# Shanghai-Hong Kong 'through train' departs

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**The Shanghai-Hong Kong Stock Connect was launched on 17 November.**

A landmark pilot stock connect scheme that aims to create mutual market access (MMA) between the stock exchanges of both Shanghai and Hong Kong was officially launched on 17 November. This followed the initial announcement about the programme from the regulators in April. The implications of the scheme are far-reaching and positive, although there are still a number of challenges to overcome.

The so-called 'through train' allows two-way trading of shares between Hong Kong and Shanghai. Firstly, mainland investors are allowed to buy eligible Hong Kong stocks on the city's Hang Seng Composite LargeCap and MidCap Indices ('southbound trading') with a RMB 10.5 billion daily quota (aggregate quota of RMB 250 billion).

The eligible number of stocks available for southbound trading is 266 –representing 82% of Hong Kong's market capitalisation. Meanwhile, 'northbound trading' – where all Hong Kong-based or international investors can purchase Shanghai-listed stocks –has been allocated a quota of RMB 13.5 billion per day (aggregate quota of RMB 300 billion). The total available number of tradable stocks in Shanghai is over double the opposite direction, at 568 –representing 90% of Shanghai's market capitalisation. The above quotas operate on a system of 'first come first serve' although daily limits for both markets are applied on a net basis.

As a result, regardless of the quota balance investors will always be able to sell. As for the trading currency, the northbound trading from Hong Kong to Shanghai is quoted in RMB but settled in offshore renminbi (CNH). As for southbound trading in the opposite direction, prices are quoted in HKD but settled in CNY. Meanwhile, local brokers in the respective markets can take on orders and settlement & clearing are also being executed through the respective local exchanges. So, for foreign investors, how will this differ from the current Qualified Foreign Institutional Investor (QFII) and Renminbi equivalent (RQFII) programmes?

Firstly, the through-train is open to all investors, with no restrictions on northbound trading, whereas the latter are open to mainly institutional investors. Secondly, the MMA is concentrated on select securities, which is in contrast to the wider range of available products in the QFII/RQFII scheme – where products such as bonds and ETFs are available. Lastly, the through-train boasts no lock up or repatriation restrictions, unlike its QFII/RQFII brethren – which require both.

Right before the official launch of the Stock Connect Scheme, the Ministry of Finance of the People's Republic of China (PRCMOF) clarified the PRC's capital gains tax (CGT) policy, providing improved guidance on a subject that has been a cause of uncertainty since the inception of both the QFII and RQFII programs in 2002. Hong Kong and foreign investors dealing in securities listed on the Shanghai Stock Exchange (SSE), both corporates and individuals, are temporarily exempt from CGT from SSE securities bought and sold via the Stock Connect Scheme from 17 November 2014.

Correspondingly, PRC individual investors who buy and sell shares listed on the Hong Kong Stock Exchange through the Stock Connect Scheme are temporarily exempt from personal income tax for three years, from 17 November 2014 to 16 November 2017. The PRCMOF has also exempted QFIIs and RQFIIs from PRC corporate income tax from 17 November 2014. However, investment gains by QFIIs and RQFIIs before 17 November 2014 will be subject to the CGT. Prior to the announcement, the potential for a CGT on China investments had not been clarified with the government giving no indication on whether one would be levied on a retroactive basis or what this right might be.

Furthermore, there are still a number of challenges to overcome. These issues include:

- **Rights issues** – another area that needs to be clarified as currently China does not allow overseas investors to exercise rights in A share-listed companies.
- **Settlement** – differing settlement cycles between Hong Kong and Shanghai mean that anyone selling A shares in Hong Kong will need to make this decision T-1 and transfer stock from custodians to brokers overnight at the end of day T-1 so that it is available for sale T0. This clearly presents considerate counterparty risk issues in particular situations, such as with long only clients with multiple custodians.
- **Daily quotas** – daily (net) quotas could be an issue in the early days as the traffic will be inevitably skewed to the buy side in both directions (no day trading allowed in A-shares). For example, on the debut day of 17 November, northbound trade far outstripped trade from mainland investors in the opposite direction, with the daily quota for buying Shanghai stocks under the scheme

exhausted by mid-afternoon. Southbound investment, on the other hand, is less active, with just 17% of the southbound quota taken up by the market close on the first trading day. However, as two-way flows balance out more evenly the regulators hope that the quotas will be hit less often and be much less of an issue.

As for the implications for the respective markets, these are clearly far-reaching and positive. Immediate beneficiaries include the listed stock exchange in Hong Kong, securities companies and brokers, who are expected to benefit from increased transaction volumes and new business opportunities resulting from this gradual integration. Meanwhile, dual A & H listings have already witnessed a narrowing of valuation discounts as investors take advantage of arbitrage opportunities – over time this should bring into line the two prices and provide further stability for long-term investors in either share class.

Further long-term benefits include bringing a more institutional-focused and balanced investment community into onshore Chinese markets. By allowing this, Chinese markets, which have been known to swing in reaction to the short-termism of retail investors, may finally start to focus on company fundamentals including dividend yields and value.

**Table 1: Key comparison of Stock Connect (northbound), QFII & RQFII**

| | **Stock Connect (Northbound)** | **QFII** | **RQFII** |
|---|---|---|---|
| **Launch date** | Nov-2014 | Nov-2002 | Dec-2011 |
| **Quota** | Aggregate quota: RMB 300 billion<br><br>Daily quota: RMB 13 billion<br><br>First-come-first-serve basis | Total quota: USD 150 billion<br><br>Individual quota: USD 50 million to USD 1 billion | Total quota: RMB 400 billion<br><br>Individual quota: No minimum or maximum quota limit |
| **Eligibility** | ALL Hong Kong and overseas investors | Qualified foreign institutions only | Qualified institutions in Hong Kong, London and Singapore only |
| **Access** | Bilateral (Northbound to China and Southbound to Hong Kong) | Inflows to Mainland China only | Inflows to Mainland China only |
| **Currency** | Offshore RMB | USD or other major foreign currency | Offshore RMB |
| **Eligible investments** | All constituent stocks of the SSE 180 & 380 only – totaling 568 stocks.<br><br>All dual-listed shares i.e. SSE-SEHK A + H shares<br><br>Exceptions: Shares not traded in RMB, shares under 'risk alert' and IPOs | Stocks, bonds, securities investment funds, warrants, IPOs, bond issuances and index futures | Same as QFII |
| **Asset allocation** | 100% in Shanghai-listed stocks | Minimum 50% in equity and no more than 20% cash | N/A |
| **Repatriation & lock-up periods** | No lock-up or repatriation restrictions | Yes | Yes |
| **Capital Gains Tax (CGT)** | Northbound - capital gains tax for HK and overseas investors will be waived "temporarily." | Temporary exemption from withholding tax on gains derived from the trading of equity investment assets effective from 17 November 2014. However, QFIIs / RQFIIs | |

shall be subject to withholding tax in respect of capital gains derived prior to 17 November 2014.

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