Shanghai-Hong Kong 'through train' picks up steam

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In early April, regulators in China announced a pilot scheme that aims to create mutual market access (MMA) between the stock exchanges of both Shanghai and Hong Kong.

The so-called ‘through train’ will allow two-way trading of shares between Hong Kong and Shanghai. Firstly, mainland investors would be allowed 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 will operate on a system of ‘first come first serve’ although daily limits for both markets will be 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 will be quoted in RMB but settled in offshore renminbi (CNH). As for southbound trading in the opposite direction, prices will be quoted in HKD but settled in CNY. Meanwhile, local brokers in the respective markets will take on orders and settlement & clearing will also be 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.

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

- **Capital gains tax** – current PRC tax laws and regulations impose a 10% withholding tax on dividend interest and is applied to programmes such as the QFII. This is assessed at source with the ‘net’ proceeds being received. However, the potential for a capital gains tax (CGT) on China investments has not been clarified with the government giving no indication on whether one will be levied on a retroactive basis or what this right might be. This has, understandably, created uncertainty on the tax status of the though-train before its launch in October.
- **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), but as two-way flows balance out more evenly they 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.

Stock Connect versus QFII/RQFII

	Stock Connect (Northbound)	**QFII**	**RQFII**
Launch date	Oct-2014 (expected)	Nov-2002	Dec-2011
Quota	• Aggregate quota: RMB 300 billion • Daily quota: RMB 13 billion • On first-come-first-serve basis	• Total quota: USD 150 billion • Individual quota: USD 50 million to USD 1 billion	• Total quota: RMB 400 billion • 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. • All dual-listed shares i.e. SSE-SEHK A + H shares • 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

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