THE COMMENCEMENT OF THE SHENZHEN-HONG KONG STOCK CONNECT – A NEW AND DIRECT WAY TO ACCESS CHINA'S CAPITAL MARKET

Date: 18 January 2017

Investment Management Alert

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BACKGROUND

Following the official launch of the Shanghai-Hong Kong Stock Connect ("**Shanghai Connect**") on 17 November 2014, the Hong Kong Securities and Futures Commission ("**SFC**") and the China Securities Regulatory Commission ("**CSRC**") made a joint announcement on 16 August 2016 ("**2016 Joint Announcement**"), to approve, in principle, the establishment of the Shenzhen-Hong Kong Stock Connect ("**Shenzhen Connect**"). Like the Shanghai Connect before it, the Shenzhen Connect aims to strengthen the interconnectivity between the capital markets of the People's Republic of China ("**PRC**" or "**China**") and Hong Kong. The Shenzhen Connect is jointly developed by the Hong Kong Exchanges and Clearing Limited ("**HKEx**"), Shenzhen Stock Exchange ("**SZSE**"), China Securities Depository and Clearing Corporation Limited ("**ChinaClear**"), and Hong Kong Securities Clearing Company Limited ("**HKSCC**").

Four months after the 2016 Joint Announcement, the Shenzhen Connect officially commenced trading on 5 December 2016.

PURPOSE OF THE SHANGHAI CONNECT AND SHENZHEN CONNECT (COLLECTIVELY REFERRED TO AS THE "STOCK CONNECT SCHEME")

A key feature of the Chinese capital markets is that they are restricted to non-PRC investors except in certain, very limited circumstances that are expressly permitted by law. One of these limited circumstances is through the Stock Connect Scheme, which has been developed to serve as a direct link between exchanges in Hong Kong and the PRC.

The primary aim of the Stock Connect Scheme is to enable (i) eligible PRC investors ("**Mainland Investors**") to invest directly in securities listed on The Stock Exchange of Hong Kong Limited ("**SEHK**"), a wholly owned subsidiary of HKEx ("**Southbound Trading**"); and (ii) eligible Hong Kong and non-PRC investors to invest in securities listed on SEHK ("**HK Investors**") to invest directly in securities listed on the Shanghai Stock Exchange ("**SSE**") or SZSE ("**Northbound Trading**").

Under the Stock Connect Scheme, the SEHK, on the one hand, and the SSE and SZSE, on the other hand, have established mutual order-routing connectivity and related technical infrastructure to enable the investors of their respective markets to invest directly in designated securities listed in the other's markets.

HKSCC and ChinaClear are responsible for the clearing, settlement and provision of depository, nominee, and other related services for the trades executed by their respective market participants and investors under the Stock Connect Scheme.

SZSE AND ITS LISTED STOCKS

To date, the SZSE is the world's seventh-largest stock exchange in terms of market capitalization (overtaking HKEx in eighth place) and one of the world's most active markets this year, eclipsing even the SSE, HKEx, and NASDAQ during several months in 2016. Its unique feature is its focus on small- and mid-cap "growth stocks" in fast-growing sectors such as information technology, consumer cyclicals, and healthcare ("**Growth Sector Stocks**") (in contrast to the SSE, which is dominated by relatively large-cap enterprises and has a strong focus on finance and industrial sectors).

According to the information published on the HKEx website on 2 December 2016, i.e. the last trading day prior to the commencement of the Shenzhen Connect, the total market turnover of the SZSE, even before the implementation of the Shenzhen Connect, already surpassed that of the SEHK and SSE:

	SEHK		**SSE**		**SZSE**	
	Main Board	**Growth Enter-prise Market**	**A Shares**	**B Shares**	**A Shares**	**B Shares**
Number of listed companies	1,707	252	1,155	52	1,837	49
Total market capitalization (billion HK dollars or RMB)	HKD 25,030	HKD 297	RMB 29,380	RMB 109	RMB 23,220	RMB 88
Total turnover (million HK dollars or RMB)	HKD 80,872	HKD 497	RMB 282,761	RMB 206	RMB 317,245	RMB 159

The Shenzhen Connect, by providing HK Investors with access to virtually all of the stocks listed on the SZSE, will enable them to diversify their investment portfolio in mainland China to include Growth Sector Stocks.

KEY FEATURES OF THE SHENZHEN CONNECT

As expected, the operational mechanism and regulatory framework of the Shenzhen Connect are very similar to those of the Shanghai Connect. However, there are certain requirements, summarized below, that pertain only to the Shenzhen Connect.

Eligible Stocks Under the Shenzhen Connect

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1. Northbound Trading Under the Shenzhen Connect

At the initial stage of the Shenzhen Connect, the A Shares listed on the SZSE eligible for Northbound Trading by HK Investors under the Shenzhen Connect ("**Eligible SZSE Securities**") include:

> a. A Shares that (i) are constituent stocks from time to time of the SZSE Component Index and SZSE Small/Mid Cap Innovation Index ("**SZSE Constituent Stocks**") and (ii) have a market capitalization of RMB 6 billion or above; and b. A Shares that are not SZSE Constituent Stocks but have corresponding H Shares listed on the SEHK.

> Like the Shanghai Connect, Eligible SZSE Securities must also be traded in Renminbi and not be under a "risk alert" pursuant to the SZSE Listing Rules or under any delisting arrangement.

2. Southbound Trading Under the Shenzhen Connect

Mainland Investors may invest in the following securities on SEHK under the Shenzhen Connect ("**Eligible SEHK Securities**"):

> a. All eligible securities listed on the SEHK that are currently available for investment by Mainland Investors under the Shanghai Connect[1]; b. Constituent stocks of the Hang Seng Composite SmallCap Index that have a market capitalization of not less than HKD 5 billion; and c. H Shares of SEHK-listed companies that have A Shares listed on the SZSE.

However, like the Shanghai Connect, the following SEHK-listed securities are excluded from the definition of Eligible SEHK Securities:

> a. SEHK-listed securities that are not traded in Hong Kong dollars; b. H Shares with corresponding A Shares listed and traded on exchanges in the PRC other than the SSE or SZSE[2]; and c. H Shares with corresponding A Shares put under a "risk alert" or under any delisting arrangement.

Eligible Investors for the Shenzhen Connect

Qualifications to engage in the Shenzhen Connect are generally the same as those for the Shanghai Connect. In respect of Southbound Trading for Mainland Investors, Mainland Investors are required to be either (i) institutional investors[3], or (ii) individual investors with an aggregate balance of not less than RMB 500,000 in their securities and cash accounts). In respect of Northbound Trading, there is no cash/securities holding requirement for HK Investors, and, so long as an investor meets the basic eligibility requirements for having a valid securities trading account in Hong Kong with a Hong Kong broker-dealer willing to act on that investor's behalf, that investor is qualified to engage in Northbound Trading.

However, access to ChiNext stocks, a NASDAQ-style board of the SZSE, is restricted to institutional professional investors in the initial launch of the Shenzhen Connect, mainly to protect HK Investors from injecting capital into ChiNext stocks without understanding their underlying risks and volatility. It is hoped that this restriction on access to ChiNext stocks may be lifted eventually, but this depends on the resolution of related legal and regulatory issues.

UPDATES TO THE SHANGHAI CONNECT AND RULES APPLICABLE TO THE STOCK CONNECT SCHEME AS A WHOLE

At the same time, the regulators also took the opportunity to update and amend the rules of the Shanghai Connect to take account of events and issues since the Shanghai Connect's launch and to make the rules of the Shanghai Connect and Shenzhen Connect consistent with each other.

Trading Quota

An aggregate trading quota of RMB 300 billion for Northbound Trading and RMB 250 billion for Southbound Trading was imposed on the Shanghai Connect when it was launched. After almost two years of operations, the SFC and the CSRC announced the abolition of this aggregate trading quota in the 2016 Joint Announcement. Following the Shanghai Connect, the Shenzhen Connect is not subject to any aggregate trading quota.

However, for market stabilization reasons, the daily trading quota remains in effect. On the Shenzhen Connect, for Northbound Trading, HK Investors are subject to a daily trading quota of RMB 13 billion and for Southbound Trading, Mainland Investors are subject to a daily trading quota of RMB 10.5 billion. The Shanghai Connect is also subject to a similar daily trading quota of an identical amount. As such, the aggregate daily trading quotas for the Northbound Trading and Southbound Trading under the Stock Connect Scheme are RMB 26 billion and RMB 23 billion, respectively.

Exchange-Traded Funds ("ETFs")
The SFC and the CSRC stated in the 2016 Joint Announcement that they have reached a consensus to include ETFs as eligible stocks under the Stock Connect Scheme in the future and that the official launch date will be

announced by the authorities in due course. At present, however, there are no such provisions for trading on ETFs under the Stock Connect Scheme.

FIRST MONTH PERFORMANCE OF THE SHENZHEN CONNECT

On the first day of trading on the Shenzhen Connect on 5 December 2016, only 20.53% of the Northbound Trading daily quota and 8.38% of the Southbound Trading daily quota were utilized. These figures are far below the amount invested on the debut of the Shanghai Connect in November 2014. Since then, the utilization of the daily quota for both the Northbound Trading and Southbound Trading of the Shenzhen Connect has dropped even more - as of 4 January 2017, one month after the commencement of the Shenzhen Connect, the utilization of the daily quota for the Northbound Trading and Southbound Trading was only 4.49% and 2.15%, respectively.

While the market's underwhelming reaction to the Shenzhen Connect appears at odds with the regulators' build up to the Shenzhen Connect and the market hype surrounding it, it is understandable in light of the fact that the Shenzhen Connect is launching at a time of global and political change and uncertainty, a stark contrast to the market two years ago when the Shanghai Connect was launched.

CONCLUSION

Despite the muted response, however, to the Stock Connect Scheme as a whole, both the Shanghai Connect and Shenzhen Connect are major breakthroughs in that they allow direct primary access to the Shanghai and Shenzhen stock markets, which broadens the investor base for issuers on those exchanges, in a way that the RQFII and QFII programmes were unable to do. And while equities are the only securities currently permitted to be traded on the Shenzhen Connect, it is not a stretch to imagine that ETFs, bonds, and other more esoteric securities may be included in the not-too-distant future. In this respect, it makes sense for investors with a serious, long-term view of Asia and, in particular, the PRC, to ensure they are conversant and compliant with the requirements of the new Shenzhen Connect and not to take or granted that because they have traded on the Shanghai Connect previously they may automatically trade on the Shenzhen Connect without more analysis. More specifically, fund managers should, before investing through the Shenzhen Connect, review and ensure the adequacy of disclosures in their offering documents, particularly for disclosures on Growth Sector Stocks exposures, liquidity, and other related risk disclosures, given the volatile and reactive nature of the SZSE market.

Notes:

[1] Under the Shanghai Connect, Mainland Investors are able to trade selective securities listed on the SEHK, including (i) all the constituent stocks of the Hang Seng Composite LargeCap index and Hang Seng Composite Midcap Index, and (ii) all the H shares that are not included as constituent stocks of the relevant indices but that have corresponding shares in the form of A Shares listed in SSE. However, the following securities listed on the SEHK are excluded: (i) shares listed on SEHK that are not traded in Hong Kong dollars; (ii) H Shares with corresponding shares listed in any China exchanges other than the SSE; and (iii) H Shares with corresponding A Shares under "risk alert".

[2] A distinction between the Shanghai Connect and Shenzhen Connect regarding this exception is that, under the Shanghai Connect, any H Shares with corresponding A Shares listed and traded on exchanges in the PRC other than the SSE are excluded. For example, if an A Share is listed on the SZSE, its corresponding H Share is excluded as eligible security for Southbound Trading under the Shanghai Connect. However, for the Shenzhen Connect, this limitation has been modified so that only those A Shares listed and traded on exchanges in the PRC (other than the SSE or SZSE) are excluded. For now, this exception is not applicable since the only exchanges in the PRC at the moment are the SSE and SZSE.

[3] There has been no legal or regulatory definition by the regulators for the term "institutional investors" so it would be considered to have the general market definition of institutional investors.