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Shanghai – Hong Kong Stock Connect Pilot Scheme

Are you ready for the challenges?

Global Financial Services Industry

The through train is coming, …are you ready?

In April 2014 at the Asian Economic Forum in Boao, Premier Li Keqiang announced the launch of the Shanghai – HK Stock Connect Pilot scheme. The scheme is proposed to be launched in October 2014 (subject to final confirmation), six months from when it was announced.

It is worth noting that this so called "Through Train" stock trading initiative was proposed seven years ago but was put on hold for a number of reasons. Subsequently, the Chinese regulators allowed domestic investors limited access to the offshore equities markets by creating the Qualified Domestic Institutional Investor Scheme (QDII) – only eligible investment managers can invest internationally but not retail clients. The rationale was to have better control over capital flows, by restricting access to regulated investment managers. Ultimately, the logic being applied was that retail investors will be better protected with their transactions conducted through the larger and qualified financial institutions. Foreign investors are currently only allowed to invest in mainland listed stocks via either the Qualified Foreign Institutional Investor (QFII) or the Renmimbi Qualified Foreign Institutional Investor (RQFII) schemes. Additionally these channels are only available to larger foreign institutional investors who meet the qualification criteria and does not provide allow direct access to retail clients.

The Shanghai – HK Stock Connect Pilot scheme finally opens market access to any investor with minimum account balances RMB/RMB 500,000. The Shanghai – Hong Kong Stock Connect Pilot will now allow Mainland investors to buy stocks in eligible companies listed in Hong Kong, and correspondingly allow Hong Kong Investors to buy stocks in companies listed in Shanghai.

With the tight timeframes from the announcement and the launch date, many market participants have been focused on understanding and overcoming the challenges to prepare for the new scheme and to confirm readiness the exchanges, especially in the context of managing the different types of risks and briefing all clients about the implication of participating in the scheme.

Some of the critical areas that need to be considered include:

Trading – Order execution

Two industry wide connectivity tests with the Hong Kong Stock Exchange have been scheduled for August and September. Stockbrokers hoping to be in the first round of entrants need to enhance internal systems to cater for the different trading rules, create new stock codes to separate holdings and establish internal controls and procedures to perform the pre-trading checks as required by the Shanghai Stock Exchange

Short selling and stock borrowing

These are currently permitted domestically in both Hong Kong and Shanghai markets. However, Hong Kong investors going Northbound will not be allowed to undertake naked short selling and will not be allowed to participate in mainland regulated margin trading and securities lending programs.

Block trades

Hong Kong investors will also be forbidden to carry out block trading on the mainland.

Holiday and typhoon procedures

We have observed that there are new rules and procedures for trading under both holiday and typhoon sessions going Northbound. Under these situations Hong Kong will be closed but the Shanghai exchange will continue to open for trading. We recommend our clients pay close attention to this subject and ensure that procedures are in place and clients are fully aware of the impact. (Considerations – have business requirements been assessed and written? Have all systems been enhanced? Have internal UATs been completed?)

Pre trading rules and checks

Prior to any buy order placement, the broker will need to confirm that the client account has the required amount of RMB. Otherwise, the broker will need to confirm that shares are available in the client account prior to any sell order placement. Whilst common in the stock exchanges in Shanghai and Taipei, it is not the current requirement in the Hong Kong market. Participants will need to ensure that internal risk management, credit and settlement systems can cope with the new requirements before they can consider going live. For Hong Kong investors, the scheme prohibits short selling and intraday turnaround trades

Ownership

The scheme states that all stocks will be held in an omnibus account at CCASS under the account of the HKEx clearing entity. The use of the proposed nominee structure is not unusual in developed markets but such structure does not exist under the Chinese law as all stock holdings in China are held at the investor level. HKEx has stated that they do not and will not have any ownership over the shares but until the Shanghai depository "Chinaclear" updates the existing rules the ownership of shares will still remain ambiguous to investors.

Settlement

there are differences in the settlement structures and settlement cycles between Shanghai and Hong Kong. The main difference is that Chinese stocks settle and transfer on trade date with the money settlement occurring on T + 1. This means it is not a delivery versus payment structure and clients will have a credit exposure to the broker for one day until the final settlement. Brokers and their clients will need to accept this model and establish credit limits to monitor the one-day difference. There may be various workarounds between the clients and brokers but these are not currently clear and any structure will create risk, operational challenges and additional costs.

Reports

There will be four New CCASS reports – 1) Quarterly Interest Report for Mainland Settlement Deposit and Mainland Security Deposit, 2) CRMGF01 Mainland Security Deposit Payable Report , 3) CRMSD01 Mainland Settlement Deposit Payable Report and 4) CCDPC01 Monthly Portfolio Fee Collection Report – it is critical for all CCASS participants to understand and familiarise themselves with these reports prior to go-live.

Fungibility of shares

Another important issue for investors is that shares purchased via the Shanghai – Hong Kong Stock Connect program are not fungible with shares bought onshore via QFII and RQFII vehicles. Therefore shares cannot be comingled and it is expected that different code / symbols are required to enable participants to easily separate the trading and holding of shares.

Quota risk

The initial quotas for "Northbound" trading are set at RMB 13 Bio per day and RMB300Bio in aggregate. Southbound limits are set at RMB10.5 Bio per day and RMB 250bio in aggregate. Aggregate quota control only applies to buy orders, but not sell orders.. The aggregate quota will be calculated at the end of each trading day.

Daily Quota is calculated real time during the trading day. Brokers and investors need to pay attention to three possible scenarios if the daily quota is <=0

1. The exchange will reject all new buy orders during the pre-opening session
2. .Suspension of all buy orders input during the market hour
3. Buy orders already input in the CSC before suspension will not be affected

Quota information: The HKEx proposes to distribute market updates to brokers every 5 seconds. Brokers will need to be monitor these limits and be able to capture updates into their execution and risk systems.

Foreign ownership

Another key issue to address is the foreign ownership limits. Brokers and clients will need to monitor the foreign investor holding limit as required by Mainland regulations. Following changes in June 2014 the official limits are set at 30% for the total holdings by all foreign investors in a single stock. And the single investor limit per stock is set at 10%. Investors need to track limits across all holdings i.e. (QFII Qualified Foreign Institutional Investor+ RQFII Renmimbi Qualified Foreign Institutional Investor + SH – HK Stock Connect holdings) , i.e. all accounts held with custodians and brokers if more than one is to be used.

Market limits

The maximum combined holdings of all foreign investors in a single Chinese listed firm will be 30 percent as defined by the CSRC. In a recent release the CSRC announced that these limits do not include stakes held by strategic investors. The regulations did not define what it meant by "strategic investors" but in China the term is ordinarily used to describe long-term investors, whose stock ownership is typically subject to a lock-up period extending several years.

Tax

Another critical area that needs clarification is Capital Gains Tax (CGT). It is stated in Chinese law that there is a 10% CGT but Chinese tax authorities have not been strictly enforcing the collection of the CGT. The use of multiple brokers may complicate the tracking of tax obligation and it is possible for back taxes to be imposed after all positions have been sold and cash-settled. The market is still awaiting clarification from the State Administration of Taxation to enable brokers and their clients to understand the procedures and implications of participating in the pilot scheme. Hong Kong brokers will need to ensure that they fully explain CGT rules and anticipate risks before the scheme goes live.

Foreign exchange

FX conversion - RMB conversion for retail clients is still limited to RMB 20,000 per day. The implications being that retail clients wanting to invest Northbound will start building additional RMB ahead of the live date. There is no impact on brokers but the overall RMB holdings should increase in the next few months.

Compliance and governance

Market conduct – HKEx's stated that Chinese investors would need to comply with market misconduct rules in Hong Kong so mainland investors would have to acquaint themselves with those rules.

Investor Protection – Per announcements by the HKEx it should be noted that the Hong Kong investor compensation fund would not cover any northbound trading activities on the mainland.

Market readiness

Special Mention needs to be given to the end to end readiness of participants as it is a requirement from the HKEx that participants confirm readiness formally to the HKEx.

Market rehearsal dates are fast approaching. Strict requirements and tight UAT schedules will be tough challenges for many participants to meet the first market wide test at the end of August. Many participants face the challenge where their system code freeze dates do not align with the testing days i.e. usual test cycles are over 40 days and the industry test are now only 3 weeks away.

Systems

Many brokers and banks use multiple integrated systems for end-to-end trade and settlement flow. We have observed through Deloitte's interaction with a number of exchange participants that full attention needs to be given to all systems used across business units and support functions from pre order management through to execution and settlement. Different internal systems integration test scripts, schedules and rollouts will create challenges to clients.

Future developments

Charles Li, the Chief Executive of Hong Kong Exchanges and Clearing Limited (HKEx), hopes to eventually enable trading in RMB -denominated fixed income and currency products through the pilot for mutual stock market access between Hong Kong and Shanghai. It is too early to say how this will be introduced but already the HKEx is looking to future expansion which can only be a benefit to the market.

Considerations and questions to ask yourselves

We have attempted to highlight many of the challenges to get ready for the target date in October. Again we reiterate to clients that they need to ensure they made the following considerations and questions have been asked.

Have business requirements been written? Have all systems been enhance? Have all operations procedures been updated? Have legal and compliance depts. reviewed of existing client contracts, have ownership rules been considered? Have the risk and compliance departments reviewed the business model? Has operations department considered how to report to clients under the new account structures? Have tax consultants been engaged? Have all systems been used been identified, analyzed? Have SIT and UATs been completed for all systems? Has client reporting been defined and designed? Have client briefings been conducted? Have new codes been established to separate the onshore / offshore holdings? Have databases been updated for all systems? Have procedures been agreed to track holdings?

Finally signoff from all key stakeholders and support functions needs to be obtained including – credit, tax, compliance, trading, operations, finance, business units, clients, IT, risk and management.

Many market participants have reacted positively to the prospect of more free and open access between the two exchanges. To our knowledge, more than 100 brokers have expressed their interest to become the first batch of participants in the pilot scheme.

In our role as consultants to a number of brokers we have observed that there is still a significant amount of work to ensure readiness to meet the tight deadline. That said, all parties are working to clarify with the regulators and exchanges and to ensure they are well-positioned to be the first to offer related services.

We have attempted to highlight some of the critical considerations for participants, including trading, settlement, risk management, credit risk, legal and compliance, investor education and tax. Realistically, not all issues may be resolved by the time the proposed scheme goes live, but it is critical that a systematic approach is in place to ensure that all actions have been considered in order to mitigate risk as much as possible.

The pilot scheme between Shanghai and Hong Kong is another groundbreaking step to open new opportunities for Mainland and international investors and create a viable mechanism for investing in Mainland stock markets with offshore RMB.

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