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International Information for International Business

VOLUME 0, NUMBER 0 >>> FEBRUARY 2016

Hong Kong

China-Hong Kong Connect: An Interconnected World

By John Chrisman, David Richardson and Alan Lee

In November 2014, the Shanghai-Hong Kong Stock Connect (the "Shanghai Train"), a pilot program for establishing mutual stock market access between mainland China and Hong Kong, was officially launched. The new cross-border investment channel established mutual stock market access between Hong Kong and mainland China, allowing Hong Kong and international investors to invest directly in designated securities listed on the Shanghai Stock Exchange (the "SSE"), and investors from mainland China to invest directly in designated securities listed on the Hong Kong Exchanges and Clearing Limited (the "HKEx").

Following the launch of the Shanghai Train, a second connect, the Shenzhen-Hong Kong Stock Connect (the "Shenzhen Train") was introduced. Although initially expected to commence operations in summer 2015, stock market turbulence during the period resulted in the Shenzhen Train being delayed, and details regarding its official launch have yet to be explained. Despite volatile trading conditions, investors eager for a further boost of trading have been calling for a third connect, in the form of a China-Hong Kong commodities connect.

This article will focus on Hong Kong's challenges and opportunities in further fostering connections with mainland China.

The Three-Year Plan

On January 21, 2016, Chief Executive of the HKEx, Charles Li, revealed the bourse's strategic plan for 2016-2018, with an ambitious objective to double its total cash market turnover during this period. At the heart of the HKEx's plan is the recognition that Hong Kong is entering a new phase as a leading international financial center.

In this new era of interconnection and interconnectedness, Hong Kong is to play to its traditional strength as the exemplary intermediary, bridging investors and products from both mainland China and abroad. To realize this vision, the strategic plan relies on three of

HKEx's "asset classes": i) equity; ii) commodity; and iii) fixed income and currency.

Plans for Equity

On December 23, 2015, Reuters reported that Hong Kong had surpassed New York as the world's single largest IPO capital and that the outlook for 2016 remained strong. In his speech, Charles Li stated that the delayed Shenzhen Train would resume, and that the HKEx was actively planning for a third board, one that is similar to the Nasdaq, specifically to cater to technology companies, as Hong Kong strives to be the regional hub for high-tech startups.

The most notable feature in his strategic plan for equity is the proposed IPO connect between Shanghai and Hong Kong. Whereas the existing Shanghai Train and the planned Shenzhen Train allow cross-border trading in the secondary market only, the IPO connect will open the door to the primary market, enabling mainland Chinese investors to subscribe to IPOs in Hong Kong, and Hong Kong as well as international investors to subscribe to IPOs in Shanghai.

The idea was generally well received by the more optimistic market analysts. Due to Hong Kong's relatively small investor pool, at present there are relatively few international companies listed here. However, once the IPO connect is in place, listing in Hong Kong could attract capital from both Hong Kong and mainland China. This unique advantage will be a huge pull for international companies seeking Chinese capital.

The realist camp of market analysts, however, were quick to point out the technical difficulties which must be resolved before the IPO connect can materialize. First and foremost, reconciling regulatory differences between Shanghai and Hong Kong presents a daunting obstacle.

Others are concerned that the IPO connect may, as an unintended consequence, bring an end to H-share listings. Their concern is that, if international investors could subscribe to A-shares in Shanghai, subscribing to H-shares in Hong Kong would become redundant. The counter-argument, however, is that H-shares will remain attractive to mainland Chinese companies, since Hong Kong still has more advanced and stable regulatory policies in place. As a result, mainland Chinese companies still seek IPOs in Hong Kong, even after the Shanghai Train was launched in November 2014.

Higher fees in Hong Kong may result in lower price-earnings ratios than in Shanghai or Shenzhen, but the cost seems a price worth paying, given the business freedom in Hong Kong. While the SFC and HKEx allow companies to decide when to proceed with listings, the China Securities Regulatory Commission (the "CSRC") controls both the pace and timing of listings. The CSRC suspended the IPO market on eight occasions in the past two decades, and most recently from July to October 2015 when the stock market was in a rout.

Plans for Commodities

On Oct. 22, 2015, it was announced that the SSE and the London Stock Exchange were looking into the feasibility of connecting with each other, creating a commodities connect between Shanghai and London (the "Shanghai-London Commodities Connect"). The purported connect would have much to learn from the Shanghai Train, particularly because of the substantial differences between Shanghai and London in terms of regulatory regimes, trading systems and market infrastructures.

Subsequent to the announcement, it was expected that the HKEx would introduce a potential commodities connect between London and Hong Kong (the "London-Hong Kong Commodities Connect"), which would differ from the Shanghai-London Commodities Connect in three areas. First, the Shanghai-London Commodities Connect would concern physical commodities, whereas the London-Hong Kong Commodities Connect would concern futures. Second, the Shanghai-London Commodities Connect would focus on mainland China, while the London-Hong Kong Commodities Connect would focus on Hong Kong. Third, the Shanghai-London Commodities Connect would deal with existent commodities, while the London-Hong Kong Commodities Connect would deal with both present and potential products.

It is envisaged that important commodities such as precious metals would be included in the London-Hong Kong Commodities Connect, and the London Metal Exchange would in the near future be listed in Hong Kong. According to Charles Li, the Shanghai-London Commodities Connect and London-Hong Kong Commodities Connect are still in the planning phase. Due to derivative products and hedge activities that are specific to the sector, regulation remains a challenge, and the method of international clearing and settlement has yet to be agreed on.

Plans for Fixed Income and Currency

Convertible and listed bonds were prominently featured in the HKEx's strategic plan, which called for regulators in both Hong Kong and mainland China to synchronize regulatory regimes to facilitate Hong Kong in launching new derivative products and enhancing exchange-traded funds.

As acknowledged by the HKEx, the internationalization of the RMB presents a unique opportunity for Hong Kong to cement its status as a gateway for cross-border fund flows and as a risk management venue. The HKEx has stated that it will seize the opportunity to build the platform that facilitates transactions as the mainland Chinese market continues to open up to foreign investors. In concrete terms, the HKEx plans to launch in Hong Kong more benchmark derivatives with regard to mainland China, including additional RMB currency products as well as derivatives on onshore interest rates, new products and services, including deliverable foreign exchange forward and swap contracts, cross-currency

   ISSN 1357-0889

swaps, currency options and client clearing, leading to a potential bond connect (the "Bond Connect").

However, the viability of the Bond Connect remains doubtful, as it currently lacks vital infrastructure. There may be a long way to go before the Bond Connect could replicate the success of the Shanghai Train.

Summary

As an outward-facing economy, Hong Kong has always been a fair and transparent market for funds and information to move freely, thanks to its stable legal and simple tax systems. The city has historically assisted the world in entering China, and China in meeting the world. It remains the ideal gateway for mainland Chinese and international businesses.

The need of the RMB's internationalization is best served when funds can exert their influence and unlock the currency's potential.

John Chrisman is a partner at Dorsey & Whitney LLP, Hong Kong. He may be reached at chrisman.john@dorsey.com. David Richardson is a partner at Dorsey & Whitney LLP, Hong Kong. He may be reached at richardson.david@dorsey.com. Alan Lee is an associate at Dorsey & Whitney LLP, Hong Kong. He may be reached at lee.alan@dorsey.com.