**MEMO# 30206**

September 6, 2016

# Shenzhen-Hong Kong Stock Connect

[30206]

September 5, 2016

TO: INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 23-16
INTERNATIONAL OPERATIONS WORKING GROUP
ICI GLOBAL REGULATED FUNDS COMMITTEE No. 59-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 39-16
ICI GLOBAL ASIA-PACIFIC CHAPTER No. 4-16 RE: SHENZHEN-HONG KONG STOCK CONNECT

On 16 August 2016, the Chinese government gave the green light to the long-awaited Shenzhen-Hong Kong Stock Connect (herein referred to as the "Shenzhen Connect"). The official launch date is expected around December 2016.

The Shenzhen Connect is the second cross-border stock trading arrangement between the Mainland China and Hong Kong, allowing investors on both sides to trade and settle shares in their local markets via their local exchanges. The first cross-border stock trading link, called the Shanghai-Hong Kong Stock Connect (herein referred to as the "Shanghai Connect") was launched in November 2014. With both Shenzhen and Shanghai markets open, the vast majority of A shares traded in the Chinese stock market are now available to investors outside China.

In this memo, we will summarize the key features of the Shenzhen Connect and highlight the opportunities it offers and the areas for further improvement.

### Key Features of the Shenzhen Connect [1]

The Shenzhen Connect will follow existing laws and regulations and operating models governing trading and clearing in the Shenzhen and Hong Kong markets.

1. Investment Quota

Under the Shanghai Connect, the trading has been subject to both an aggregate quota (till 16 August 2016) and a daily quota. The northbound aggregate quota was set at RMB 300 billion (US$ 46 billion) while the southbound aggregate quota was RMB 250 billion (US$ 38 billion). As for the daily quota, the northbound transactions are entitled to RMB 13 billion (US $2.1 billion) and the southbound transactions are entitled to RMB 10.5 billion (US $1.71 billion).

Similar to the Shanghai Connect, the Shenzhen Connect will be subject to a daily quota of

RMB 13 billion (US $2.1 billion) on northbound transactions and RMB 10.5 billion (US $1.71 billion) on southbound transactions. However, no aggregate trading quota applies to the Shenzhen Connect. The aggregate trading quota under the Shanghai Connect has been abolished with effect from 16 August 2016. The elimination of the aggregate trading quota means that investors in Mainland China and Hong Kong can invest into each other's markets without fears of quota restriction.

The daily quotas are calculated on a netting basis at the end of each trading day. Since the launch of the Shanghai Connect in November 2014, the average daily quota usage rate for the northbound trade has been around 5% and the southbound trade has been around 7%, meaning the current daily quota is sufficient to meet the investment needs of both Mainland, Hong Kong, and international investors.

## 2. Eligible Stocks

For the Northbound Shenzhen Trading Link, eligible shares refer to:

- any constituent stock of the Shenzhen Stock Exchange ("SZSE") Component Index and SZSE Small/Mid Cap Innovation Index which has a market capitalization of RMB 6 billion or above; and
- all SZSE-listed shares of companies which have issued both A shares and H shares.

For the Southbound Hong Kong Trading Link, eligible shares refer to:

- the constituent stocks of the Hang Seng Composite LargeCap index, and Hang Seng Composite MidCap Index;
- any constituent stock of the Hang Seng Composite SmallCap Index which has a market capitalisation of HK$5 billion or above; and
- all HKEx-listed shares of companies which have issued both A shares and H shares.

There are currently 1,790 companies listed on the Shenzhen Stock Exchange and the Exchange consists of three boards: the Main Board, the Small and Medium Enterprise (SME) Board, and the ChiNext Board. The Main Board was set up in 1990 and it is primarily comprised of large companies. The SME Board was established in May 2004 and hosts small and medium size companies. Finally, the ChiNext Board was launched in October 2009 and it primarily targets innovative growth enterprises with profitability.

The northbound trading link under the Shenzhen Connect will cover around 880 stocks, of which around 270 will come from the Main board, around 410 from the SME board and around 200 from the ChiNext Board.

In terms of product offerings, the existing Shanghai Connect only covers selected stocks in the Shanghai and Hong Kong stock markets. Now with the blessing of Shenzhen Connect, exchange-traded funds (ETFs) will also be included as eligible securities both for the Shenzhen and Shanghai Connect.

3. Eligible Participants

Northbound trading

All individual and institutional investors will be eligible to trade shares under the Northbound link, except for shares listed on the ChiNext Board. In the initial stage, only institutional professional investors as defined by Hong Kong's rules and regulations (i.e. individuals who, either alone or with their spouse or children on a joint account, have a portfolio of at least HK$8 million or its foreign currency equivalent) will be allowed to trade shares listed on the ChiNext Board.

Southbound trading

Similar to the Shanghai Connect, all Mainland institutional investors (including the mutual funds) and individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts will be eligible to trade shares under the Southbound link.

## Additional Opportunities Offered by the Launch of the Shenzhen Connect

As of July 2016, the Shenzhen stock exchange is the 7th largest in the world in terms of market capitalization, while the Shanghai stock exchange ranked 4th in the world. [2] The composition of stocks listed on the Shanghai and Shenzhen stock exchanges are quite different, giving investors more choices when accessing the China stock markets.

The Shanghai stock market is dominated by large state-owned enterprises and financial companies. The biggest sector consists of heavy industrial companies such as coal miners while the second biggest segment is made up of financial companies.

In contrast, the Shenzhen stock market features many smaller, younger, and privately-owned companies. Shenzhen is the listing venue of choice for technology-focused private sector enterprises serving China's fast-growing consumer market. As of August 2016, nearly one-fifth of the companies listed on the Shenzhen Stock Exchange are technology companies (compared with 4% of the Shanghai market). With the exception of technology giants like Tencent, only few technology companies have offshore listings.

Another noticeable difference between the eligible investments under the two stock connect schemes is that companies listed on the Shanghai Stock Exchange are mainly "large cap" state-owned enterprises that are already listed on the Hong Kong Stock Exchange. Whereas companies listed on the Shenzhen Stock Exchange are mainly companies with smaller market capitalisation from the high tech sector or start-up type companies and have not been listed in Hong Kong before.

## Areas for further improvement

The Shenzhen Connect is another major step towards the internationalization of China's capital market. Together with the eligible stocks under the Shanghai Connect, foreign investors can now access the vast majority of A shares traded in China.

When the Shanghai Connect was launched in November 2014, the foreign investors participation rate in the scheme was very low due to operational hurdles, such as differences in pre-trade checking requirements in the Hong Kong and Shanghai stock markets, and lack of clarities over the beneficiary ownership of shares. Through continuous dialogues and collaboration between the Hong Kong and Shanghai stock exchanges, regulatory authorities, and market participants, the ambiguities regarding these outstanding issues have largely been resolved.

While the details of the Shenzhen Connect have been announced, ICI Global believes that there are several areas where the regulators can focus on to further improve the scheme and make it more attractive to investors. First, under the current rules and regulations of the Shenzhen Connect, retail investors in Hong Kong cannot participate in the trading of the

ChiNext Board. As mentioned earlier, the ChiNext Board is a startup board with a number of small cap companies that are higher in risk and volatility. Hence, they are subject to higher fluctuation in stock prices and liquidity and have higher risks and turnover ratios. In China, the regulators have set restrictions regarding the trading of shares in the ChiNext Board. For example, Mainland investors who want to participate in ChiNext must sign a risk disclosure statement. For now, there is no such investor protection system in Hong Kong, so retail investors who are interested in ChiNext stocks can only trade them via institutions. We hope the Hong Kong regulator will introduce suitable risk warning procedures to allow retail investors to know the risks associated with trading in ChiNext stocks. This will pave way for the eventual opening up of the ChiNext Board to retail investors, thus allowing both retail and institutional investors to have full accessibility into the Shenzhen stock market.

Second, the expansion of ETFs to both the Shanghai and Shenzhen Connect schemes is very encouraging. We hope to see more products and features added to both the Connect schemes to further broaden investor choices and access into the China financial market. In fact, Mr. Charles Li, Chief Executives of the Hong Kong Exchanges and Clearing Limited, has said that the current Stock Connect model is scalable and can be replicated and extended to other asset classes, including derivatives, commodities, and currencies. We hope that the Mainland regulators will eventually open up more Connect schemes (such as Bond Connect and Futures Connect) to provide more opportunities to foreign investors. This will bring the China financial market one step closer to full liberalization.

Lastly, with three exchanges and clearing houses participating in the Shanghai and Shenzhen Connect schemes, we encourage the regulators to be mindful of the differences such as trading and settlement arrangements, short-selling mechanism, investors characteristics, etc. This will ensure the smooth operation of the cross border trading schemes and investors can reap the benefits from the additional investment opportunities and convenience that the schemes can offer when accessing the China stock markets.

ICI Global welcomes the joint announcement by the Mainland and Hong Kong regulators on the launch of the Shenzhen Connect. Meanwhile, we will continue to monitor the development of the Shenzhen Connect, and we will work closely with the regulators on both sides to share our views on the implementation as the new scheme gets underway.

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**endnotes**

[1] Refer to the "Joint Announcement of the China Securities Regulatory Commission and the Securities and Futures Commission, 16 August 2016" for the full details of the Shenzhen Connect.
http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=16PR80

[2]
http://www.wsj.com/articles/5-things-on-the-shenzhen-hong-kong-stock-connect-plan-1471346243

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