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SYNOPSIS SERIES

Mainland China and Hong Kong Cross-Market Access and Integration

Investing in China - Exposure and Access

From the perspective of global investors, presumably a key point the market has been awaiting is China's inclusion into MSCI's Emerging Markets Index. China has in past years been taking steps to widen market access and international connectivity to pave way, and in August 2016, the Mainland China and Hong Kong regulators further announced the launch of the Hong Kong-Shenzhen Stock Connect to complete the link between the stock exchanges in the two markets.

While in autumn 2016 MSCI once again gave a deferment verdict on the inclusion of China domestic A shares, the Hong Kong-Shenzhen Stock Connect came live December 2016, which replicates an earlier program connecting the Hong Kong and Shanghai stock exchanges which was first launched in 2014.

Stock Connect allows mutual stock market access between Mainland China and Hong Kong, whereby Mainland investors may access eligible Hong Kong stocks within scope through their domestic Mainland securities firms, while investors in Hong Kong may access eligible Mainland stocks within scope through Hong Kong brokers. Given Hong Kong's open market infrastructure and position as an international financial and asset management center, through Hong Kong, international investors are hence able to access selected stocks listed on the Shanghai Stock Exchange under the Shanghai-Hong Kong Stock Connect, as well as access selected stocks listed on the Shenzhen Stock Exchange (SZSE) through the Shenzhen-Hong Kong Stock Connect.

The Shenzhen-Hong Kong Stock Connect expanded the universe of Mainland stocks that may be accessed through the Hong Kong Stock Exchange, in particular eligible constituent stocks of the SZSE Component Index and SZSE Small/Mid Cap Innovation Index with market capitalization of RMB6 billion or above. All SZSE-listed shares of companies which have H-shares listed on the Hong Kong Stock Exchange are also within scope. On the other hand, Mainland investors are able to access constituent stocks of the Hang Seng Composite LargeCap Index and Hang Seng Composite MidCap Index, any constituent stocks of Hang Seng Composite SmallCap Index with market capitalization of HK$5 billion or above, and shares of all Mainland Chinese companies with both listed H shares and A shares.

While the range of accessible stocks have broadened for cross-market access, the regulators have stipulated that, at the initial stage, only institutional professional investors as defined under Hong Kong law and regulations will be able to invest in shares listed on the ChiNext Board of SZSE. The ChiNext lists high-tech new innovative enterprises and has been referred to as the NASDAQ of SZSE. The restriction that only institutional professional investors may access ChiNext stocks may be considered to be in line with the SFC enhanced investor protection measures introduced in recent years including around increased regulatory requirements on suitability of investments and financial products for investors, which may now be exempted only for institutional professional

investors or corporate professional investors that satisfy relevant conditions under a designated assessment of investment decision-making process and investment personnel.

Accordingly, investors who are not "institutional professional investors" under Hong Kong law and regulations and initially unable to access ChiNext stocks under the Shenzhen-Hong Kong Connect may only have exposure through "institutional professional investors". The definition of "institutional professional investors" as defined in the Hong Kong Securities and Futures Ordinance (Cap 571) covers mostly regulated financial institutions such as licensed investment intermediaries, banks, insurance companies, central banks, and regulated collective investment schemes or provident fund/retirement schemes in Hong Kong[1].

The Stock Connect is an unusual and innovative framework providing cross-market access that neatly leverages the One-Country-Two-Systems between Mainland China and Hong Kong's well established market infrastructure of international standard. It has also been key in developing and deepening cross-border links and cooperation not just in market access, systems and infrastructure, but also in challenging and bridging differences in market practices. The financial regulators in Mainland China and Hong Kong have been increasing cross-market regulatory cooperation to better engage in market and conduct supervision of asset managers and intermediaries that now invest and trade cross markets.

Accessing China interbank bond market

In reflection, the Stock Connect sits alongside the Qualified Foreign Institutional Investors ("QFII") scheme and the Renminbi version – RQFII scheme as the closely regulated programs that offer international investors access to invest in the Mainland domestic market, all of which have come a long way from when only B shares denominated in foreign currencies were available to foreign investors. Many Hong Kong and international asset managers and institutional investors now use a combination of these schemes for accessing China domestic stocks, with even some revival for B shares amidst cautious sentiments on the currency value of the Renminbi.

A similar story has evolved with respect to accessing Mainland bonds. Up until mid-February 2016, foreign institutional investors accessing China onshore bonds through the China Interbank Bond Market (CIBM) would do so via the RQFII and QFII schemes, which are subject to specific restrictions and compliance requirements on investment quota and repatriation. Access to CIBM was otherwise limited to foreign central banks or monetary authorities, RMB settlement banks and settlement participating banks.

On 24 February 2016, Announcement No. 3 issued by the People's Bank of China opened up direct access to foreign institutional investors, including commercial banks, insurance companies, fund management companies, asset management institutions, investment products and funds, to directly access the CIBM and trade in onshore RMB bonds upon successful application to their settlement agents. Under subsequent implementing rules, settlement agents are delegated with the responsibility to determine the eligibility of foreign institutional investors, which should be

[1] Schemes authorized by the SFC under Section 104 of the SFO for retail distribution in Hong Kong, registered schemes or constituent funds under the Mandatory Provident Fund Schemes Ordinance (Cap 485) and registered schemes under the Occupational Retirement Schemes Ordinance (Cap 426).

'medium and long term' investors. Although technically it is possible for institutional investors who are RQFII and/or QFII to also access CIMB under the direct access, the regulators have requested that investors should enter the CIBM in one capacity only, either through RQFII/QFII or directly under Announcement No.3.

Mainland and Hong Kong regulators in May 2017 announced plans to establish "Bond Connect" for cross-market trading link for bonds. Similar to Stock Connect, Bond Connect is to enable investors to conveniently trade in bonds on the other market through their local accounts. While it has been usual for new China market access arrangements to be tagged with tight foreign exchange regulation, it is remarkable that no foreign exchange investment quota is set for northbound trading. This may reflect China's intention to further relax foreign exchange controls, but in a persistent climate of foreign exchange outflow pressures, Bond Connect will initially be limited one way to northbound trading – giving international investors access through Hong Kong to Mainland bonds such as government bonds, financial bonds and corporate bonds, but not yet for Mainland investors to access the Hong Kong bond market.

Meanwhile, Hong Kong has been engaging in efforts to develop its role as a key fundraising centre to finance infrastructure projects under China's Belt and Road initiative, which is slated for economic, trade and cooperation with countries along the Silk Road. With a long established international debt capital market, mature legal and business infrastructure, efficient and comprehensive links to the Mainland, Hong Kong is well suited for the issuance of infrastructure debts. As the largest Renminbi centre outside the Mainland, Hong Kong is also naturally well placed for raising Renminbi-denominated debts. The Hong Kong Monetary Authority has established an Infrastructure Financing Facilitation Office as a framework for cooperation to this end, with numerous key partners including several global, regional and Mainland banks and institutions investors.[2]

Accessing China Investors

Besides investments and exposure to asset classes to tap China's economic growth and development, a big challenge and opportunity lies in accessing the wealth of Chinese investors. Although China's rate of economic growth has slowed, the sheer size of the economy and the results of economic restructuring to-date have continued to produce immense levels of private wealth. A combination of these factors have spurred demand for wealth management and private banking services, and global asset allocation needs.

Under China's foreign exchange controls, the main avenue for Chinese investors to invest overseas has been through domestic investment products of China fund managers, securities companies, banks or trust companies who are Qualified Domestic Institutional Investors approved and granted quota for overseas investments. In 2016, the first batch of approved Hong Kong retail funds for public offer was launched for distribution in the Mainland, under the Mainland-Hong Kong Mutual Recognition of Funds (MRF) arrangement. As China tightens regulation of capital outflows, the MRF arrangement is able to offer Mainland retail investors exposure to global investment opportunities through eligible fund products approved by the Hong Kong Securities and Futures

[2] For list of partners of the Hong Kong Infrastructure Financing Facilitation Office: https://www.iffo.org.hk/about-us/IFFO_Partners

Commission. This access to Chinese investors has attracted international and regional fund houses to apply for North-bound approval, although the number of funds approved to-date has been limited compared to the number of Mainland funds approved in Hong Kong.

Other global asset managers have established wholly-foreign owned private fund managers to be positioned to offer domestic fund products raising capital from domestic investors under China private placement rules. A wholly-foreign private fund manager is required to be registered with the China Asset Management Association, a quasi-regulatory industry organization appointed with the power to regulate the Mainland private funds industry. Private fund managers are further differentiated between those that target venture capital, private equity investments, and those that engage in securities investments (meaning stocks (ie. A shares), bonds and futures).

The option to set up wholly-foreign owned private fund managers that may launch domestic products to invest in Mainland domestic securities is a bright spark for global managers who had for a long time been limited to joint venture fund management companies to enter the domestic funds space. International managers who wish to apply would need to meet basic qualification requirements such as 3 years' clean regulatory record, being registered and regulated in a country or region where the financial regulator has entered into a memorandum of understanding with the China Securities Regulatory Commission (MOU country), and that the actual controller shall similarly be registered and regulated as a financial institution in a MOU country. There are further more specific requirements on the detailed set-up and personnel qualifications, including a restriction from placing trades through a foreign entity or foreign system. In January 2017 Fidelity became the first wholly-foreign owned private fund manager, and in May as the first foreign manager to launch a domestic product, laid groundwork for competing domestically.

Cross-Border Roadmap

China in-bound

- Direct / Strategic Foreign Investments (FDI)
- Qualified Foreign Institutional Investors (QFII) regime
  - Asset managers, investment funds, pension funds, endowments, foundations, sovereign wealth funds etc.
  - License from CSRC
  - Foreign exchange quota
- RQFII (RMB version of QFII)
- Direct access to China Inter-bank Bond Market (CIBM)
- Selected Shanghai and Shenzhen stocks under Stock Connect **through Hong Kong Stock Exchange**
- Bond Connect **through Hong Kong (pending launch)**
- Mainland-Hong Kong Mutual Recognition of Funds – **Mainland public funds approved for distribution in Hong Kong**

China out-bound

- Overseas Direct Investments (ODI)
- Qualified Domestic Institutional Investors (QDII) regime
  - Domestic financial institutions – fund companies, securities companies, commercial banks, trust companies (investment products);
  - Foreign exchange quota
- RQDII (RMB version of QDII)
- Institutional mandates of Mainland insurance companies / China sovereign wealth funds
- **Selected Hong Kong stocks under Stock Connect** - through Shanghai Stock Exchange and Shenzhen Stock Exchange
- Qualified Domestic Limited Partner (QDLP) scheme or equivalent (new approvals suspended)
- Mainland-Hong Kong Mutual Recognition of Funds – **Hong Kong eligible funds approved for distribution in Mainland China**

Hong Kong Subsidiary of Mainland Entities

The demands and opportunities of China outbound investments also see many Mainland China institutions and corporations setting up in Hong Kong. Just as Hong Kong has been a significant hub for international asset managers and investors to access China, Hong Kong has solidly become the location of choice for Mainland financial institutions, fund managers and corporates to establish a foothold for accessing the international markets.

According to the Hong Kong Securities and Futures Commission, new license applications to establish a Hong Kong presence to engage in regulated activities grew more than 50% in 2016, and more Mainland companies are setting up subsidiaries or acquiring existing licensed entities in Hong Kong. Ms Julia Leung, Executive Director, Intermediaries, in a May 4 speech titled "Supervision in a time of change", expressed that the Mainland is now the source of the largest number of shareholder groups controlling Hong Kong licensed corporations.

Indeed, it has been and remains a time of change, with evolving macro-economic and political environment, that draws and pushes new market strategies, new market players and new initiatives. As China grows in importance and expands beyond its border to the international stage, while the implications are most immediately and keenly felt in Hong Kong, this is the place to first meet the opportunities and challenges and it would no doubt from here spread its influence globally.

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