

# SHENZHEN-HONG KONG STOCK CONNECT OPEN FOR BUSINESS

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Legal Briefings

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Trading through the much anticipated Shenzhen-Hong Kong Stock Connect (**Shenzhen Connect**) commenced on 5 December 2016, offering international and Hong Kong investors direct access to most companies traded in Mainland China for the first time. 100 small cap stocks listed in Hong Kong are also now available to Mainland investors through Shenzhen Connect. The launch of Shenzhen Connect follows on from the launch of Shanghai-Hong Kong Stock Connect (**Shanghai Connect**) in November 2014.

The key features of Shenzhen Connect were outlined in our [e-bulletin of 1 September 2016](#), where we compared them to some of the key features of Shanghai Connect outlined in our [e-bulletin of 1 September 2014](#). This e-bulletin provides an update on the regulatory arrangements for Shenzhen Connect following its successful launch.

## OVERVIEW OF SHENZHEN CONNECT

### Participant and investor eligibility

Shenzhen Connect is open to all market participants that satisfy certain eligibility and readiness requirements prescribed by the relevant exchange, clearing house and regulators.

Trading of Shenzhen Stock Exchange (**SZSE**) listed securities that can be traded under Shenzhen Connect (**SZSE Securities**), other than those that are also listed on the ChiNext market, is open to all Hong Kong and overseas investors, including institutional and individual investors. SZSE Securities that are also listed on the ChiNext market can only be traded by institutional professional investors for the time being.

- Only Mainland institutional investors and those individual investors who satisfy the eligibility criteria (ie, individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts) are accepted to trade securities listed on The Stock Exchange Hong Kong Limited (**SEHK**) which may be traded by Mainland investors under Shenzhen Connect (**SEHK Securities**) in Southbound trading.

## Trading

SEHK has established a wholly-owned subsidiary incorporated in Qianhai Shenzhen (Gangshen Information Services (Shanghai) Limited) (**SEHK Subsidiary**), which is a special trading participant of SZSE and will act as the order routing facilitator for eligible exchange participants placing orders in SZSE Securities for Northbound trading activities under Shenzhen Connect. A similar arrangement is in place to facilitate Southbound trading by Mainland investors of SEHK securities on SEHK.

The Rules of the Exchange of SEHK have been amended to include, amongst other amendments, a new chapter (chapter 14B), which sets out the rights and obligations of eligible participants who engage in Northbound Trading under Shenzhen Connect via the SEHK Subsidiary. See [amended provisions](#) in mark-up.

## Clearing and settlement

- Northbound trades executed on SZSE will be settled by Hong Kong Securities Clearing Company Limited (**HKSCC**) with China Securities Depository and Clearing Corporation Limited, Shenzhen Branch on behalf of its counterparties. Whereas HKSCC will settle such trades with its counterparties in Hong Kong.
- HKSCC has extended its existing participants (in respect of Shanghai Connect) with

China Securities Depository and Clearing Corporation Limited (**ChinaClear**) to undertake the settlement obligations in respect of Northbound trades executed under Shenzhen Connect. A similar settlement arrangement has been adopted by ChinaClear for Southbound trades initiated by Mainland investors under Shenzhen Connect.

## Risk management

- New risk management measures have been incorporated into the *General Rules of CCASS* (see [amended provisions](#) in mark-up) and the *CCASS Operational Procedures* (see [amended provisions](#) in mark-up), to align counterparties' obligations with those imposed by ChinaClear Shenzhen on their other clearing participants.
- To avoid risk spill-over across markets, ChinaClear does not contribute to the HKSCC Guarantee Fund and ChinaClear will not be required to share any default loss of CCASS participants. CCASS participants' Guarantee Fund contributions will not be utilised to offset close-out loss in ChinaClear's default.

## Information technology

- The China Stock Connect System (**CSC**) is used to capture and handle the Northbound orders input by eligible participants. While Hong Kong Exchanges and Clearing Limited (**HKEX**) has completed three rounds of connectivity testing and market rehearsals to ascertain technical readiness of the market infrastructure and operational readiness of market participants, a two-week stabilisation period will be in place until approximately 19 December 2016. In the unlikely event that there is a critical incident disrupting the normal functioning of CSC during the stabilisation period, CSC will fall back to the previous software version (ie, the system version as of 2 December 2016 without Shenzhen Connect).

## Fees and levies

- Investors trading across the boundary under Shenzhen Connect are subject to the same trading fees and levies applicable to local investors.

## REGULATORY AND ENFORCEMENT COOPERATION

The regulatory arrangements for Shenzhen Connect include the Securities and Futures Commission (**SFC**) and the China Securities Regulatory Commission (**CSRC**) entering into a new [memorandum of understanding](#) on strengthening of regulatory and enforcement cooperation under the mutual access between the Mainland and Hong Kong stock markets (**MOU**). This supersedes the previous memorandum of understanding that was signed on 17 October 2014 in relation to Shanghai Connect.

Under the new MOU, the SFC and the CSRC have agreed to, amongst other things, strengthen their market surveillance capabilities and complement each other's respective surveillance strengths, enhance the precision and accuracy of market monitoring reports, and further expand the channels and platforms for exchanging alerts and market surveillance intelligence.

In addition, the SFC and the CSRC [announced](#) on 25 November 2016 that they have established arrangements and procedures for cross-boundary liaison and cooperation on any contingency or major event that affects the mutual trading access, and for referring and handling investors' complaints.

The new MOU is said to strengthen the enforcement cooperation between the CSRC and the SFC and signify their joint commitment to take effective action against cross-boundary illegal activities and market misconduct to maintain an orderly market and protect investors.

## INVESTOR PROTECTION

It has been confirmed that Hong Kong's Investor Compensation Fund established under the *Securities and Futures Ordinance* (**SFO**) does not cover any Northbound trading (or Southbound trading) under Shenzhen Connect. However, eligible participants are required to comply with the investor protection measures under the SFO and the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (**SFC Code of Conduct**) applicable to Northbound trading activities undertaken for clients under Shenzhen Connect, including those relating to dealings with client securities and payment of client money into segregated accounts.

As referred to above, trading in SZSE Securities which are listed on the ChiNext market is limited to institutional professional investors for the time being. This is because of the speculative nature of the lightly traded small-cap ChiNext stocks, which gives rise to volatility and lower liquidity risks that are unlikely to be understood by investors without further education and appropriate risk disclosure. It is expected that other investors will be able to trade the restricted stocks once these regulatory issues have been resolved.

In the meantime, if a ChiNext order is executed for a non-institutional professional investor client, China Clear Exchange Participants (**CCEPs**) are expected to self-report to the SEHK as is the case of any violation of HKEX and/or SEHK rules (they should also consider whether it is necessary to self-report to the SFC). It is also expected that CCEPs should already have necessary measures in place to rectify the breach given that it would be no different from, for example, a non-professional investor mistakenly purchasing debt securities, which is currently restricted under the SEHK listing rules and the SFC Code of Conduct.

In the [frequently asked questions](#) issued on 25 November 2016, it is stated that the SEHK takes any breaches of rules seriously and will review and follow up on each incident, including issuing warning letters, conducting further enquiries, commencing investigations and reporting matters to the SFC and the Mainland regulator and/or exchanges.

## **PROVIDING SECURITIES DEALING SERVICES UNDER SHANGHAI CONNECT AND SHENZHEN CONNECT**

On 11 November 2016, the SFC issued a [circular](#), which reminded licensed corporations to ensure compliance with the relevant requirements of the SFC, HKEX, SEHK, HKSCC, Shanghai Stock Exchange (**SSE**) and ChinaClear when providing Northbound trading services to their clients. (In respect of Shenzhen Connect, this reminder should now extend to the requirements of SZSE.)

In particular, licensed corporations should ensure that their clients are aware of the differences in rules and regulations, trading and settlement arrangements and risks associated when trading SSE listed and traded securities which may be traded under Shanghai Connect (**SSE Securities**) and SZSE Securities, including by:

making available updated client agreements and other account opening documents that contain terms and conditions covering the Northbound trading under Shanghai Connect and Shenzhen Connect and adequate risk disclosure statements regarding the risks associated with the same, before services are provided to clients;

providing clients with information regarding the trading and settlement arrangements under Shanghai Connect and Shenzhen Connect; and

- stating clearly the scope of services available to clients (eg, margin financing, stock borrowing and lending etc) and the corresponding terms and conditions.

In light of the perceived increase in trading volume relating to Northbound trading activities after the launch of Shenzhen Connect, the circular also encouraged licensed corporations to enhance their controls and systems to monitor clients' compliance with shareholding restrictions and disclosure obligations and changes to the list of SSE Securities (and SZSE Securities) eligible for margin trading.

Licensed corporations were also reminded to put in place adequate policies and procedures to ensure compliance with all applicable regulatory requirements as well as the firm's own internal policies and procedures, including in respect of customer due diligence, transaction monitoring, record keeping etc. Appropriate and effective measures must also be implemented and reasonable steps taken to ensure that trading of SZSE Securities that are also listed on the ChiNext market will be limited to institutional professional investors.

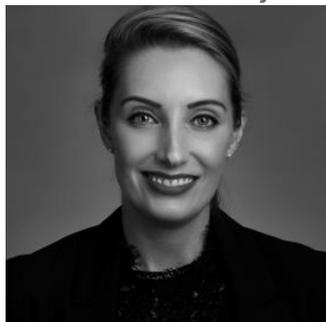
## CONCLUSION

As referred to in [our e-bulletin of 1 September 2016](#), the SFC and the CSRC have stated that to further enrich the variety of traded products and provide more investment opportunities and convenience for domestic and overseas investors, they will be including exchange-traded funds as eligible securities under Shanghai Connect and Shenzhen Connect in the future.

The HKEX also continues to look ahead and has declared that its next step in the equity space is to launch "Primary Equity Connect" to enable investors to subscribe to primary market offerings, and to expand its derivatives suite to help cross-border investors manage their risks.

## KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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