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Another milestone in mutual market access: The Shenzhen-Hong Kong Stock Connect

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Introduction

Following the joint announcement by the China Securities Regulatory Commission ("**CSRC**") and the Securities Futures Commission ("**SFC**") in August of their in-principle approval of the establishment of mutual stock market access between Shenzhen and Hong Kong (the "**Shenzhen-Hong Kong Stock Connect**"), the Hong Kong Exchanges and Clearing Limited ("**HKEx**") published proposed amendments to the Rules of the Exchange, the General Rules of CCASS and the CCASS Operational Procedures (which are subject to approval by the Securities and Futures Commission) on 29 September 2016.[1] A revised Information Book for Market Participants and a set of Frequently Asked Questions were also published.

We discuss in this bulletin the features of the Shenzhen-Hong Kong Stock Connect, in particular, the differences from the Shanghai-Hong Kong Stock Connect which has been in operation since November 2014. We will also discuss the legal and regulatory issues which market participants and prospective investors should be aware of, as well as the possible impact of the new service on client and deal documentation.

The Shenzhen-Hong Kong Stock Connect

The Shenzhen-Hong Kong Stock Connect is another major milestone in the establishment of mutual market access between Mainland China and Hong Kong. The Shenzhen-Hong Kong Stock Connect extends the current arrangements of the Shanghai-Hong Kong Stock Connect by linking up the stock exchanges in Hong Kong and Shenzhen. The Shenzhen-Hong Kong Stock Connect will be subject to existing laws and regulations as well as trading and clearing models under the Shanghai-Hong Kong Stock Connect.

Similar to the Shanghai-Hong Kong Stock Connect, the Shenzhen-Hong Kong Stock Connect comprises two links: (i) the Northbound link, through which Hong Kong and overseas investors will be able to trade eligible A-shares ("**SZSE Shares**") listed on the Shenzhen Stock Exchange ("**SZSE**") through The Stock Exchange of Hong Kong Limited ("**SEHK**"), and (ii) the Southbound link, through which eligible Mainland investors will be able to

[1] The CSRC, SZSE and ChinaClear have also published rules for public consultation and these are expected to be finalised soon.

trade eligible shares listed on the SEHK through the SZSE. We focus on the Northbound link in this bulletin.

The trading and clearing framework of the Shenzhen-Hong Kong Stock Connect follows that of the Shanghai-Hong Kong Stock Connect. Under the trading link to be established between the SEHK and the SZSE, each of the SEHK and the SZSE will provide order-routing services through which their exchange participants can directly trade eligible shares listed on the other market across the border. In addition, a clearing link will be established between Hong Kong Securities Clearing Company Limited ("**HKSCC**") and China Securities Depository and Clearing Corporation Limited ("**ChinaClear**"), under which HKSCC and ChinaClear become a clearing participant of each other and clear trades with their own clearing participants. For the Northbound link, HKSCC will appear on the record of ChinaClear and will hold SZSE shares as nominee for Hong Kong and overseas investors.

Eligible shares

SZSE Shares eligible to be traded through the Northbound link will comprise any constituent stock of the SZSE Component Index and SZSE Small/Mid Cap Innovation Index which has a market capitalisation of RMB6 billion or above, and A-shares of SZSE-listed companies which have issued both A-shares and H-shares.

Eligible investors

Similar to the Shanghai-Hong Kong Stock Connect, Hong Kong and overseas investors may purchase and hold eligible A-shares listed on the SZSE under Northbound trading. However, at the initial stage, only institutional professional investors (i.e. those persons falling under paragraphs (a) to (i) of the definition of "professional investors" in the Securities and Futures Ordinance (Cap. 571)) are eligible to trade shares that are listed on the ChiNext Board of the SZSE[2]. Both the SZSE Component Index and SZSE Small/Mid Cap Innovation Index include shares listed on the Main Board, the Small and Medium Enterprise Board and the ChiNext Board of SZSE.

Investment quota

There will be no aggregate quota under the Shenzhen-Hong Kong Stock Connect[3]. Daily quotas (which are the same as that under the Shanghai-Hong Kong Stock Connect, i.e. RMB13 billion for Northbound trading and RMB10.5 billion for Southbound trading) will apply to the Shenzhen-Hong Kong Stock Connect.

Other financial products

In the joint announcement, the CSRC and the SFC indicated that they will jointly study and introduce other financial products to be traded under the mutual market access programmes. In particular, exchange-traded funds ("**ETFs**") were mentioned as the next type of eligible securities under the

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2 It is expected that this restriction will be relaxed at a later stage subject to resolution of the relevant regulatory issues.

3 The aggregate investment quota for the Shanghai-Hong Kong Stock Connect has also been abolished with immediate effect.

mutual market access scheme. It is expected that ETFs will be included in the product scope after the Shenzhen-Hong Kong Stock Connect has been in operation for a period of time.

Legal and regulatory issues

Given the similarities between the arrangements of the Shenzhen-Hong Kong Stock Connect and the Shanghai-Hong Kong Stock Connect, the legal and regulatory issues we described in our previous client bulletins on the Shanghai-Hong Kong Stock Connect would equally apply[4]. It is expected that at launch of the Shenzhen-Hong Kong Stock Connect, those provisions in the SEHK trading rules governing pre-trade checking, foreign ownership limits, non-trade transfers, covered short selling, stock borrowing and lending and margin trading as applicable to the Shanghai-Hong Kong Stock Connect would be extended to cover the Shenzhen-Hong Kong Stock Connect in a similar way.

In light of the restriction on the type of investors who can trade in shares that are listed on the ChiNext Board of the SZSE under Northbound trading, it should be considered whether non-institutional professional investors can gain an economic exposure to these shares via equity derivatives or whether equity derivatives referencing shares listed on the ChiNext Board should be limited to institutional professional investors.

Documentation issues

Market participants who currently offer clients services or products relating to the Shanghai-Hong Kong Stock Connect (whether it is general cash trading, private banking, prime brokerage services, custodial services, structured note programmes, OTC derivatives or security arrangements over A-shares traded under the stock connect) will probably have amended their client and transaction documentation to take into account the special features of the Shanghai-Hong Kong Stock Connect. With the Shanghai-Hong Kong Stock Connect having been in operation for almost two years, it is apt for market participants to revisit their documentation to see if any changes are required should they wish to extend their product offerings to cover the Shenzhen-Hong Kong Stock Connect.

Given the similarities between the two stock connect programmes, there should not be substantial changes to client or transaction documentation. Indeed, a number of houses have client terms and conditions that adopt wide terminology (e.g. “China Connect Securities” and “China Connect Market”) so these should cater for both the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect. The following points should however be considered:

[4] Our previous client bulletins on the Shanghai-Hong Kong Stock Connect can be found here:
Shanghai-Hong Kong Stock Connect: Are you ready for the “through train” to Shanghai? (September 2014)
Shanghai-Hong Kong Stock Connect: Further Clarifications of the Stock Connect Rules (October 2014)
Shanghai-Hong Kong Stock Connect: New short selling rules (March 2015)
Stock Connect: the beneficial ownership conundrum (March 2015)

> The CSRC has clarified in its “FAQ on Beneficial Ownership under SH-HK Stock Connect” published in May 2015 that overseas investors enjoy proprietary rights in the Shanghai Stock Exchange-listed shares acquired through Northbound trading under the Shanghai stock connect. The issue of beneficial ownership was previously considered by some market participants as a potential uncertainty and most markets participants included provisions in their client documentation to address this issue. With the CSRC clarification there may be scope to provide the much needed certainty.

> The PRC equity markets have experienced significant events since the launch of Shanghai-Hong Kong Stock Connect including the market fallout of last July and the introduction of associated measures (e.g. circuit breaker rules). The market also saw increased regulatory investigations associated with this. It may be a good opportunity to re-visit client documentation to see if changes are required.

> There are specific changes in the Shenzhen-Hong Kong Stock Connect which have to be addressed from a documentation perspective: e.g. the abolition of the aggregate investment quota and the initial limitation of Northbound trading of SZSE Shares listed on the ChiNext Board to institutional professional investors.

> Client terms and conditions and risk disclosures prepared at the time when the Shanghai-Hong Kong Stock Connect was launched tend to be very long, reflecting in part the market’s unfamiliarity with the stock connect programme. Almost two years have since passed and a number of issues have now been clarified by the regulators. It may be possible to streamline these documents to make them simpler.

ETFs are expected to be another type of eligible securities to be traded under the mutual market access scheme. Those looking into the future may even consider how the addition of this new type of assets under the stock connect programme may impact their documentation and provide for flexibility accordingly.

Conclusions

The CSRC and the SFC indicated in the joint announcement that the formal preparations for the Shenzhen-Hong Kong Stock Connect are expected to take approximately four months. Market participants wishing to extend its offerings to include A-shares traded under the Shenzhen-Hong Kong Stock Connect should now prepare themselves operationally for this exciting page in the development of mutual market access between Mainland China and Hong Kong.

Linklaters

Contacts

For further information please contact:

Andrew Malcolm
Partner
(+852) 2842 4803
andrew.malcolm@linklaters.com

Chin-Chong Liew
Partner
(+852) 2842 4857
chin-chong.liew@linklaters.com

Victor Wan
Partner
(+852) 2901 5338
victor.wan@linklaters.com

I-Ping Soong
Counsel
(+852) 2901 5181
i-ping.soong@linklaters.com

Simon Zhang
Counsel
(+852) 2842 4844
simon.zhang@linklaters.com

Stephen Song
Managing Associate
(+852) 2901 5440
stephen.song@linklaters.com

Derek Chua
Managing Associate
(+852) 2842 4805
derek.chua@linklaters.com

Jenny Wong
Managing Professional Support Lawyer
(+852) 2901 5560
jenny.wong@linklaters.com

Author: Jenny Wong