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Briefing note 17 November 2014

Shanghai-Hong Kong Stock Connect: China opens the way for global investors in Chinese equity

Today marks a significant milestone in the internationalisation of the Renminbi ("**RMB**") and the liberalisation of the Chinese financial markets. The launch of the Shanghai-Hong Kong Stock Connect programme ("**Stock Connect**") on 17 November 2014 is the culmination of over 7 months of preparatory work by regulators, exchanges, broker-dealers and investors after the joint announcement made on 10 April 2014 by the China Securities Regulatory Commission ("**CSRC**") and the Hong Kong Securities and Futures Commission ("**SFC**").

The establishment of mutual market access between the Shanghai Stock Exchange ("**SSE**") and The Stock Exchange of Hong Kong ("**SEHK**") represents the first time that two stock exchanges have linked up in this manner. The Stock Connect programme provides a number of unique opportunities and challenges for market participants, and Clifford Chance has been fortunate to have the opportunity to work with the Asia Securities Industry & Financial Markets Association and many market participants on this project. This client briefing sets out some of our key observations and insights from our work on Stock Connect.

Background

"*This is something that has never been tried before*" – Charles Li, Chief Executive of SEHK

The Stock Connect Programme was first conceptualised by the government of the People's Republic of China ("**PRC**") as a method for opening up the Mainland capital market and to reinforce Shanghai and Hong Kong's position as international financial centres.

For the first time, Hong Kong and international investors are able directly to trade eligible shares listed on the SSE (referred to as "A shares") through SEHK ("**Northbound trading**") without the need to obtain regulatory approval from any PRC authorities. Similarly, eligible PRC investors are able directly to trade eligible shares listed on the SEHK through SSE. In this briefing, we will focus on Northbound trading.

"There has been a very high degree of commitment on the part of the Shanghai and Hong Kong exchanges and the regulators, brokers and international investor community to achieve the launch of Stock Connect within seven months and to address the legal, operational and regulatory complexity of the link arrangements. This reflects the belief on all sides in the opportunity Stock Connect represents for the Chinese financial markets and for global investors."

- Francis Edwards, Partner

Crucially, Stock Connect is designed to maintain the current market structure such that for Northbound trading, orders will be placed with SEHK and trades will be cleared through the Hong Kong Central Clearing and Settlement System ("**CCASS**"). In other words, market participants will not face the SSE or the China Securities Depository and Clearing Corporation ("**CSDCC**") directly[1].

However, market participants will need to familiarise themselves with the laws and regulations of both Hong Kong and the PRC (as well as the new SEHK and CCASS rules), all of which will apply to Northbound trading.

Opportunities

"*This is a game changer for China*" – Mark Austen, Chief Executive Officer of ASIFMA

The launch of Northbound trading under Stock Connect represents tremendous opportunities for all stakeholders in this project:

1. *Investors*: From 17 November 2014, Hong Kong and international investors will have access to 568 eligible shares on SSE representing more than USD2 trillion of market capitalisation on SSE. The fact that the SSE Composite Index has risen nearly 15% since the announcement of the Stock Connect programme in April (and rose over 2% on the first trading day after announcement of the launch date) is indicative of the level of investor interest;
2. *Broker-dealers*: Brokers have done a large amount of work to resolve the operational challenges of providing trading services for SSE shares traded through Stock Connect and are now in a position to provide services to their clients in Hong Kong, Europe and the US. Some of the operational hurdles have included addressing the pre-trade checking requirement and the T+1 settlement cycle, managing the quota arrangements, restrictions on off-exchange transfers and addressing PRC regulatory issues, such as disclosure of interests. In addition, brokers will be looking to provide clients with derivatives and structured products linked to Stock Connect shares.

"Adding Stock Connect to the QFII/RQFII tools available for accessing the A Share market is an incredibly important development towards the liberalisation of RMB. Further enhancements and solutions are still required for the programme to fire on all cylinders. We also now look forward to China mutual recognition going back on the agenda!"

- Mark Shipman, Partner

[1] A diagram setting out the structure of Stock Connect can be found in the Annex to this Client Briefing

3. *Hong Kong*: The successful launch of Stock Connect will reinforce Hong Kong's position as the most important offshore RMB centre and strengthen its position as the access point to the PRC financial markets. The programme could be expanded in future to include A shares traded on other Chinese stock exchanges, and the potential expansion to asset classes such as commodities may allow the Hong Kong Exchange and Clearing Limited (which acquired the London Metal Exchange recently) to challenge Singapore's status as the commodity hub in Asia.
4. *Mainland China:* The successful launch of Stock Connect signifies one further step in opening up China's financial markets and is an important development in the internationalisation of the RMB.

Challenges

"*We will not be in a position to offer solutions for all concerns at the time of launch. After launch, we will continue to allocate resources to explore solutions*." – Scott Sapp, HKEx spokesperson

The regulators, exchanges and market participants have worked tirelessly on the Stock Connect project to resolve the legal, regulatory, operational and technical issues arising from the establishment of a trading link between two different exchanges belonging to two different legal and regulatory systems.

"The ease by which investors will be able to trade through Stock Connect masks the enormous complexity of the underlying legal and operational infrastructure."

- Matt Feldmann, Partner

While the issues were often complex and difficult to resolve, the stakeholders in this project have worked together closely to address the vast majority of these challenges. An example of this is the circular of Caishui [2014] No.81 jointly issued by the PRC Ministry of Finance, the State Administration of Taxation and CSRC announcement on 14 November 2014, which relates to the application of PRC tax rules to trading through Stock Connect. Under this circular (which is effective from 17 November 2014), certain PRC taxes (such as enterprise income tax, individual income tax and business tax) will be temporarily exempted on capital gains derived from Northbound trading of A shares.

However, it is important to note that certain questions still remain. For example:

1. *Ownership of SSE shares*: Under the Northbound trading link of Stock Connect, all SSE shares are registered in the name of the Hong Kong Securities Clearing Company Limited ("**HKSCC**") in an omnibus securities account opened by HKSCC with CSDCC. Although the relevant Stock Connect rules of CSRC give comfort that it is the intention of the PRC regulatory authorities to recognise the ownership interest of investors in SSE shares acquired through Northbound trading, these rules are high-level and may not give market participants full comfort and clarity on this point. In particular, the lack of a clear definition for, and distinction between, "legal ownership" and "beneficial ownership" under PRC law means that there is a fundamental difference between how end investors' ownership interests are recognised under PRC law compared with Hong Kong law. As a result, there remains some residual uncertainty about the nature and rights of a Stock Connect investor in SSE Shares, and enforcement of the interests of Northbound investors under PRC law is not free from doubt;

2. *PRC regulations*: For many investors seeking exposure to PRC equity, Northbound trading through Stock Connect will be their first experience in dealing with PRC share trading laws. In particular, market participants have spent significant time analysing the implications of the forced-sale procedures in the SEHK and CCASS rules, which were included to address any potential breach of foreign ownership limits under PRC regulations, and may involve mandatory liquidation of Stock Connect shares held by end investors.

   Another example is the application of the short swing profit rule to Northbound trading under the Stock Connect programme. This rule, which requires investors holding above 5% of a PRC listed company to disgorge any profits made from trading shares in such company within a 6 month period, will apply to Northbound investors. Northbound investors will also need to comply with the PRC disclosure of interests regime;
3. *Regulatory enforcement*: While the CSRC and the SFC signed a memorandum of understanding ("**MOU**") on 17 October 2014 to strengthen enforcement cooperation for the purposes of Stock Connect, there remains uncertainty as to how this will work in practice; and
4. *Stock lending, margin financing and short selling*: While market participants have pushed for the ability to conduct stock lending, margin financing and short selling in relation to A shares acquired under Stock Connect, there have been difficult discussions between the regulators and exchanges on this subject. At the moment, the rules in place for conducting stock lending and margin financing are quite restrictive, with rules for covered short selling to be published sometime after the launch of Stock Connect. Unless these rules are relaxed in the near future, the restrictions may hamper the development of products and services related to the Stock Connect programme.

Implications for QFII and RQFII regimes

"*CSRC chairman Xiao Gang said…that the [Stock Connect] through train scheme will have a "substitution effect" on the existing QFII programme*" – The South China Morning Post

When the Qualified Foreign Institutional Investor ("**QFII**") and RMB Qualified Foreign Institutional Investor ("**RQFII**") regimes were first introduced, they were the only route through which international investors could acquire shares and other investments onshore in the PRC.

With the launch of the Stock Connect programme, it has been predicted by certain segments of the market that the QFII/RQFII schemes may become redundant over time. While it is true that the QFII/RQFII regimes will no longer have a "monopoly" on investments into A shares, reports of their demise may be greatly exaggerated.

There are several crucial differences between Stock Connect and QFII/RQFII which suggests that these programmes can co-exist as methods for investors to access the PRC markets:

1. *Eligible investors*: For Northbound trading under Stock Connect, all Hong Kong and overseas investors (including individuals, as well as investors such as overseas hedge funds which are currently discouraged from the QFII/RQFII regimes) will be allowed to trade SSE shares. Under the QFII/RQFII regimes, qualified institutions that are licensed by PRC regulatory authorities are allowed to trade PRC securities;
2. *Investment scope*: Under Stock Connect, only eligible shares listed on SSE can be traded. Under QFII/RQFII, various product types (including equities, bonds and exchange-traded funds) are available for investment;

3. *Quotas*: For Northbound trading under Stock Connect, an aggregate quota of RMB300 billion and a daily quota of RMB13 billion will be imposed. These quotas are applied market-wide so investors are at risk that their trades may not be executed if the quotas have been exhausted. Under QFII/RQFII, the investment quota is reserved for the quota holder and an investor can be certain to acquire additional investments in the PRC as long as there is sufficient quota remaining; and
4. *Repatriation*: Under Stock Connect, proceeds from the disposal of shares under Northbound trading must be repatriated. Under QFII/RQFII, proceeds from the disposal of investments may be retained onshore in the PRC.

"*Stock Connect is an important step in the RMB internationalisation process and is intended to be a repeatable model.*"

- TieCheng Yang, Partner

Looking ahead

"*If the scheme is expanded to Shenzhen Stock Exchange as many banks anticipate, China's combined exchanges would form the biggest stock market in the world outside of the U.S.*" – The Wall Street Journal

One of the key messages in the SEHK Information Book for Market Participants is that Stock Connect is a pilot programme that has been designed to ensure "sustainability and scalability of the model for further expansion to other markets and/or asset classes".

There is anticipation in the market that the daily and aggregate quotas on Northbound trading will be gradually increased over time as the regulators gain comfort with the stability of the programme.

Furthermore, the SEHK and CCASS rules clearly anticipate the expansion of the Stock Connect model to other exchanges in the PRC (such as the Shenzhen Stock Exchange).

Market participants have also speculated about the possibility of establishing a trading link for fixed income and commodity investments, as well as the potential for SSE (and other PRC exchanges) to connect with exchanges in other cities (such as London or Singapore).

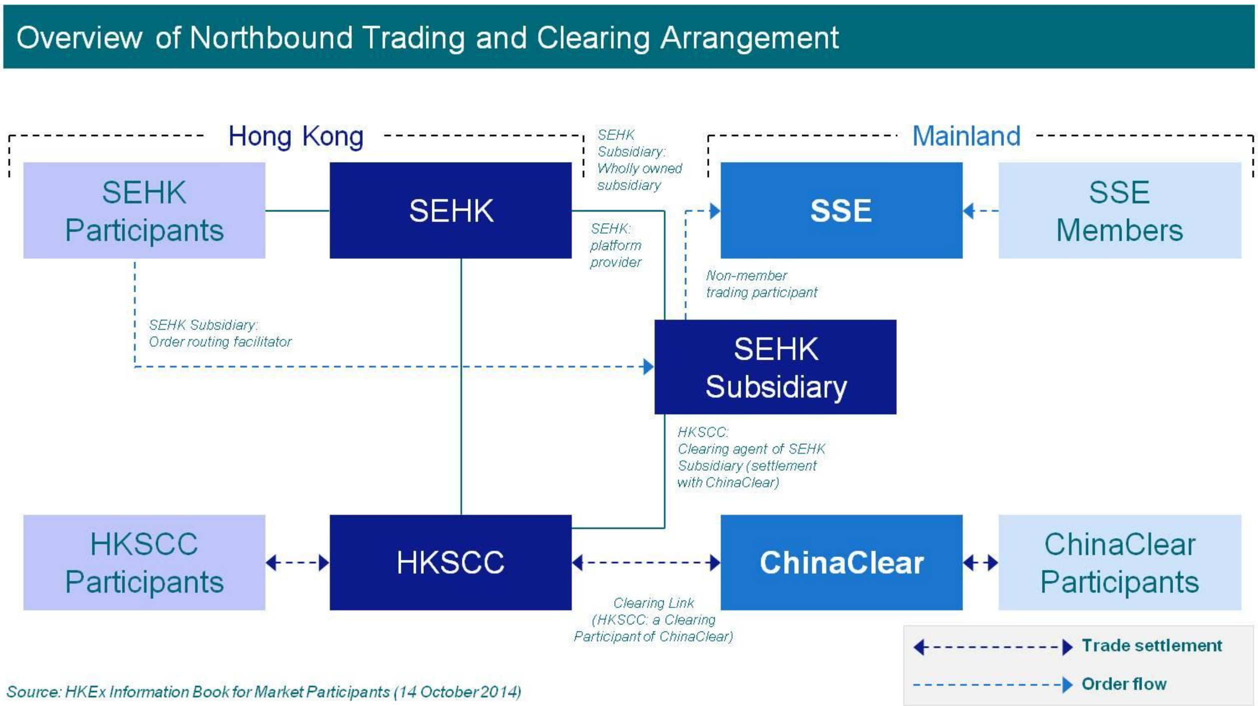
Conclusion

"*Trading through the Shanghai-Hong Kong Stock Connect will commence on 17 November 2014.*" – Joint Announcement of CSRC and SFC

Undoubtedly, the complexity and novelty of the Stock Connect programme will result in some teething problems for both regulators and market participants. However, it is widely recognised that the launch of this trading link on 17 November 2014 marks a historic moment in the liberalisation of the PRC financial markets and provides unique opportunities for investors globally.

Clifford Chance looks forward to continuing work with market participants, industry groups and regulators to iron out any residual issues and ensure the success of the Stock Connect programme.

Annex



Source: HKEx Information Book for Market Participants (14 October 2014)

Contact us

Francis Edwards
Partner, Hong Kong

T +852 2826 3453

E Francis.Edwards@cliffordchance.com

Matthias Feldmann
Partner, Hong Kong

T +852 2825 8859

E Matthias.Feldmann@cliffordchance.com

Helen Fok
Consultant, Hong Kong

T +852 2825 8934

E Helen.Fok@cliffordchance.com

Hilda Loong
Senior Associate, Hong Kong

T +852 2826 3493

E Hilda.Loong@cliffordchance.com

Viola Lui
Senior Associate, Hong Kong

T +852 2825 8842

E Viola.Lui@cliffordchance.com

Mark Shipman
Partner, Hong Kong

T +852 2825 8992

E Mark.Shipman@cliffordchance.com

Yang TieCheng
Partner, Beijing

T +86 10 6535 2265

E Tiecheng.Yang@cliffordchance.com

Terry Yang
Senior Associate, Hong Kong

T +852 2825 8863

E Terry.Yang@cliffordchance.com

Yin Ge
Senior Associate, Shanghai

T +86 212320 7202

E Yin.Ge@cliffordchance.com

Clifford Chance, 27th Floor, Jardine House, One Connaught Place, Hong Kong

Clifford Chance

www.cliffordchance.com

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*Linda Widyati & Partners in association with Clifford Chance.