Shanghai-HK Connect Opens Possibilities for Companies Looking to Tap Chinese Investor Demand

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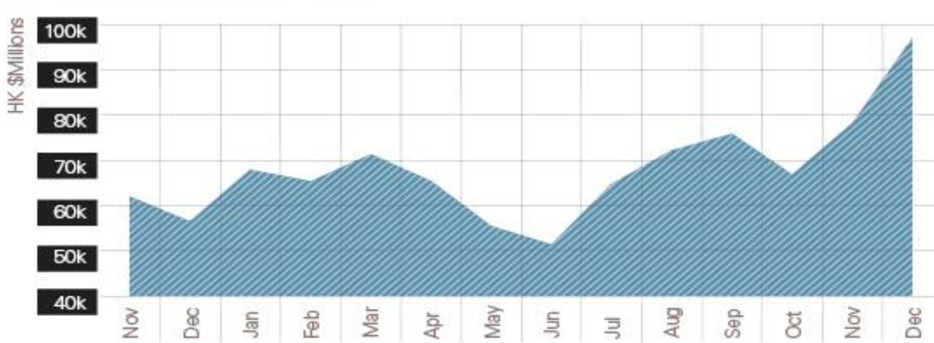
Contributing Partner

Christopher W. Betts
Hong Kong

November 17, 2014, marked the first day of trading under the Shanghai-Hong Kong Stock Connect, a mutual market access platform that effectively opens the Hong Kong market to mainland Chinese investors. The Shanghai-HK Connect enables mainland Chinese investors to trade in securities listed on the Hong Kong Stock Exchange (HKEx) in renminbi (RMB) through broker members of the Shanghai Stock Exchange (SSE), and Hong Kong investors to trade in securities listed on the SSE through their HKEx brokers. Although it is in its infancy, the Shanghai-HK Connect is an important step in the liberalization of China's capital markets and adds to the appeal of Hong Kong as a listing venue for companies looking to tap Chinese investor demand.

A modest rise in trading volumes on the Hong Kong exchange from mid-2014 lows had been broadly attributed to the impending commencement of the platform, with valuations of Shanghai-listed companies generally much higher than those of Hong Kong-listed companies and the platform potentially leading to a narrowing of that gap. Even more pronounced has been the rise in the average daily turnover on the SSE, from a low of US$9.7 billion in May 2014 to US$40 billion in November 2014.

Average Daily Market Turnover on the HKEx
(November 2013 through December 2014)



Source: HKEx

At least initially, the scope of the Shanghai-HK Connect has limitations. Mainland Chinese, or "southbound," investors are only able to invest in constituent stocks of the Hang Seng Composite LargeCap Index, the Hang Seng Composite MidCap Index, and the H shares of any other PRC-incorporated companies that have corresponding listed A shares in Shanghai — a sum total of approximately 270 companies that together represent approximately 82 percent of the HKEx's total market capitalization and 78 percent of average daily turnover. Companies that only have a secondary listing on the HKEx, namely companies with a primary listing on an exchange outside China and Hong Kong, are one notable group excluded from the platform. Hong Kong, or "northbound," investors are able to trade in the shares of 568 SSE-listed companies that represent approximately 90 percent of the SSE's

Four Times Square
New York, NY 10036
212.735.3000

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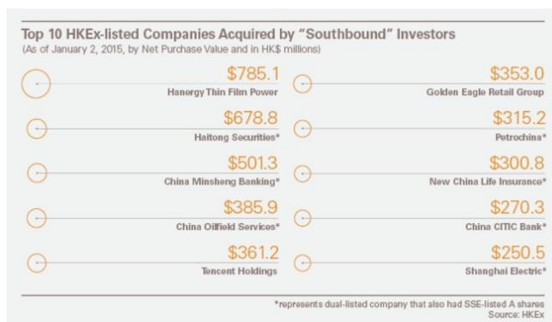
total market capitalization and 80 percent of average daily turnover.

The platform does not extend to subscribing for shares in initial public offerings, which are often perceived as higher-risk, so companies listing on the HKEx will need to wait until they qualify for one of the applicable Hang Seng indices to benefit from the platform. Chinese investors also are unable to short sell or engage in margin financing or stock borrowing or lending. In line with China's tight foreign currency controls, an initial cap of RMB250 billion exists on the net amount of HKEx-listed securities that may be purchased under the program by mainland Chinese investors (together with a daily net purchase cap of RMB10.5 billion), as well as a corresponding RMB300 billion aggregate quota on the purchase of Shanghai-listed securities by Hong Kong investors. The RMB250 billion aggregate cap, just over US$40 billion, is equivalent to roughly one week’s turnover on the HKEx — although as sales are netted off against purchases the cap is not necessarily indicative of the overall level of turnover generated by the platform.

Additionally, both northbound and southbound investors need to comply with the securities laws governing the markets in which they are trading, including the applicable disclosure requirements of those markets. The Securities and Futures Commission of Hong Kong and the China Securities Regulatory Commission have entered into a memorandum of understanding to strengthen cooperation on enforcement matters that provides, among other things, for the sharing of information and data about potential or suspected wrongdoing. Non-Chinese investors seeking to use the program to trade in SSE-listed securities must, therefore, ensure that they familiarize themselves with applicable requirements.



By the beginning of 2015, shares in 268 HKEx-listed entities had been traded by southbound investors, with the most heavily traded shares a mix of the HKEx’s largest constituent stocks and state-owned companies with H shares trading at significant discounts to their SSE-listed A shares. Counter to the expectations of many who anticipated the HKEx's lower valuations to be of primary appeal, net northbound purchases of SSE-listed shares by Hong Kong investors have significantly exceeded net southbound purchases. As of December 26, 2014, roughly one-quarter of the RMB300 billion net purchase quota for northbound trades had been used, compared to only RMB10.5 billion of the net purchase quota for southbound trades.

If the Shanghai-HK Connect is successful in its initial pilot phase, both sides have publicly indicated that the platform may be broadened in terms of the quotas, markets and securities covered. However, no timetable has yet been set for any broadening of the platform.