting the system security and normal trading order of the exchanges as provided in Article 45 of the PRC Security Law. Program trading could also be subject to the API Consultation Draft to the extent institutional investors generate orders automatically and route to exchanges via APIs provided by brokers.

The industry notes that the formulation of rules on program trading has been listed in CSRC's annual legislation plan for several years and *we look forward to their early release of the draft rules and the subsequent market consultation.* The release of the draft measures will provide guidance to the industry, and quite importantly, it will also improve market liquidity and provide efficiency of price discovery. *We would also welcome an opportunity to present our comments on a consultation draft before any rule is finalized.*

ASIFMA's Recommendations: Relax current single broker restriction for investors and provide optionality to switch across multiple brokers in line with global best execution regulatory obligations. Allow brokers to provide Direct Market Access ("DMA") to clients and remove the drafted prerequisite that a broker must be rated grade A or higher for the past two out of three years which would be unfair for foreign brokers. Engage Industry to formulate clear rules for program trading.

3 QFI Participation in SBL Impaired by the Long Sale Uptick Rule:

The current rules require that as long as there are borrowed shares held by a firm, all of that firm's sell orders in that stock must be sold at a price not lower than the most recent execution price (i.e., the uptick rule), even if that firm has a different long position for a different client.

The industry would recommend the segregation of owned versus borrowed. For instance, Korea and Hong Kong allow investors to set up different aggregation units so that the same investor with different trading desks or investment strategies can segregate its flow and only apply the uptick rule to the aggregation unit actually shorting shares. For many institutions, even within the same entity, there may be a number of independent trading desks which may engage in separate investment strategies simultaneously. The application of the Long Sale uptick rule will mean that a trading desk that is a long holder in a security will be subject to the uptick rule, if another independent trading desk within the same entity is short in the same security. This would impede the ability for the long holder to trade and would not be in the spirit of the market. Hence, such segregation would add fluidity to the market and fairness to all investors, regardless of investment style or strategy type.

ASIFMA's Recommendations: Exchange rules require that even long sales are subject to the uptick rule up to the quantity of the borrowed shares, which is unique to China's capital markets. QFI's may employ different trading strategies amongst different independent trading desks within the same entity and engaging in SBL by one trading desk may impair the ability of the other trading desks within the same QFI to trade as the long sale uptick requirement is imposed across all accounts under the same QFI's control. Request that this rule be amended to facilitate more active QFI participation in SBL. For example, to introduce the concept of aggregation units similar to the practice in Hong Kong and Korea, so that uptick is only applied to the aggregation unit, which is actually short selling the shares.

Stock Connect Issues

4 Expansion of Product Scope

Stock Connect security eligibility is currently limited to a subset of A shares traded on Shanghai & Shenzhen Main boards and corresponding STAR and ChiNext innovation boards. Foreign investors would benefit from increased access to all securities traded on these boards with the continuation of exceptions for shares under risk alert, delisting or shares traded not in RMB.

ASIFMA's Recommendations: Current security eligibility for Northbound Connect is restricted to constituent stocks in major indices, A shares with corresponding H shares, and/or market capitalization thresholds. Foreign investors would benefit from broadening the range of Main Board, STAR and ChiNext securities allowed within the existing Connect program to include all ordinary A shares. Additionally, the Connect model should be enhanced to bring IPO issuances into scope.

5 Holiday Trading

Currently Stock Connect only operates on days when both the Hong Kong and Mainland stock markets are open for trading and when banks in both markets are open on the corresponding settlement days. As a result, due to differences in the public holidays in Hong Kong and the Mainland, it is not possible for the investors to trade through Stock Connect not only on Mainland holidays, but also on Mainland trading days that fall on Hong Kong holidays (H days), as well as on the day before such holidays (H-1 days).

Therefore, there are occasions where the Mainland market is open for trading, but overseas investors are unable to buy/sell out of their positions through Stock Connect. Consequently, if there are any price fluctuations in China A-shares during such days, overseas investors are unable to take timely actions and may potentially be exposed to greater risks.

Stock Connect aligns with the HK market practice that net buy stock will be put on-hold till money is paid. To release such stock early requires cash prepayment. Since Stock Connect follows T+0 stock settlement, releasing on-hold stock on the same day therefore requires cash prepayment to be paid in the late afternoon. To relieve the CNH funding pressure, HKEX has put in place a collateral service in USD and HKD so that CPs can pay CNH on T+1 while allowing stock to be released on T.

While the current arrangement of non-holiday trading is essential in ensuring that proper banking support is available to process settlement for northbound trading, it would greatly enhance the Stock Connect scheme for overseas investors if the SSE, SZSE and HKEX can develop the systems and operational support for cross-border trading/money settlement during holidays. This can be achieved via a phased approach, such as in the first phase, allowing buy and sell orders via Stock Connect to be done on the day prior to a Hong Kong holiday (H-1 days); and in the second phase, with regulatory support, allowing Stock Connect participants to trade through Stock Connect on Mainland and Hong Kong holidays.

ASIFMA's Recommendations: Foreign investors cannot trade through Stock Connect if the China market is open, but the HK market is closed during an HK holiday as well as for the day prior. Request that the SSE, the SZSE, and the HKEX work with the Industry develop solutions to address this issue and market risks.

6 Expansion of Block Trading

A block trade is a transaction between two or more parties for the sale/purchase of a significantly large number of shares (from a dollar value and/or average daily volume perspective) in a specific stock. Block trades are critical tools used by institutional investors to minimize price slippage and reduce impact costs (typically the largest component of total transactions costs), and to achieve best execution of large transactions.

This block trading window is currently not available to participants of Stock Connect. This limits liquidity in the block trading window for both domestic and foreign onshore participants as many Stock Connect participants who can offer liquidity do not have a QFI license and hence are unable to access the window. Instead, these participants use algorithms to conduct large numbers of transactions at benchmarks (such as VWAP), Time-Weighted Average Price ("**TWAP**"), etc.), which can take days to complete and can lead to price slippage, signalling risk, and information leakage.

The ability to transact large block trades with minimal slippage and interference is a key feature of equity markets across the globe. Block trades enable institutional investors to adjust their portfolios more efficiently therefore increasing the attractiveness of markets where such trades are allowed. Block trading is equally important for foreign investors investing under the northbound Stock Connect so it would be helpful if this is made available to them as well. Stock Connect participants are a large universe and can provide more liquidity in the block trading facility; additionally, they may leverage block trading to facilitate Guaranteed VWAP ("**GVWAP**") strategies, client facilitation and minimize closing auction strain on rebalance days. The ability to block trade will encourage more institutional investors to participate in the Stock Connect and A-share markets.

In providing access to a block trading window for Stock Connect participants, it can take a phased approach. For phase 1, the industry suggests building a separate, reciprocal block trading mechanism to allow block trading between Stock Connect participants, which can be a framework similar to that of the onshore block trading window (such as adopting same volume/value threshold, price band, etc.). The block trading between foreign participants may also offer a better framework for them to manage limitation on foreign ownership. There would not be a material issue for reporting related obligations under the block trading mechanism as participants' shareholding positions are already accessible to the regulators per current Stock Connect agreements, and foreign investors should be comfortable with sharing trading data on a daily basis post block trade if required. *For phase 2, it would be good if Stock Connect participants can access the onshore block trading window just as QFI investors can.*

There are some QFI constraints as well. Although currently QFIs are permitted to participate in onshore block trading, the current onshore block trading window is only open from 3:00 pm to 3:30 pm, which is quite limited. In addition, the manual nature of this facility makes it operationally challenging to use effectively, especially for fund managers trading for hundreds of underlying funds. All these may explain the lack of usage of the block trading facility by QFIs to date. Therefore, it would be helpful if the block trading window can be extended possibly throughout the entire trading day with instant matching.

ASIFMA's Recommendations: Request that Stock Connect participants also be provided a mechanism to conduct block trading, a facility which is currently available only for QFI investors and only during a 30-minute window between 3pm and 3:30pm. For QFI investors, request that the block trading window be extended for matching throughout the entire trading day (similar to the block window for STAR Board names, where blocks can be reported to the exchange from 09:30 – 11:30 and 13:00 – 15:30, and matching is instant).

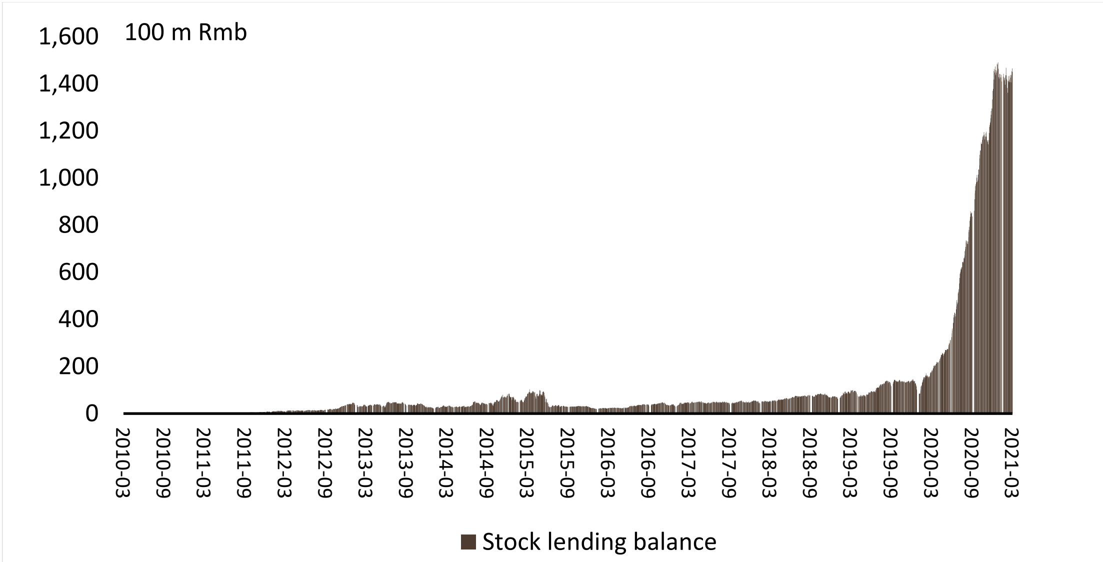
7 **Activate Dormant SBL Framework by Expanding Definition of Exchange Participant (EP):**

An efficient SBL environment helps to enhance overall equity market efficiency, enables more efficient hedging to better manage risks and protects against fail trades that may arise due to the tight settlement timeframe. The following points highlight the importance of a robust, transparent, and well-functioning SBL market:

- It allows active asset managers to take the other side of passive flows into the close and around index rebalances;
- It reduces unintended volatility around closing auctions on index events as it allows more sellers to be active as well;
- SBL promotes liquidity in the system rather than only having 'buy and hold', locking up liquidity;
- It serves as a 'fail cover' mechanism which allows for growth of the ETF industry when creating and redeeming; and
- It serves as a 'fail cover' mechanism which helps around holiday trading and for future changes in settlement cycle (that is, to T+1 or T+2).

Riding on the new rules released in June 2019 that allow the PRC mutual funds to lend PRC securities into the SBL system, the size of PRC onshore stock lending business broke out and registered rapid gains. Outstanding stock lending now stands at a record RMB 140 billion, up nearly 1,400% from the prior RMB 10 billion and far outstripping the 2015 bull market level (Ref. Figure 3 below). This implies a great potential of the PRC SBL market.

Figure 3: Since June 2019 (MFs allowed to participate in securities lending), securities refinancing rose after a preparation phase; now makes up a higher % of MTSL



Source: UBS Securities

Foreign investors appreciate the recent inclusion of margin trading and securities financing on stock exchanges, and securities lending to the China Securities Finance Corporation Limited ("**CSFC**") under the New QFI Rules. Allowing QFIs to access the onshore SBL framework will benefit the market as it would enable international active funds to participate in covered short selling trading which has the advantage of providing an offset against passive trading flow from other international participants. This will improve price discovery, reduce price volatility, and enhance liquidity of PRC securities.

To better benefit the investors and align with international practice, more improvements, and clarifications on the rules on how SBL would work under each of the QFI and Stock Connect channels would be welcomed, as proposed below:

(1) SBL under Stock Connect

Although SBL via the Stock Connect channel has been available for years, the participation is quite limited due to regulatory and practical obstacles. *Set out below are some proposals on improving the Stock Connect SBL framework:*

- Enhancing the existing model to broaden the eligibility in the program to all SBL market participants;
- Developing the trading mechanism to make SBL more time and cost-efficient; and
- Ensuring globally recognized standards of transparency and visibility of market activity in the SBL and short selling programs.

The proposals are divided into seven key areas based on the order of importance:

(i) Participants

Under the current Stock Connect rules of HKEX, only exchange participants (i.e., the brokers) and qualified institutions may lend China Connect Securities, which has resulted in minimal usage of the SBL mechanism. However, it is the affiliates of exchanges participants, affiliates, or lending agents of the investment managers, who hold stock inventory to lend. Therefore, the list of participants which are eligible to lend China Connect Securities should be expanded to include affiliates of EPs and affiliates or lending agents of investment managers, which would allow the majority of offshore borrowers and lenders to participate, whilst maintaining the ability to exercise control over who is able to act in the above categories. It is also important for these participants to be able to lend or on-lend securities to all permitted stock lenders and borrowers to improve usage of the program.

(ii) Short Selling Ratio Limit

The current Stock Connect rules require that the short selling ratio (based on the HKSCC's holding of the specific security in the omnibus account maintained with CSDC) for any short selling security cannot exceed 1% on any northbound trading day, and the cumulative short selling ratios for a short selling security in any period of 10 consecutive northbound trading days cannot exceed 5%. Any short selling order that, if executed, will cause the 1% daily limit or the 5% cumulative limit for a short selling security to be exceeded during the course of a northbound trading day will be rejected.

To prevent liquidity reductions around higher volume events, it is recommended to expand the daily and cumulative limits to reduce the likelihood of existing hedging strategies affecting the ability of active managers to participate in or around closing auctions, such as 5% daily limit and 20% cumulative limit for 10 consecutive northbound trading days.

(iii) Stock Borrowing for Short Selling

The current rules require the broker to ensure that the client has borrowed sufficient short selling securities to settle the short selling order if executed. This may cause the investor to miss the market trading as the settlement of shares into the account prior to short selling would take one day to occur. *It is recommended* *to follow the Hong Kong market convention where short sells can be executed upon a 'confirmed' borrow with the executing broker providing confirmation upon request. That would include a confirmed hold and not necessitate a physical and settled borrow prior to short selling.*

(iv) Term of Agreement

The current rules require that the SBL agreements for the purpose of short selling cannot be longer than one calendar month. Such limit could create the need to trade in the market, due to the need to roll back a borrow and cover the underlying short. Roll activity could mask genuine trading and have the effect of reducing transparency to the broader market. This could create the undesired effect of artificially inflated volumes and increased trading volatility. *It would be helpful if the borrow limit can be extended to 6 months, which can be extended to 1 year upon agreement between both parties. This would be similar to the SBL term limit for the domestic securities refinancing market.*

(v) Purposes of SBL

Currently the use of SBL is limited to short selling and meeting the pre-trade checking requirement (with the term of no longer than one day and is not renewable). *Foreign investors would recommend the addition of borrowing for the purpose of covering any failing trades as part of the overall SBL mechanism.*

This also allows for development of the ETF industry through providing a 'fail cover' mechanism during creation and redemption and would ultimately pave the way for flexibility around different market settlement cycles (T+1 or T+2).

If deemed necessary to prevent abuses, it can be specified that borrowing should not be for the purpose of voting on borrowed shares, nor solely to influence the outcome of any corporate action event through simply holding borrowed shares with no intention to sell these shares.

(vi) Reporting Requirements

Under the current rules, the relevant Exchange participants are required to submit reports to HKEX relating to the open short positions of any short selling security and any other information required by HKEX as and when they may require such information.

While the foreign investment community agrees and is a strong advocate for transparency and openness around short selling and around SBL, *it would recommend a distinction of reporting that segregates short selling activity and borrow / return activity. All regulated entities acting as an agent or principal should provide weekly reporting of new borrows and returns, including counterparty information. A separate aggregated end-of-week short positions could be compiled and reported.*

Separately, it would be helpful if the short selling information published on the HKEX website can be migrated to real-time transmission to avoid the need to resend or amend orders continuously.

(vii) Securities Lending/Borrowing to CSFC

The industry would like to explore the possibility, with the regulators, the exchanges, and the CSFC, of how to allow Stock Connect participants to participate in refinanced securities lending and borrowing which can further promote the liquidity of the onshore securities market. Explore the idea of having a subsidiary of the Stock Exchange as the notional financing lender or borrower, aggregating A-share lending or borrowing orders from Hong Kong brokers (or custodian banks), with the order transmission and matching transaction links handled in accordance with the refinancing business.

(viii) Regulatory Controls Across Different Jurisdictions

<u>Figure 4: The table below describes the regulatory controls across some of the major jurisdictions which help markets to better safeguard against harmful short-selling activities. It also shows how well China is positioned in terms of controls versus other markets.</u>

	Broad Short Sell Controls				**Market Specific Nuances**			
	Short Position Reporting	**Tick Rule**	**Short Sell List**	**Centralized SBL Facility**	**Overheated Shorts**	**Short Sell Quota**	**Daily Maximums**	**Total Outstanding Limit**
Australia	Yes	X	X	X				

China	Yes	Yes	Yes	Yes				
China / HK Connect	Yes	Yes	Yes	X				
Hong Kong	Yes	Yes	Yes	X				
India	X	X	X	Yes				
Indonesia	X	Yes	Yes	X				
Japan	Yes	Yes	X	X				
Malaysia	X	Yes	Yes	Yes*				
New Zealand	X	X	X	Yes*				
Singapore	Yes	X	X	Yes*				
South Korea	Yes	Yes	Yes***	X	Yes			
Taiwan	X	Yes	X	Yes*		Yes	Yes	Yes
Thailand****	X	X	Yes	Yes*				

*** Optional**

**** Currently exempted across most names**

***** Owing to a partial lifting of the short sell ban**

******Restrictions relate to onshore activity on the local line**

Source: Pan Asia Securities Lending Association (PASLA) Chairman

ASIFMA's Recommendations: Stock Connect rules allow for securities lending between EPs of the Exchange. However, actual market participants are affiliates of EP's or Agent Lenders and not the EPs themselves. Permit that the EP definition be expanded (to include EP affiliates and Agent Lenders) to permit refinanced securities lending and borrowing between Stock Connect participants, under the arranged mechanism of CSFC, as originally intended during the initial launch.

Key Challenges Hindering Growth in this Channel

The Northbound Stock Connect market, which has seen significant growth since inception, was the focus of exponential volume increases in 2020, and has continued to demonstrate sustained growth into 2021. Although investors continue to increase their allocation into China A shares via this channel, there are serious concerns about the sustainability of these increasing volumes due to two main factors:

(i) Operational risk resulting from the T+0 settlement cycle

Timely counterparty transfers between brokers and custodians and effective fail management and communications among market participants are keys to handle growing volumes in Stock Connect markets. These are sequential processes involving multiple parties before settlement instructions are sent downstream to HKEX's Central Clearing and Settlement System ("**CCASS**"). Equally, reliable and robust order management and middle office systems are essential to brokers and custodians to ensure timely completion of trade processing functions. HKSCC regularly monitors and ensures CCASS' system capacity has sufficient head room and that system functions are enhanced to ease pain points in the market (e.g., SPSA, master SPSA, RDVP).

(ii) Funding, Liquidity and Payment Considerations

The situation described above is especially true for the sell-side, in particular the large/high volume agency brokers (and their clearers), who have to settle trades on a same day back-to-back basis very late in the day. T+0 settlement means that investors need to match trade details with their brokers, and then send settlement instructions to custodians on the other side. These instructions / allocation information can come after 6 pm, making the final cash position that a broker and/or its clearing agent needs to fund uncertain until close to, or past the payment cut off times, risking settlement failure and buy-ins.

As a result, most sell-side participants are forced to prefund their clients' trades to avoid issues later in the day when it may be too late to fund.

On the client-side (delivery from the broker to the end client), there is also a need to differentiate between RDVP (HKSCC offers real-time delivery versus payment, with which delivery of securities happen upon receipt of payment confirmation) and normal DVP. RDVP is employed by regulated funds such as UCITS to ensure near simultaneous exchange of cash and securities. However, RDVP trades need to be funded upfront and, on a gross, not net, basis, meaning that purchases absorb a huge amount of liquidity, particularly very late in the day when liquidity tends to be scarce. RDVP is a function that the Hong Kong Securities Clearing Company Ltd ("**HKSCC**") provides to facilitate bilateral stock transfer between custodian and broker only. Since HKSCC does not stand as a central counterparty for such transfers, netting of such transfers in stock and money legs are not possible to be done by HKSCC. To achieve netting, counterparties of RDVP can liaise among themselves to net off transfers of the same stocks before entering into RDVP.

In addition, there is a mismatch between the payment cut off times in the banking system, and settlement batches at HKEX's Central Clearing and Settlement System (CCASS) that compounds the need for additional CNH liquidity by market participants. In order for CCASS to release a "hold" on the securities that brokers receive from the clearing house and onward-deliver them to the end-investor's custodian on the same day, brokers are forced to make a pre-payment to CCASS equivalent to their total settlement obligation (or a less common delivery of collateral). However, cash cut off times to make the prepayment comes before the final market settlement batch when broker or their clearer has a clear picture of their final funding position. As such, brokers are forced to make a guess of the amount of prepayment they might need, which may still prove to be insufficient when the final settlement batch has run, at which time it is too late to make any additional payments and the trades will fail.

The Real-time Delivery Versus Payment ("**RDVP**") mechanism, however, requires for the funding of securities purchases on a gross (i.e., trade-by-trade) basis (unlike Non-Standard DVP which only requires net funding of participants' buys and sells), giving rise to a significant knock-on impact on funding especially in CNH for brokers and clearers.

__**Common Issues Across both QFI and Stock Connect Channels**__

8 Expand Listed Derivatives Access to Facilitate Better Hedging and Risk Management

Foreign investors applaud the expansion of onshore derivatives access to QFIs and offshore derivatives access to offshore investors under the Stock Connect scheme to facilitate better hedging and investment risk management. But, given the increasing allocation to Chinse assets and the need for investors to hedge their risks, the foreign investment community would like to recommend PRC regulators consider the following to further open up the market.

(1) Accessibility to Onshore Derivative Products

(i) QFIs

Although QFIs have been permitted in principle to access various types of derivative products, currently, except for stock index futures and specified commodity futures that can be traded by all foreign investors, listed options and other futures products (e.g., bond futures traded on China Financial Futures Exchange ("**CFFEX**")) are still not available for trading by QFIs. These products are still pending the CSRC's approval upon the Exchanges' application. We also welcome creation of more listed onshore derivatives for hedging (e.g., single stock products).

The foreign investment community welcomes both the publication and consultation on the details and rules of trading the pending products. *We would recommend allowing sufficient flexibility, for example, options which carry a delta (hedge ratio) and restrictions on trading volumes to a notional exposure (maximum exposure being the value of the portfolio), tight quotas and other limitations could restrict investors' ability to fully hedge a portfolio.* This also restricts the types of strategies used (e.g., put spreads/call spreads, straddles and strangle combinations, etc.) limiting strategy diversification which is critical to healthy market dynamics.

Conversely, reducing the limits and restrictions will allow greater liquidity and better pricing for all participants. Derivative products are used as hedging or positioning tools by various different market participants – from hedge funds to investment managers – the ability to use them will increase capital inflow through the QFI channel.

We also note that the accessible derivative products on CFFEX are limited (seven products in total as of today) and would welcome the creation of new products (e.g., index products covering ChiNext, STAR, and CSI 1,000) in order to better hedge their risks.

Additionally, the CFFEX margin system requires clearing members to deposit funds in the form of Trading Margin and Clearing Reserve, while interest is paid only on the cash balance of the Clearing Reserve and not on the Trading Margin.

QFIs as clients of the clearing member currently do not receive any benchmark interest from CFFEX on the initial trading margin that they post until the margin posted exceeds 12%, making initial trading margin requirements expensive and unattractive. Additionally, we note that netting of long and short positions within products or across products is not possible, and margin is instead charged on a portfolio basis based on whichever side would generate the larger amount of required margin[3], even if there are overlapping long or short positions in the portfolio. The introduction of netting (and across products) would help reduce the

[3] Note: CFFEX currently uses "Larger Side" margining, which collects margin on whichever side (either long or short) would require the most margin. This rule applies to positions either in the same product or across different products but excludes those physically delivered contracts held after market close on the trading day immediately preceding the delivery month.

cost of trading CFFEX futures and together with benchmark interest, it would increase the attractiveness of CFFEX futures to QFIs.

A clearer cross margining/netting framework would help reduce the cost of trading CFFEX futures and together with benchmark interest, increase the attractiveness of CFFEX futures to QFIs. ASIFMA encourages CFFEX to consult the market for feedback on benchmark interest, a clearer cross margining/netting framework, and how to expand the product suite to further develop the Chinese market.

(ii) Other Offshore Investors

Offshore investors including those trading under the Stock Connect scheme are currently not granted access to PRC onshore derivative products. While the industry appreciates that offshore investors can access offshore derivative products (e.g., the SGX FTSE China A50), the correlation of offshore derivative products with PRC onshore assets is not as strong for investors as onshore derivative products would be. *It would be ideal if the onshore derivative products on CFFEX could be specified by CSRC pursuant to the Interim Administrative Measures for Trading in Specified Futures Varieties in China by Foreign Traders and Foreign Brokerage Agencies to be open for trading by foreign investors without necessarily needing to secure a QFI license.*

In the offshore derivatives market, the futures products on the MSCI China A Index was jointly announced in March 2019 by MSCI and HKEX. However, it is yet to be launched by HKEX. The availability of these MSCI China A-share index futures products would further benefit Stock Connect investors. HKEX's launch of A-share index futures would diversify the range of offshore derivative products which is currently limited only to the SGX FTSE China A50 index futures for offshore investors.

An HKMA official recently stated that they are attempting to launch more Connect schemes for other asset classes, such as stock and bond derivative products, to meet the increasing demands of foreign asset managers to hedge risk exposures from holding RMB-denominated assets. *The foreign investment community welcomes this new initiative and would like to see the early circulation of detailed plans.*

(2) Trading Limits on Onshore Stock Index Futures

While QFIs can, in principle, trade stock index futures, they are subject to rigid hedging requirements and must apply with CFFEX for hedging quota. Specifically, when a QFI takes long hedge positions, the notional value, or the value of risks of the long positions cannot exceed the value or the value of risks of the underlying assets to be substituted for. We note that these limits only take into consideration positions at the time of the application and do not take into consideration market circumstances, strategies, or changes in capital positions. When a QFI takes short hedge positions, the total notional value of all equity index futures shorted cannot exceed 1.1 times the sum of the market value of all underlying assets to be hedged against (including underlying indices' constituent stocks, stock ETFs, and stock Listed Open-end Fund ("**LOFs**")). Additionally, turnover of hedging transactions cannot exceed two times the long position / short position hedging quota on a weekly basis. Given the level of volatility in the market in the past 18 months, the foresaid restrictions can prevent QFIs from fully hedging their entire portfolio risk and the prior quota application requirement hinders QFIs' ability to transact immediately or otherwise execute trading or portfolio opportunities as they occur.

Conversely, certain types of PRC domestic investors (e.g., privately offered funds) are able to apply for dedicated trading codes which allow for broader activities, including for arbitrage purposes. *ASIFMA respectfully requests the CSRC to consider easing or even ideally removing the hedging requirement and/or the trading limits for those QFIs to the extent comparable with those PRC domestic investors that are not subject to the hedging requirement.* Long futures can often be held in lieu of single stock positions, specifically, fund managers can utilize these tools for exposure or transition management, holding futures positions until such time as the position is rotated into a stock exposure.

(3) Low Trading Volume in China vs. Comparable Jurisdiction

The percentage of primary benchmark stock index futures trading vs. equities is very limited in China in comparison to other jurisdictions. Given the limited activity in the PRC stock index futures market, doubling, or tripling the volume of futures traded is unlikely to have a major impact on the market or to an increase in on-market volatility.

Per below, the percentage of futures trading vs equities is very limited in China when compared to other regional markets, and given the current size of the activity, doubling, or tripling the volume of futures traded is very unlikely to have a major impact on the market or materially increase on-market volatility.

Figure 5: Primary benchmark index futures as a percentage of total single stock listed equities average daily traded volume (US$) by market in FY20[4]

Market	Futures (% of total market's equities)
China	13.3%
Japan	123.1%
Hong Kong	187.9%
Korea	104.1%
Taiwan	209.1%
Australia	127.1%

Source: Bank of America Securities

ASIFMA's Recommendations: Increase flexibility on hedging quota calculations and diversify derivative product suite (current products limited to CSI300/500 and SSE50 index futures, one index option on CSI300 and three ETF options on CSI300 and SSE50 ETFs) to further expand the portfolio of available hedging instruments onshore. Provide offshore investors without a QFI license, including those under the Stock Connect scheme, access to PRC onshore derivative products. Broaden offshore hedging instruments including HKEX futures products on the MSCI China-A Index. Efficient hedging capabilities critical to attract more global investment.

9 Equity OTC Derivatives as an Important Market Access Product

The provision of market access products as a complement to investment via the cash segment has been the practice for many years. We note Article 10 of QFI Implementing Rules which provides that the CSRC may, based on its regulatory needs, require QFIs to report their offshore hedging positions relevant to their domestic securities and futures investments.

In the case of China, market access products allow global institutional investors who are at an early stage of considering investing in China and seeking a low friction gateway to gain A-share exposure. The experiences gained by such investors can improve their knowledge about the Chinese market and potentially result in them deepening their investments and commitments into China via the QFI channel. It is important to note that market access products constitute an important investing and risk management tool for investors and remains a key part of the

[4] Reference primary benchmark index futures used: CSI 300, OSE Nikkei, OSE TPX, Hang Seng, HSCEI, KOSPI 200, TAIEX, and SPI 200. The table shows the turnover of primary benchmark index futures only, while equity turnover is for all single stocks listed on the exchange – not just the underlying stocks. The turnover of CSI 300 index futures vs the underlying constituent stocks is 60%.

capital markets even in mature international markets, where the hedging activities provide additional market liquidity.

ASIFMA is currently engaged with the CSRC to enhance the reporting regime around OTC derivatives to increase the transparency around these products, including the product types, transaction volumes, and end investors, etc. for the regulator.

ASIFMA's Recommendations: We would welcome CSRC's support for QFI license holders to launch more OTC equity derivatives products, which will support the expansion of global investor activity in the onshore market. ASIFMA appreciates if the CSRC could reconsider relaxing the hedging requirement for the trading of stock index futures to permit QFIs to hedge and expand their provision of OTC derivative products accordingly.

VI. Future Outlook

The pace of market reforms has been accelerating over the past few years, benefiting investors leveraging both the QFI and the Stock Connect channels. The onshore and offshore channels each boast its own unique advantages along with trading/investment frictions which have been highlighted at length above and summarized per below. One path of evolution is for the Chinese regulators to address the friction points and to level the playing field across both channels, eliminating the distinctions and allowing market forces to decide amidst agnostic preferences. Another path of evolution is to maintain or to deepen the differentiation across the channels (Stock Connect as a pilot for new reforms, for example) and to respectively appeal to different classes of investors at different stages of appetite/commitment for China investments. To this end, in addition to QFI and Stock Connect schemes, OTC derivatives may be further cultivated as another form of market access for global investors. These are all important channels to promote capital inflows into China. China's capital markets have been well served by a vibrant ecosystem of independent access channels which has helped foster an ecosystem of increasingly diverse market participants, both offshore and onshore. Ease of access should be coupled with a strong regulatory framework which is principles based to better balance market efficiency with market protection.

The near term has shown great potential for the future growth of China's capital markets. A strong listings regime on the primary market side needs to be underpinned by a robust and vibrant investor community on the secondary market side to help foster better price equilibrium to attract high quality corporate issuers to list on the Exchange. To attract more and more global and institutional investors, the Chinese government has announced and implemented a series of measures at the central and local levels with unprecedented expansion of access for foreign investors and foreign financial institutions. In the China Development Forum 2021, Chairman Yi also mentioned that the regulators will continue to open up the capital markets for foreign investors and will be open and supportive for the relevant business activities and product developments. We have been closely following the new policies and reforms relating to the continuing support for China's stock market, and actively participating in (and encouraging our members to participate in) the policy-making process and reform discussions with China's financial regulators. We look forward to continuing active collaboration with Chinese policy makers on market reforms to the QFI and Stock Connect schemes to maintain the positive regulatory momentum and to continue to attract more global investors to China's capital markets.

Annex I: Summary of the Proposed Refinements

Proposed Refinements for Stock Connect scheme: Shadowed in Green

Proposed Refinements for QFI scheme: Shadowed in Yellow

Proposed Refinements for both schemes: Shadowed in Blue

Items	QFI	Stock Connect	Recommendations
Block Trading	Access to the onshore block trading window, open from 3-3:30 pm. The mechanism is manual in nature.	Not available	• Allow Stock Connect participants to access block trading facility ✓ Phase 1: allow block trading between Stock Connect participants ✓ Phase 2: allow Stock Connect participants to access onshore block trading facility • Extend availability of block trading window to the entire trading day
Expansion of Product Scope	Full Access	Limited Access	Expand the list of eligible securities to include more STAR Board and ChiNext securities, IPO issuances.
Holiday trading	Not applicable	Not available	Allow Northbound investors to trade through Stock Connect when Mainland stock markets are open

Items	QFI	Stock Connect	Recommendations
			✓ Allow northbound trading on H-1 days ✓ Allow northbound trading on H days (HK holidays)
Delivery versus payment ("**DVP**")	Not available. Pre-funding is required; securities is delivered on T0, cash on T+1.	RDVP has been introduced in 2017.	• Allow DVP as well as a move to T+1 or T+2 settlement for both stock and cash • Implement a workable SBL regime • Remove the pre-funding requirement • Allow banks to temporary credit solutions to investors
Multi-broker model	Not available. Investors must sell through the same broker which they purchased through, which in practice has restricted usage to one broker.	Available. No broker restrictions and investors may buy and sell through any participating broker.	Allow QFIs to sell any of their shares through any broker they choose to align with global practices.
Direct Market Access ("**DMA**") and program trading	Available but with uncertainty. Need clarity over how QFI's trading system may connect to broker's platform under the current third-party system connection rule.	Available.	• CSRC to confirm broker-dealers are allowed to offer their QFI clients DMA services via Application Programming Interface ("**API**"). • Early promulgate the *Interim Administrative Provisions on External Interface with Trading Information Systems of Securities Companies* to standardize the provision of API. • Early promulgate the rules on program trading.
Securities borrowing and	Available	Available but subject to strict regulatory restrictions.	For SBL under Stock Connect channel: • Expand the permitted stock lenders and borrowers in the program to the affiliates of exchanges participants, affiliates, or lending agents of the investment managers

Items	QFI	Stock Connect	Recommendations
Lending ("**SBL**")			• Develop the market microstructure around the action of borrowing and lending securities, such as increasing the short selling ratio limit, expanding the use and term of SBL trading, etc. • Ensure transparency and visibility of all market activity in SBL and short selling For SBL under QFI channel: • Exchanges to clarify the application of uptick rule to long share positions
Listed Derivatives Access	• Access to stock index futures for hedging purpose only and hedging quota is a must • Access to listed options and other futures products (e.g., bond futures) pending CSRC's approval upon exchanges' application.	Not available. Foreign investors under Stock Connect scheme may only get access to limited choices of offshore derivatives for risk management.	• Early promulgate the rules on the trading of listed options and other futures products and allowing sufficient flexibility. • Expand the product suite of onshore derivative products. • Ease or remove hedging requirements or quota and trading limits on onshore derivative products. • Grant access to foreign investors under Stock Connect Scheme to onshore derivative products.