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Stock Connect Programme: The Open Sesame to a Strong Chinese Capital Market

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In considering the highly regarded Shanghai-Hong Kong Stock Connect programme, this article offers a brief comparison with other investor regimes and summarizes some key trading and clearance arrangements under the Stock Connect programme, including northbound and southbound trading. Relevant taxes and fees charges under the existing Stock Connect programme, along with potential future developments and reactions of competitors are also discussed.

1. Introduction

On 10 April 2014, a Joint Announcement[1] was made by the Chinese Securities Regulatory Commission (CSRC) and the Securities and Futures Commission (SFC) of Hong Kong with the aim to establish mutual access between the mainland China and Hong Kong stock markets through the highly regarded Shanghai-Hong Kong Stock Connect programme, which was officially launched on 17 November 2014 further to a clarification of the relevant Chinese tax implications.[2]

In brief, this regime would enable Hong Kong and overseas investors to trade and settle, through Hong Kong brokers, the A shares listed on the Shanghai Stock Exchange (i.e. northbound trading or China Connect – Shanghai), and vice versa, Chinese investors are given access, via their Chinese securities houses, to certain eligible shares[3] listed on the Main Board of the Stock Exchange of Hong Kong (southbound trading).

Chinese officials stated that it represents a significant breakthrough in the opening up of China’s capital market and provides momentum for an enhanced renminbi internationalization process, even though – at this initial stage – the designated trading volume is still subject to quota control[4] and available only for certain eligible Chinese individual investors.

Along with China’s bull market rally, from the launch of the Shanghai-Hong Kong Stock Connect programme until the end of May 2015, the Shanghai Stock Exchange Composite Index surged from 2,474 points to higher than 4,800 points, representing a nearly 95% increase.

Separately, the Hang Seng Index has barely increased prior to the boost at the end of March 2015 (further to the announcement by the Chinese authorities that allowed Chinese mutual funds to invest in Stock Exchange of Hong Kong shares via the Shanghai-Hong Kong Stock Connect programme), and marked an approximately 19% increase at the end of April 2015 following its reaching the highest point in seven years.

2. Features of the Shanghai-Hong Kong Stock Connect Programme

For market participants, the Shanghai-Hong Kong Stock Connect programme has adopted a home-market rule, under which the laws and regulations of the home market of the securities should prevail. As such, in principle, northbound

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* Tax manager, PwC Luxembourg.
2 CN: Notice on relevant Tax Treatment for the Pilot Programme of the Shanghai-Hong Kong Stock Connect, Caishui [2014] No. 81 (Notice 81), jointly issued by the Ministry of Finance, SAT (State Administration of Taxation) and CSRC on 14 Nov. 2014.
3 See sec. 2.3.2.2.
4 See sec. 2.3.4.
trading should abide by the relevant Chinese legal requirements,[5] while the Hong Kong law should apply to southbound trading.

2.1. Comparison with qualified foreign institutional investor and renminbi qualified foreign institutional investor regimes

Like the qualified foreign institutional investor[6] and renminbi qualified foreign institutional investor[7] regimes, the newly introduced Shanghai-Hong Kong Stock Connect programme is also regarded as one of the special channels to penetrate the Great Wall of Chinese foreign exchange control on renminbi capital accounts. Given their nature as a temporary measure to gradually and methodically liberate Chinese securities markets to international investors, they are all subject to certain eligibility restrictions and may not exceed the shareholding threshold as imposed on foreign investors.

In a nutshell, these regimes share many similarities, but also have some differences. For example, status as qualified foreign institutional investor and renminbi qualified foreign institutional investor, is reserved for only selected institutional investors (so the allocated quota cannot be transferred) and investment principal funds are subject to a certain lock-up period upon subsequent repatriation, which is not the case for northbound trading in the Shanghai-Hong Kong Stock Connect programme. Table 1 illustrates some of the major differences between the three channels.

Table 1: Differences amongst northbound trading, qualified foreign institutional investor and renminbi qualified foreign institutional investor regimes[1]

<table>
<thead>
<tr>
<th></th>
<th>Shanghai-Hong Kong Stock Connect (northbound trading)</th>
<th>Qualified foreign institutional investor</th>
<th>Renminbi qualified foreign institutional investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quota</td>
<td>Daily quota: RMB 13 billion</td>
<td>Depending on allocated quota to each qualified foreign institutional investor</td>
<td>Depending on allocated quota to each qualified foreign institutional investor</td>
</tr>
<tr>
<td></td>
<td>Aggregate quota: RMB 300 billion</td>
<td>Maximum: USD 150 billion total</td>
<td>Aggregate: RMB 970 billion[2]</td>
</tr>
<tr>
<td>Eligible investors</td>
<td>All Hong Kong and overseas investors for Shanghai Stock Connect trades</td>
<td>Institutional investors subject to selection process[3] and approval</td>
<td>Institutional investors subject to selection process and approval</td>
</tr>
<tr>
<td>Transaction currency</td>
<td>Renminbi</td>
<td>Dedicated foreign currency account[4] and corresponding special renminbi account</td>
<td>Renminbi</td>
</tr>
<tr>
<td>Lock-up period for repatriation</td>
<td>No lock-up period; funds must be repatriated afterwards</td>
<td>1 year (exception: 3 months)[7] and may stay in China afterwards</td>
<td>1 year, and may stay in China afterwards</td>
</tr>
<tr>
<td>Investors' entitlement</td>
<td>Only for securities covered by Shanghai-Hong Kong Stock Connect programme</td>
<td>No limitation[8]</td>
<td>No limitation</td>
</tr>
<tr>
<td>Cross-border fund flow and currency exchange</td>
<td>Handled by China Securities Depository and Clearing Corp. and Honk</td>
<td>By respective qualified foreign institutional investor institutions</td>
<td>By respective renminbi qualified foreign institutional investor institution</td>
</tr>
</tbody>
</table>

5 CN: art. 12 Measures for Shanghai-Hong Kong Stock Connect Pilot Programme of the Shanghai Stock Exchange (SSE [2014] No. 60, 26 Sept. 2014 (Shanghai-Hong Kong Stock Connect Measures).
6 Qualified foreign institutional investor.
7 Offshore renminbi qualified foreign institutional investor.
Shanghai-Hong Kong Stock Connect (northbound trading) | Qualified foreign institutional investor | Renminbi qualified foreign institutional investor
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Kong Securities Clearing Company Ltd

1. Summarized by the author.
2. For the time being, Hong Kong, RMB 270 billion; Taiwan, RMB 100 billion; Australia, Canada, Luxembourg, Singapore and Switzerland, RMB 50 billion each; France, Germany, Korea and the United Kingdom, RMB 80 billion each; and Qatar, RMB 30 billion.
3. Securities companies (five or more years in operation, having net equity of at least USD 500 million and managing security assets in the latest accounting year of at least USD 5 billion), commercial banks (ten or more years in operation, Tier 1 capital of at least USD 300 million, and manages security assets in the latest accounting year of at least USD 5 billion), as well as, for example, asset management institutions, insurance companies and other institutional investors, pension funds, charitable funds, donation funds, trust companies and governmental investment management companies, (two or more years in operation, and managing security assets in the latest accounting year of at least USD 500 million).
4. US dollar, euro, British pound, Hong Kong dollar and Japanese yen.
5. See sec. 2.3.2.1.
6. Shares, bonds and warrants listed and traded on Chinese stock exchanges, fixed income products on the interbank market, security investment funds, index futures and other financial products as approved by the CSRC.
7. Qualified foreign institutional investors in the form of pension funds, insurance funds, mutual funds, charitable funds, donation funds, governmental and currency management authorities, as well as open-ended Chinese funds (i.e. an open-ended securities investment fund launched overseas having more than 70% of its fund assets invested within China).
8. A qualified foreign institutional investor may also participate in the issuance of new shares, convertible bonds and stock dividends.

Due to the higher quota available, wider pool of eligible investors, quicker time to market as well as lower set-up and running costs (e.g. absence of formality in applying quota, dealing with currency exchange, fewer onshore accounts), it appears that northbound trading does offer overseas investors an attractive alternative to invest into the Chinese A share market.

### 2.2. Comparison with qualified domestic institutional investor regime

Unlike the untimely so-called “Hong Kong ghost train scheme” floated in 2007, the Shanghai-Hong Kong Stock Connect programme was successfully launched in November 2014 and fortunately remained on track this time. Subject to Chinese foreign exchange rules (in particular, the annual conversion ceiling equivalent to USD 50,000 that is applicable to individuals), Chinese investors are permitted to hold foreign investments via the qualified domestic institutional investor regime, under which only approved Chinese institutions may apply for investment quotas (USD 90 billion had been approved as at 28 April 2015) on behalf of their underlying investors.

Compared with the qualified domestic institutional investor regime, the scope of eligible investments under southbound trading is limited to certain shares listed on the Main Board of the Stock Exchange of Hong Kong. Moreover, only certain Chinese individuals who have passed the eligibility criteria (including holding a security and cash account of at least RMB 500,000, not having a bad credit record, and never having been prohibited or restricted from participating in southbound trading by any relevant laws, administrative regulations, or operational procedures) are allowed to invest through southbound trading.

Apparently, a stronger Chinese capital outflow figure will ease the appreciation pressure on the renminbi, and thus – in addition to the qualified domestic institutional investor and southbound trading schemes – the Chinese authorities are now contemplating the introduction of the second qualified domestic institutional investor regime (known as “QDII 2”), in

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essence to broaden the coverage of the current qualified domestic institutional investor regime (reserved for institutional investors) to individuals, as well (i.e. qualified domestic individual investors).

2.3. Trading and clearance arrangements

2.3.1. Eligible investors

Northbound trading is open to all Hong Kong and overseas investors, including both institutional and individual investors, via any Stock Exchange of Hong Kong participant (exchange participant, or Stock Exchange of Hong Kong securities trading service company), provided that the Exchange participant is eligible to participate in the Shanghai-Hong Kong Stock Connect programme (where Exchange participants must fulfil certain requirements in relation to, for example, information technical capability and risk management).

As for southbound trading, only Chinese institutional investors and those individual investors who satisfy the eligibility criteria will be allowed to trade qualified Stock Exchange of Hong Kong shares via the Shanghai-Hong Kong Stock Connect programme.

Some uncertainty remains regarding how to differentiate Chinese investors from Hong Kong and overseas investors (for example, migrated investors and investors with dual residency).

2.3.2. Eligible shares

2.3.2.1. Northbound trading

Initially, the scope of eligible shares available for northbound trading is defined as:

- constituent shares of the Shanghai Stock Exchange 180 Index;
- constituent shares of the Shanghai Stock Exchange 380 Index; and
- Shanghai Stock Exchange-listed A shares of A+H companies, even though A shares are not included as constituent shares of the above-mentioned indices.

Shares that have been earmarked as “risk alert” by the Shanghai Stock Exchange (i.e. ST, *ST and pre-delisting shares), shares that are traded in foreign currencies (i.e. B shares) and other shares with special situations as recognized by Shanghai Stock Exchange are not included among eligible shares for northbound trading.

In essence, only A shares are considered as eligible in this initial stage of the Shanghai-Hong Kong Stock Connect programme, among the various types of securities listed on the Shanghai Stock Exchange. For example B shares, exchange-traded funds, bonds and other securities are excluded. As of 21 May 2015, 571 eligible shares are available to be traded under northbound trading, as published on the website of Hong Kong Exchanges and Clearing Limited (the parent of the Stock Exchange of Hong Kong).

Shares subsequently removed from the list of eligible shares (e.g. adjustment of index constituent shares) but still listed on the Shanghai Stock Exchange must be disposed of, but may not be purchased in through the Shanghai-Hong Kong Stock Connect programme. The same also applies to entitlement securities granted by invested eligible Shanghai Stock Exchange A shares. In the event that the entitlement security is not listed on the Shanghai Stock Exchange, it is most likely that the said security will be acquired from investors by the respective clearing house.

There is a forced sale rule applicable to the foreign ownership restriction under northbound trading (see section 2.3.7.).

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14 Art. 85 Shanghai-Hong Kong Stock Connect Measures.
15 Supra n. 19.
16 Art. 16 Shanghai-Hong Kong Stock Connect Measures.
17 Dual-listed on the Stock Exchange of Hong Kong and a Chinese stock exchange in Shanghai or Shenzhen.
18 ST stands for Special Treatment, which is a precautionary measure implemented by the Shanghai Stock Exchange to indicate that the said listed company has shown abnormal (financial or other) circumstances, for instance having been in a loss position for two consecutive years.
19 *ST means the quoted shares have realized losses in past years and may be delisted.

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2.3.2.2. Southbound trading

At this initial phase, the defined scope of eligible shares included in southbound trading is as follows:[20]

– constituent shares of the Hang Seng Composite LargeCap Index;
– constituent shares of the Hang Seng Composite MidCap Index; and
– Stock Exchange of Hong Kong-listed $H$ shares of $A+H$ companies, although $A$ shares are not included as constituent shares of above-mentioned indices.

Similarly, the $H$ shares of $A+H$ companies the $A$ shares of which have been placed under risk alert by the Shanghai Stock Exchange, the $H$ shares issued by companies that are concurrently listed on Chinese stock exchanges other than the Shanghai Stock Exchange (e.g. the Shenzhen Stock Exchange), Stock Exchange of Hong Kong-listed shares which are quoted and traded in currencies other than the Hong Kong dollar, and other shares with special situations as recognized by the Shanghai Stock Exchange fall outside the scope of eligible shares for southbound trading. In short, only Stock Exchange of Hong Kong equities listed on the Main Board constitute eligible shares for southbound trading, excluding shares listed on the Growth Enterprise Market, exchange-traded funds, real estate investment trusts, structured products, bonds and other securities. As at 25 May 2015, 286 names that are eligible for southbound trading have been published on the website of the Shanghai Stock Exchange.

Likewise, investors must dispose of shares that are subsequently removed from the list of eligible shares, and same treatment is applicable to entitlement securities derived from eligible Stock Exchange of Hong Kong shares. As for entitlement securities not listed on the Stock Exchange of Hong Kong, they will likely be acquired by the relevant clearing house from the recipients.

2.3.3. Trading currency

For northbound trading, the Shanghai Stock Exchange $A$ shares will be traded and settled in renminbi only,[21] whereas southbound trading is quoted in Hong Kong dollar and settled in renminbi.

2.3.4. Quotas

Two types of quotas apply under the Shanghai-Hong Kong Stock Connect programme, namely an aggregate quota (all time maximum amount to be bought in) and daily quota (maximum net buy value per day). Both quotas are operated on a net buy basis, such that each sale by investors will release the used quota to the other participants.

Currently, the aggregate quota is set at RMB 300 billion (48% of which has already been used by the middle of May 2015) for northbound trading and RMB 250 billion for southbound trading (approximately 37% utilized). The daily quota is RMB 13 billion for northbound trading and RMB 10.5 billion for southbound trading. Any unused daily quota will not be carried forward.

The aggregate quota is calculated at the end of each trading day, whereas the daily quota is computed on a real-time basis and monitored by the Shanghai Stock Exchange (for southbound trading) and the Stock Exchange of Hong Kong (for northbound trading).

The remaining balances should follow the following formulae:

– the daily quota balance[22] is equal to: one assigned daily quota (RMB 13 or 10.5 billion) – buy orders + sell trades + buy orders cancelled by relevant participants or rejected by the Shanghai Stock Exchange/the Stock Exchange of Hong Kong + margin between the execution prices and declared prices of buy orders; and
– the aggregate quota balance[23] is equal to: assigned aggregate quota (RMB 300 or 250 billion) – aggregate buy trades + aggregate sell trades[24]

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20 Art. 57 Shanghai-Hong Kong Stock Connect Measures.
21 Art. 20 Shanghai-Hong Kong Stock Connect Measures.
22 Arts. 39 and 80 Shanghai-Hong Kong Stock Connect Measures.
23 Arts. 41 and 82 Shanghai-Hong Kong Stock Connect Measures.
24 Aggregate sell trades refer to the total weighted average costs of all buy trades of respective eligible shares instead of the corresponding actual buy trade costs.

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Once the daily quota balance drops to zero or lower during trading hours, new buy orders under the Shanghai-Hong Kong Stock Connect programme will be temporarily suspended unless the balance has resumed a positive level due to the cancellation of buy orders or an increase of sell trades.

By the same token, if the aggregate quota balance falls below one assigned daily quota, the Shanghai-Hong Kong Stock Connect programme will be suspended on the next trading day, although investors may still place sell orders. The programme will be reopened on the condition that the aggregate quota exceeds one assigned daily quota.

2.3.5. Trading hours and trading days

The Shanghai Stock Exchange and the Stock Exchange of Hong Kong have followed different trading hours during the day (excluding lunch break time), namely the Shanghai Stock Exchange trades from 9:15 to 15:00 and the Stock Exchange of Hong Kong trades from 9:00 to 16:00. As a reminder of the fundamental home market principle of the Shanghai-Hong Kong Stock Connect programme, northbound trading must follow the rule of the Shanghai Stock Exchange, while the southbound trading follows the hours of the Stock Exchange of Hong Kong.

In addition, the Shanghai-Hong Kong Stock Connect programme is currently available only on the days where both trading and banking services are open in China and Hong Kong. In other words, investment via this programme will not be possible on the days that either the Shanghai Stock Exchange or the Stock Exchange of Hong Kong is closed, nor on bank holidays of clearing houses in China or Hong Kong.

During half trading days[25] scheduled by the Stock Exchange of Hong Kong, however, northbound trading will be continued until the Shanghai Stock Exchange market is closed, while southbound trading will be opened for half a day (but settlement will be done the next day).

2.3.6. Margin trading and covered short selling

One of the significant changes, since the Joint Announcement, to the actual launch of the Shanghai-Hong Kong Stock Connect programme is that it is now possible for investors to conduct margin trading and covered short selling in northbound trading, subject to conditions set by the Shanghai Stock Exchange, specifically as restricted by the margin trading and securities lending programme of the Shanghai Stock Exchange.[26]

One practical issue that may arise is that whether the securities traded via the Shanghai-Hong Kong Stock Connect programme may be injected in the collateral account under the margin trading and securities lending programme where the brokers could accept cash and other recognized securities to compute the collateral, but subject to a certain discounted rate.[27] Obviously, securities under judicial seizure or freeze order are excluded from acceptable collateral security and the scope of security lending as required by margin trading and the securities lending programme.

In the author’s view, insofar as the ownership will remain unchanged, the assignment of security into a collateral account should not constitute a non-trade transfer as prohibited by the Shanghai-Hong Kong Stock Connect programme, whereas in the event of a title transfer, a financial collateral arrangement will most likely give rise to concerns from the Shanghai Stock Exchange.

2.3.6.1. Margin trading

Even though eligible northbound trading investors may not join the margin trading and securities lending programme, under the current Shanghai-Hong Kong Stock Connect programme, Hong Kong and international investors may still enter into any form of securities margin financing arrangement to use the funds provided by Exchange participants to buy eligible northbound trading securities.

To ensure parity, only A shares under the margin trading and securities lending programme of the Shanghai Stock Exchange’s may be covered by the above-mentioned securities margin financing arrangements provided by Hong Kong Exchange participants. Margin trading activities, as permitted under northbound trading, is also subject to the risk

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25 Christmas Eve, New Year’s Eve and Chinese New Year’s Eve.
26 CN: Notice on Promulgating Measures for the Pilot Margin Trading and Securities Lending Business of Securities Companies (CSRC [2006] No. 69, 30 June 2006), where margin trading and security lending services may be provide by trading houses with Shanghai Stock Exchange membership and available on certain shares (required thresholds include shares already quoted on the Shanghai Stock Exchange for more than three months, and having at least 4,000 shareholders), investment funds, bonds and other securities.
27 CN: Art. 24 Margin Trading and Securities Lending Programme Measures.
management control measures (e.g. the Shanghai Stock Exchange may suspend margin trading in the event that the underlying stock margin balance exceeds 25% of outstanding circulation)\cite{28} set out by the Shanghai Stock Exchange.

As for southbound trading, the Shanghai Stock Exchange is still in the process of analysing how to allow Exchange members to provide margin trading and securities lending services for southbound trading participants. For the time being, the relevant rules are left blank.\cite{29}

### 2.3.6.2. Short selling

Under northbound trading, only covered short selling is allowed, while naked short selling is forbidden per se. For the time being, allowed covered short selling is subject to various restrictions, including:

- similar to margin trading, only securities within the margin trading and securities lending programme of the Shanghai Stock Exchange (as at 21 May 2015, only 412 out of 571 names) may be considered as eligible;\cite{30}
- Stock Exchange of Hong Kong participants must flag their short selling orders;
- the input price and total quantity of covered short selling orders are restricted;
- a mandatory reporting obligation is imposed on Stock Exchange of Hong Kong participants; and
- the Shanghai Stock Exchange may suspend short selling if the total open short positions exceeds 25% of outstanding circulation.

Given the numerous embedded restrictions, investors have shown very little interest since covered short selling was first permitted on 2 March 2015. Although there are more than 400 shares available for selling short, almost no one has actually submitted an order (as of April 2015, not a single short selling transaction had been concluded).

Just as in the case of margin trading under northbound trading, so far the relevant rules for southbound trading short selling have not yet been released by the Shanghai Stock Exchange.

### 2.3.7. Nominee holder and foreign shareholding restrictions

#### 2.3.7.1. Proprietary rights of investors

In Hong Kong, the law recognizes the proprietary rights of investors in shares held by their brokers or custodians in the Hong Kong Central Clearing and Settlement System, such that the brokers or custodian is deemed to be the “nominee holder” on behalf of investors (being the “beneficial owner”) and do not possess a proprietary interest in the securities.

An equivalent position as confirmed by the Shanghai Stock Exchange should apply to securities held by Hong Kong and overseas investors under northbound trading. As such, the A shares are registered with the China Securities Depository and Clearing Corporation in an omnibus security account under the name of a nominee holder (Hong Kong Securities Clearing Company). As such, the Hong Kong Securities Clearing Company should, in its own name, exercise the rights of the northbound trading securities in accordance with the instructions from the underlying investors, and is entitled to participate in the online voting system of the Shanghai Stock Exchange in relation to the shareholders’ meetings of Shanghai Stock Exchange-listed security-issuing companies.\cite{31} and to benefit from entitlement to dividends.\cite{32}

Some potential complications may arise, such as with regard to which governing law should apply in case of a dispute between the nominee holder and the investors (through local dealers), how Chinese courts might recognize or enforce the beneficial ownership concept of the underlying investors, whether there is a possibility to raise class action litigation, and limitations on recourse.

#### 2.3.7.2. Restrictions on foreign ownership

The same foreign ownership restrictions for qualified foreign institutional investors and renminbi qualified foreign institutional investors apply also for northbound trading, such that a single foreign investor’s shareholding in a Chinese company cannot exceed 30% of its paid-up capital under northbound trading.

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\textsuperscript{28} Margin trading may be resumed on the next trading day after the underlying stock margin balance (equity bought in under margin minus repayment to margin account) drops below 20% of total circulation.

\textsuperscript{29} Art. 120 Shanghai-Hong Kong Stock Connect Measures.

\textsuperscript{30} Art. 25 Shanghai-Hong Kong Stock Connect Measures.

\textsuperscript{31} Art. 118 Shanghai-Hong Kong Stock Connect Measures. For further details, see Notice on the Announcement of Guidelines for Hong Kong Securities Clearing Company’s Participation in Online Voting of Shanghai Stock Connect Companies (SSE [2014] No. 71, 10 Nov. 2014).

\textsuperscript{32} Art. 119 Shanghai-Hong Kong Stock Connect Measures.

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listed company may not exceed 10% of the total shares issued, and the combined shareholding by foreign investors in a Chinese listed company may not exceed 30% of the total issued shares.\[33\]

To ensure compliance with Chinese foreign shareholding restrictions, the Shanghai Stock Exchange will take the following actions, as appropriate:

- if the total foreign shareholding in a Chinese listed company is greater than or equal to 26%, a notice will be published on the website of the Shanghai Stock Exchange;
- when the total foreign shareholding is greater than or equal to 28%, the Stock Exchange of Hong Kong will limit buy orders on that company;
- when the total foreign shareholding reaches or exceeds 30% due to northbound trading, the shares must be sold within five trading days; and
- when the total foreign shareholding drops below 26%, northbound trading will be resumed on the following trading day.

As for the 10% foreign shareholding restriction, it is the obligation of the Stock Exchange of Hong Kong participant to monitor and remind its clients in this regard, and warn them of the potential risk of forced selling-out treatment.

As regards the determination of shareholding, the CSRC clarified at a press conference that all equities as issued (including A and B shares, as well as shares listed on overseas stock exchanges, like H shares, N shares,\[34\] and S shares)\[35\] and the shares held by parties acting in concert\[36\] (e.g. controlled subsidiaries and sister companies under the same controlling shareholder) must be taken into account as already implemented for investment made by qualified foreign institutional investors. By taking this position, it is clear that the criterion of actual control (in the form of voting power) is to be regarded as a deciding factor. Nevertheless, it is not yet clear whether some preferred shares with limited voting rights should be treated differently and, if so, to what extent.

In general, from a Hong Kong perspective, foreign investments in southbound trading are not restricted, except for the quota limitation set by the Shanghai-Hong Kong Stock Connect programme.

### 2.3.8. Short swing profit rule and insider information disclosure

To comply with the Chinese Law on Securities, where a 5% shareholder of a Chinese listed company sells (or purchases) shares (in the present case, via northbound trading under the Shanghai-Hong Kong Stock Connect programme) and realizes a gain (i.e. short-swing profit) within six months of the acquisition (or sale), in the event of any gain therefrom, the shareholder must relinquish such gain, which would then be recovered by the security issuer’s board of directors.\[37\] Hong Kong does not impose a similar rule.

In respect of the disclosure obligation under the Chinese Law on Securities, once the shareholding reaches (or falls under) a 5% interest in a Chinese listed company (as this is deemed to be a major event),\[38\] a disclosure obligation arises, such that the investors must (i) inform the CSRC and the relevant Chinese stock exchange in writing and (ii) notify the issuer to make necessary publication, within three working days. During that three-day period, no share transfer of the Chinese listed company may be conducted by that investor. Going forward, if the investor increases or decreases its interest by 5%, the subsequent disclosure obligation must be fulfilled within two working days (with temporary suspension of relevant trading).

Insider information is defined as any unpublished information relating to the business or financial position of a company, or carrying significant effect on the market price of the securities.\[39\] Insider trading, as prescribed by the Chinese Law on Securities, is deemed to occur where an insider (such as a shareholder holding at least 5%, including the shares held by

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\[33\] Art. 12 Provisions on the Shanghai-Hong Kong Stock Connect Pilot Programme (CSRC No. [101], 13 June 2014).

\[34\] Listed on the New York Stock Exchange.

\[35\] Listed on the Singapore Stock Exchange.

\[36\] CN: Measures for the Administration of the Takeover of Listed Companies (CSRC No. [35], 31 July 2006). This refers to the other parties acting in concert with the investor, for example legally bound by some agreements.

\[37\] CN: Art. 47 Law on Securities. Shares underwritten by securities dealer are not subject to this six-month rule.

\[38\] Arts. 67 and 86 Law on Securities.

\[39\] Art. 75 Law on Securities.
its parties acting in concert) uses the insider information to trade securities or to make a suggestion to others, or leaks the insider information. The insider will be held liable for any losses suffered by investors due to the insider trading.\(^{[40]}\)

Although the insider trading concept under the Chinese Law on Securities is largely similar to that from a Hong Kong perspective, the Chinese judicial interpretation of the scope of the safe harbour for insider trading\(^{[41]}\) seems to be more restricted compared with the Hong Kong practice on insider trading.

### 2.3.9. Derivatives

Based on a four-party agreement signed on 4 September 2014,\(^{[42]}\) on-exchange derivative products are expressly excluded from the scope of eligible shares that may be traded through the Shanghai-Hong Kong Stock Connect programme at this initial stage. As such, both the Shanghai Stock Exchange and the Stock Exchange of Hong Kong will neither develop nor accept derivative products based on any stock or stock index as listed on the other exchange’s market unless the other exchange gives its consent in writing.

On the other hand, a commentator is of the opinion that – given that there is no prohibition under Chinese law to create economic interests over A shares listed on the Shanghai Stock Exchange (as already seen for qualified foreign institutional investor and renminbi qualified foreign institutional investor shares) – market participants should be able to issue over-the-counter equity derivatives that are cash settled and that may be hedged without breaching the prohibition on non-trade transfer restrictions as imposed under the current Shanghai-Hong Kong Stock Connect programme.\(^{[43]}\) Also, the general observation of this commentator is that, due to reluctance of Chinese regulators, it is still uncertain whether over-the-counter derivatives may be issued in the form of synthetic shorts or as bearish products over A shares by market participants.\(^{[44]}\)

### 2.3.10. Miscellaneous

Under northbound trading, day (turnaround) trading is not permitted (as the settlement of funds will only be effected the day after the trading day, i.e. T+1) but Chinese investors are allowed to do so for Stock Exchange of Hong Kong shares in southbound trading.

Block trading and manual trade facilities are not available, irrespective of northbound or southbound trading. Off-exchange and non-trade transfer are generally prohibited unless otherwise allowed, for instance to rectify trading errors between brokers and their clients, allocation between funds of funds,\(^{[45]}\) succession, divorce, dissolution of companies and donation to a charitable foundation.\(^{[46]}\)

For both northbound and southbound trading, only limit orders\(^{[47]}\) will be accepted. Unlike the quotation rules applicable on the Stock Exchange of Hong Kong, the Shanghai Stock Exchange operates a price limit of about 10%\(^{[48]}\) on the previous closing price in order to stabilize share prices.

### 3. Taxation and Fees under the Shanghai-Hong Kong Stock Connect Programme

To grasp the potential transaction charges (taxes and fees) on the Shanghai-Hong Kong Stock Connect programme, one should firstly consider a notice jointly issued by the Ministry of Finance, the SAT and CSRC on 14 November 2014, namely Notice 81,\(^{[49]}\) in which the Chinese tax implication are clarified by the Chinese tax authorities in detail.

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\(^{[40]}\) Art. 76 Law on Securities.

\(^{[41]}\) CN: SC, 29 Mar. 2012, Interpretation of the People’s Supreme Court and the People’s Supreme Procuratorate on Several Issues Concerning the Specific Application of Law in the Handling of Criminal Cases of Engaging in Insider Trading or Leaking Insider Information (Chinese Supreme Court [2012] No. 6).

\(^{[42]}\) Among the Shanghai Stock Exchange, the Stock Exchange of Hong Kong, the China Securities Depository and Clearing Corporation and the Hong Kong Securities Clearing Company.


\(^{[44]}\) Id.

\(^{[45]}\) Arts. 41 and 82 Shanghai-Hong Kong Stock Connect Measures.

\(^{[46]}\) CN: art. 9 Implementing Rules for Registration, Depository and Clearing Services under the Shanghai-Hong Kong Stock Connect Pilot Programme, CSDC [2014] No. 109 (26 Sept. 2014).

\(^{[47]}\) An order with a specified price which can be matched only at the specified or better price.

\(^{[48]}\) Approximately 5% for ST shares.

\(^{[49]}\) See supra n. 2. 
It is noteworthy that another notice was issued on the same day to render the tax treatment for the Shanghai-Hong Kong Stock Connect programme on par with that for qualified foreign institutional investors and renminbi qualified foreign institutional investors. As such, qualified foreign institutional investors and renminbi qualified foreign institutional investors will also be temporarily exempt from withholding tax on gains derived from the trading of equity investment assets (e.g. A shares, B shares, equity mutual funds, stock warrants and stock indexed futures). Apparently, the scope is greater than that under the current Shanghai-Hong Kong Stock Connect programme. A main criticism in this regard is the lack of clarity regarding the temporary nature of the exemption period.

Moreover, Notice 81 also provides a long-awaited clarification regarding qualified foreign institutional investor capital gain taxation, stipulating that qualified foreign institutional investors and renminbi qualified foreign institutional investors will be subject to withholding tax on their capital gains derived before 17 November 2014.

Based on the recently signed Fourth Protocol to the China-Hong Kong income tax treaty, the capital gain provision will provide that only the resident state will tax gains derived by its tax residents (and some eligible resident investment funds) on their disposal of Chinese listed shares if the shares are bought and sold on the same stock exchange (i.e. the Shanghai-Hong Kong Stock Connect programme is covered). In addition, the main-purpose test is introduced for the dividend, interest, royalty and capital gain articles of the treaty.

### 3.1. Northbound trading

In light of Notice 81, the key Chinese tax treatment to be applied under the Shanghai-Hong Kong Stock Connect programme is summarized and presented in the following table, along with the fees to be charged by the Shanghai Stock Exchange.

**Table 2: Taxes and fees applicable to northbound trading**

<table>
<thead>
<tr>
<th>Item</th>
<th>Rate</th>
<th>Charged by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese income tax (for both individuals and enterprises)</td>
<td>Temporarily exempted on transfer gains derived from eligible A shares</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td></td>
<td>10% withholding tax on dividends, or a reduced treaty rate with subsequent refund</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td>Chinese business tax (for both individuals and enterprises)</td>
<td>Temporarily exempted on transfer gains derived from eligible A shares</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td>Chinese stamp duty</td>
<td>0.1% of the consideration (sale, succession or gift) by the seller</td>
<td>Collected by Shanghai Stock Exchange on behalf of Chinese tax authorities</td>
</tr>
<tr>
<td>Chinese handling fee</td>
<td>0.00696% of the consideration by both seller and buyer</td>
<td>Shanghai Stock Exchange</td>
</tr>
<tr>
<td>Chinese securities management fee</td>
<td>0.002% of the consideration by both seller and buyer</td>
<td>Collected by Shanghai Stock Exchange on behalf of CSRC</td>
</tr>
<tr>
<td>Chinese transfer fee</td>
<td>0.06% of the consideration by both seller and buyer</td>
<td>Collected by Shanghai Stock Exchange on behalf of China Securities Depository and Clearing Corporation</td>
</tr>
</tbody>
</table>

Summarized by the author. The fees charged by respective security brokers are not included, nor are the Hong Kong tax implications of the investors.

Despite the clarification provided in Notice 81, a few issues still require further clarification, for example as regards the basis on which the gain is to be computed (e.g. will netting be allowed or is gain determined purely on a transaction-by-transaction basis), the method that may be used to calculate the cost basis of A shares (e.g. weighted average or first-in-first-out), whether related fees/charges may be considered as a part of the acquisition cost and whether it is necessary to

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50 To the extent that qualified foreign institutional investors and renminbi qualified foreign institutional investors do not have an establishment or place in China, or the Chinese-source income is not effectively connected with the Chinese establishment or place.

51 Art. 13(6).
obtain a declaration from the nominee holder to apply for treaty benefits under the Shanghai-Hong Kong Stock Connect programme as required by a public announcement[53] issued by the SAT.

3.2. Southbound trading

Hong Kong does not impose non-resident withholding tax on dividend payments, nor does it tax capital gains derived by non-resident investors. Therefore, the primary costs will be the fees to be charged, while the Chinese tax implications are mainly set forth in Notice 81.

Table 3: Taxes and fees applicable to southbound trading[1]

<table>
<thead>
<tr>
<th>Items</th>
<th>Rate</th>
<th>Charged by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chinese individual income tax</td>
<td>3-year[2] exemption on transfer gains derived from eligible Stock Exchange of Hong Kong equities</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td></td>
<td>20% withholding tax on dividends, creditable against corresponding individual income tax liability with valid certificate</td>
<td>Withheld by H share companies or China Securities Depository and Clearing Corporation on behalf of Chinese tax authorities</td>
</tr>
<tr>
<td>Chinese enterprise income tax</td>
<td>Transfer gain is fully taxed in the hands of Chinese corporate investors</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td></td>
<td>Dividends subject to enterprise income tax, although dividends derived from H shares held for at least 12 months are exempted</td>
<td></td>
</tr>
<tr>
<td>Chinese business tax</td>
<td>Temporarily exempted on transfer gains derived on Stock Exchange of Hong Kong equities by Chinese individuals</td>
<td>Chinese tax authorities</td>
</tr>
<tr>
<td></td>
<td>Gains derived by Chinese institutional investors are taxed or exempted under current Chinese tax rules</td>
<td></td>
</tr>
<tr>
<td>Hong Kong stamp duty</td>
<td>0.1% on the transaction value, on both the buyer and the seller</td>
<td>Collected by Stock Exchange of Hong Kong on behalf of Hong Kong tax authorities</td>
</tr>
<tr>
<td>Hong Kong transaction levy</td>
<td>0.0027% per party (buyer and seller) of the consideration</td>
<td>Collected by Stock Exchange of Hong Kong on behalf of SFC</td>
</tr>
<tr>
<td>Hong Kong trading fee</td>
<td>0.005% per party to the transaction, on the consideration of the transaction</td>
<td>Stock Exchange of Hong Kong</td>
</tr>
<tr>
<td>Hong Kong trading tariff</td>
<td>HKD 0.5 on each and every purchase or sale transaction</td>
<td>Stock Exchange of Hong Kong</td>
</tr>
<tr>
<td>Hong Kong stock settlement fee</td>
<td>0.002% of gross value, subject to a minimum fee of HKD 2 and maximum of HKD 100 per party to the transaction, per trade</td>
<td>Hong Kong Securities Clearing Company</td>
</tr>
<tr>
<td>Hong Kong stock clearing fee</td>
<td>HKD 1 per input</td>
<td>Hong Kong Securities Clearing Company</td>
</tr>
<tr>
<td>Hong Kong portfolio fee for depository and</td>
<td>0.008% – 0.003%, depending on the aggregate daily stock portfolio value in stock accounts, collected on a monthly basis</td>
<td>Collected by Hong Kong Securities Clearing Company Nominee Limited</td>
</tr>
<tr>
<td>nominee services</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1 Summarized by the author. The fees charged by respective security brokers are not included.


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4. Future Outlook

As a ground-breaking initiative to open the Chinese capital market, the Shanghai-Hong Kong Stock Connect programme must overcome several obstacles, in particular the difference between the two connected markets (see section 2.3.) in terms of, for example, the legal environment and stock market practices.

After a few months, nearly 48% of the aggregate quota under northbound trading had already been used up by the middle of May 2015, and approximately 37% had been utilized for southbound trading. In effect, this is expected to create an increased investment flow into the merged greater China pool of capital as fuelled by the Shanghai-Hong Kong Stock Connect programme.

Despite the uncertainty as to how long the bull market will last for Chinese shares, in order to foster an improved Shanghai-Hong Kong Stock Connect programme, the Shanghai Stock Exchange is already giving serious thought to expand the scope of permitted margin trading and security lending transactions, such that the scope of eligible securities would also include bonds, exchange-traded funds and stock-indexed futures.

On the other hand, to respond investor enthusiasm, it is anticipated by market participants that in the short term (some say as early as September 2015), the next stock connect programme will be launched between the Stock Exchange of Hong Kong and the Shenzhen Stock Exchange, so as to expand the asset classes available to Hong Kong and overseas investors. Compared with its counterpart in Shanghai (the Shanghai Stock Exchange), there are more small and medium-sized enterprises and start-up technical companies quoted on Shenzhen Stock Exchange. In addition, some participants are anticipating that the Shenzhen-Hong Kong Stock Connect programme will also cover the trading of listed investment funds, bonds and even derivative products.

In the same vein, based on the comments given by a CSRC official, it is understood that Chinese authorities are also considering tapping the Taiwan Stock Exchange to participate in a stock connect programme (i.e. Shanghai-Taiwan Stock Connect). It is also rumoured that the Singapore Stock Exchange is also in the process of negotiating its participation in a Chinese stock connect programme in the next 12 to 18 months.

Inspired by the success brought about by the Shanghai-Hong Kong Stock Connect programme, the stock exchanges in Japan, Singapore and Taiwan are exploring new connections amongst each other in order to drive an increase in volume. For instance the Japan Exchange Group (JPX)\[^{56}\] has signed a letter of intent with Singapore to collaborate in the joint development and promotion of the markets on both exchanges, and Taiwanese regulators have publicly announced that Singapore and Taiwan have plans to link their stock markets in July 2015.\[^{57}\]

However, not every joint venture between stock exchanges will work well. For instance, the connection between the Singapore and Australian stock exchanges was unfortunately put on hold due to opposition by regulators.

5. Conclusion

It has been said that:

Overall, Stock Connect will be of much more use to the mainland than to Hong Kong. It is a tool to develop effective capital markets to fund its most competitive companies and take pressure off the banking system to provide short-term loans. Foreign investors in A shares will bring in new valuation techniques that will no doubt find and reward good quality companies.\[^{58}\]

It remains to be seen in the long run whether the Shanghai-Hong Kong Stock Connect programme will head in the expected direction. However, as concluded by Hong Kong Exchanges and Clearing Limited, the Shanghai-Hong Kong Stock Connect programme has indeed created a feasible, controllable and expandable channel for mutual market access.

between mainland China and Hong Kong. Needless to say, several similar regimes are on their way to becoming a part of the strong Chinese (or pan-Asian) capital market in the near future, and the story is just beginning.