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LEGAL UPDATE

Investing via the Shenzhen–Hong Kong Stock Connect - Disclosure and Approval Requirements for SFC authorized funds

Further to the Shanghai-Hong Kong Stock Connect announced in 2014, in August 2016, a good two years later, it was jointly announced by the China Securities Regulatory Commission (**CSRC**) and the Hong Kong Securities and Futures Commission (**SFC**) that the Shenzhen–Hong Kong Stock Connect will soon be implemented. It is anticipated that the Shenzhen-Hong Kong Stock Connect will be launched in November 2016.

Expanded universe of stocks for cross-market access

Stock Connect refers to the program that 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 Hong Kong investors may access eligible Mainland stocks within scope through Hong Kong brokers. Hong Kong investors already able to access selected stocks listed on the Shanghai Stock Exchange under the Shanghai-Hong Kong Stock Connect will now also have access to selected stock lists on the Shenzhen Stock Exchange (**SZSE**) through the Shenzhen-Hong Kong Stock Connect.

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

ChiNext access restricted

However, while the range of accessible stocks have broadened for investors' cross-market access, the regulators have stipulated that, for the Northbound link, 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 restriction that only institutional professional investors may access ChiNext stocks may be considered to be in line with the SFC enhanced investor protection measures including around increased regulatory requirements around 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.[1] The definition of "institutional professional investors" as defined in the Securities and Futures Ordinance (Cap 571) (**SFO**) covers mostly regulated financial institutions such as licensed

[1] Please refer to our firm's publication dated 20 July 2016 "New Changes to Hong Kong Professional Investors regime" regarding the enhanced investor protection and suitability requirements.

investment intermediaries, banks, insurance companies, central banks. Collective investment schemes authorized by the SFC under Section 104 of the SFO (**SFC Authorised Funds**), registered schemes or constituent funds under the Mandatory Provident Fund Schemes Ordinance (Cap 485) (**MPF Schemes**) and registered schemes under the Occupational Retirement Schemes Ordinance (Cap 426) (**ORSO Schemes**).

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 SFC-Authorized Funds. Investment by MPF Schemes in Mainland securities are limited to 10% of the scheme's net asset value.

SFC Updated FAQ re Shenzhen-Hong Kong Connect

On 25 October 2016, the SFC updated question No. 19 under its "Frequently Asked Questions on Post Authorization Compliance Issues of SFC-authorized Unit Trusts and Mutual Funds" (**SFC's FAQ**) regarding disclosure and approval requirements for participation in Stock Connect, to include Shenzhen–Hong Kong Stock Connect within scope.

Most fund issuers of SFC authorized funds have already included disclosures in their offering documents if they intended to invest in Mainland China securities through various means: A Shares via the Shanghai–Hong Kong Stock Connect, the QFII (Qualified Foreign Institutional Investors) regime, Renminbi QFII (**RQFII**) regime and access products; or PRC domestic bonds via the China Interbank Bond Market[2].

Now that fund issuers can invest in A Shares through Shenzhen-Hong Kong Stock Connect as an additional route, they may wish to check if the current disclosure wordings may need to be enhanced to comply with SFC's requirement.

If a fund wishes to make substantial investment in A Shares (i.e. 30% or more of the fund's NAV):

- When the existing investment objectives and strategy do not cover substantial investment in A Shares, prior SFC approval will need to be sought to amend the investment objectives to include A Shares and at least 1 month's prior notice to investors are required before such investments can be made.
- When the existing disclosures already allow investments in A Shares to be made (whether via Shanghai–Hong Kong Stock Connect, RQFII/QFII regime or other A share market access products, through one or a combination of such channels), generally no further prior approval from SFC is required for participating in the Shenzhen–Hong Kong Stock Connect if the fund issuer considers such changes as immaterial (as per definition under SFC's FAQ). The fund issuer will still need to notify the shareholders of the inclusion of Shenzhen–Hong Kong Stock Connect as one of the channels as soon as reasonably practicable.
- The offering documents (including the product key facts statement for Hong Kong investors) should be updated to include further details and risks.
- In particular, fund issuers should include risks associated with investment in shares listed on the ChiNext Board and/or the Small and Medium Enterprise Board of the Shenzhen Stock Exchange.

[2] Please refer to our firm's publication dated 20 July 2016 "Access to China Interbank Bond Market" regarding approval/disclosure requirements for SFC authorized funds seeking to invest under this scheme.

If a fund wishes to make an ancillary investment in A Shares (i.e. more than 10% but less than 30% of the fund's NAV):

- Generally no SFC prior approval is required but fund issuers should ensure that the offering documents should be updated to include further details and risks as outlined above. The updated offering documents should be filed with SFC as soon as practicable and will be subject to post vesting by the SFC.
- The fund issuer should notify the shareholders of this change as soon as reasonably practicable.

If a fund wishes to make a minimal investment in A Shares (i.e. less than 10% of the fund's NAV):

- No SFC prior approval required.
- Fund issuers should exercise discretion/ judgement and consider if any updates are necessary.

Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

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