Stock Connect - Changing the game for financing China A-Shares

J.P. Morgan, the Hong Kong Stock Exchange, and Linklaters have come together to offer an in-depth overview of the Hong Kong-Shanghai Stock Connect, along with key legal considerations and how securities can be utilised within a triparty collateral management structure

As offshore banks and broker-dealers continue to grow their China A-share positions, driven by increasing access to the A-Shares market via Stock Connect, demand to utilise these securities as collateral is on the rise. There is a significant opportunity for triparty lenders to accept Stock Connect securities as collateral as the triparty structure is one of the only practical options for securities financing.

J.P. Morgan recently hosted more than 50 participants from Hong Kong, London and Tokyo at a roundtable to take a deeper look at the structure and opportunity. J.P. Morgan, the Hong Kong Stock Exchange (HKEX) and Linklaters provided an in depth overview of Stock Connect, key legal considerations and how securities can be utilised within a triparty collateral management structure.

The basics... and beyond

Historically access to China's mainland capital markets by offshore investors has been restricted through investment quota limits and local currency controls. Over the past five years, with the introduction of the Stock Connect programme, offshore investors no longer have access or repatriation restrictions. Stock Connect was developed as a mutual market access service between Hong Kong and mainland China. Through this programme the Chinese regulators allow money to flow in and out of China in a controlled manner, via a single channel which is connected to the Hong Kong, Shanghai and Shenzhen Stock Exchanges.

Using Stock Connect, institutional and retail investors in Hong Kong and mainland China can directly buy shares in each other's markets. The structure allows for significant investment flows in both directions:

- Northbound trading: Hong Kong and international investors can trade in selected equities on the Shanghai (SSE) and Shenzhen (SZSE) Stock Exchanges, routed through Hong Kong brokers.
- Southbound trading: Investors in mainland China can trade selected equities on the HKEX through brokers in mainland China.

The programme is mutually beneficial: Hong Kong and international investors gain access to China, one of the world's largest equity markets which is largely untapped from an international investment perspective. At the same time, certain mainland Chinese investors can access equities listed on the HKEX, giving them additional diversification and investment opportunities via Hong Kong's more established stock market.

Expanding access to China

Stock Connect has created additional flexibility for international investors (institutional and retail) than existing programs available to international investors. Although the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) program have allowed investment in Chinese securities for some time, they only allow participation from approved, well established institutional investors that meet certain requirements as set by the China Securities Regulatory Commission (CSRC).

While some of these requirements have been alleviated over the years, Stock Connect provides an option with no lock-ups or repatriation restrictions.

Our immediate focus is on northbound trading — specifically, how clients can access China A-shares for investment purposes and the associated opportunities for using these securities as collateral in global securities finance transactions.

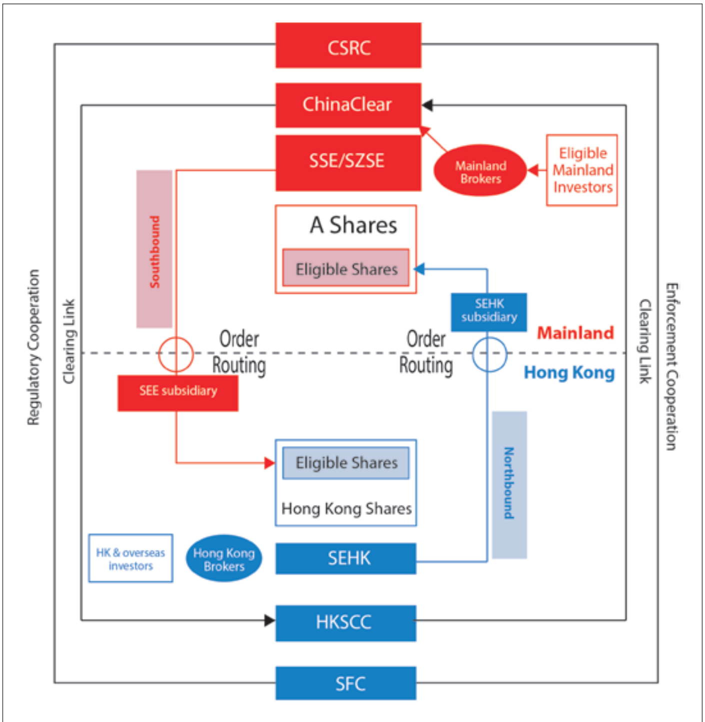
How does the trading link actually work for northbound trading?

Hong Kong and international investors trade A-shares through Hong Kong or international brokers. Clearing, settlement, depository and nominee services of A-shares executed through Stock Connect are provided by Hong Kong Securities Clearing Company

(HKSCC), a wholly-owned subsidiary of the HKEX, through the CSD and clearing links it established with the China Securities Depository and Clearing Corporation Limited (ChinaClear).

HKSCC, as ChinaClear's sole clearing participant, has opened and maintained two omnibus stock accounts with ChinaClear to hold A-shares for each China Connect Market (Shanghai and Shenzhen) separately on behalf of its clearing participants. HKSCC holds such China Connect Securities as a nominee.

A-shares purchased through Stock Connect will be recorded in the stock accounts held by their brokers or custodians in the Hong Kong Central Clearing and Settlement System (CCASS) operated by HKSCC as ChinaClear's clearing participant. The total shareholding of HKSCC in each China Connect security is equal to the aggregate shareholdings of all CCASS Participants of China Connect Securities recorded in CCASS.



Source: The Hong Kong Stock Exchange

How do international investors purchase China A-shares?

- Offshore investors instruct brokers in Hong Kong to buy A-shares
- Brokers instruct Hong Kong Exchange participants to conduct trades on SSE or SZSE Stock Exchange
- Hong Kong Exchange's subsidiary (as a SSE/ SZSE participant) effects instructions to trade on the SSE or SZSE Stock Exchanges
- The trade is cleared in ChinaClear. HKSCC is a participant in ChinaClear as nominee for all CCASS clearing participants. The shares for international investors are then held in an onshore omnibus securities account registered in the name of HKSCC
- HKSCC settles the buy trade with its CCASS participants in Hong Kong and offshore investors acquire an interest in A-shares

Importantly, international brokers trading through Stock Connect will only ever face the HKSCC as the clearing house, and will never face ChinaClear or the Chinese broker. The HKSCC essentially guarantees the performance of the trade to the offshore broker.

How is Stock Connect changing the game for market participants?

Stock Connect has presented a variety of immediate and long-term opportunities for investors, banks, broker-dealers and the buy side.

With Stock Connect providing the conduit for all northbound trades, broker dealers are now in a position to service investor demand for A-shares from multiple segments, including hedge funds, wealth managers and long only buy-side institutions.

Initial trading in Stock Connect was dominated by hedge funds, which did not have access to the licensed QFII and RQFII systems, and were thus locked out of the A-share market. Since the inception of Stock Connect, banks and broker dealers with prime brokerage (PB) operations have captured the vast majority of hedge fund trading activity and, as a result, have been providing the associated ancillary PB services such as financing, custody and clearing.

The opportunity for banks and broker-dealers to service traditional institutional investors and asset managers was initially somewhat muted as they were reluctant to participate due to a perceived lack of ownership rights and complex operational requirements.

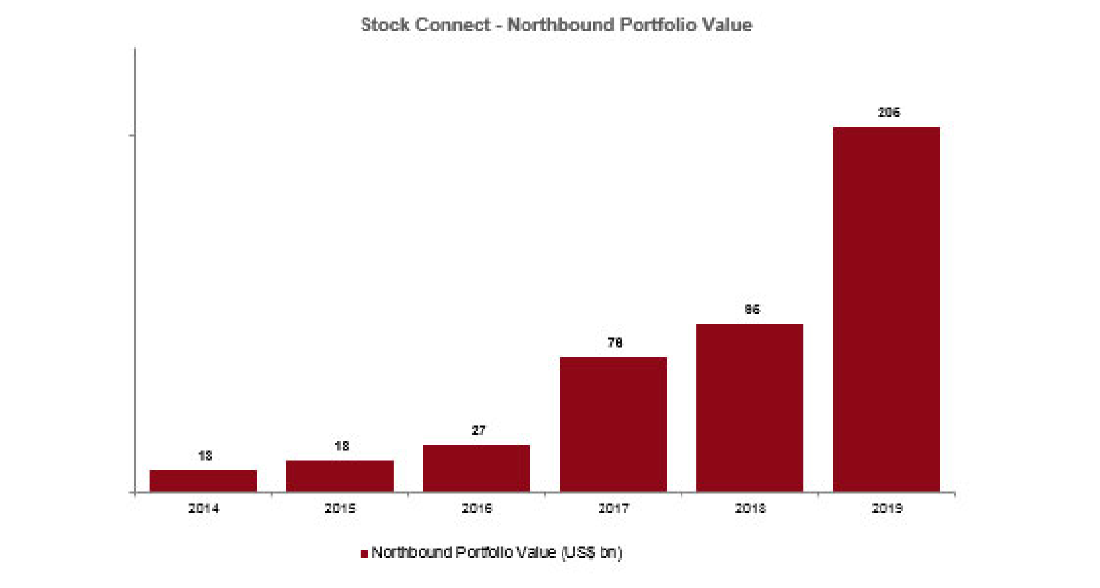
Over the past few years, however, beneficial owner rights have been clarified (as detailed by Linklaters in Ask an Expert) and HKEX has implemented operational improvements in Stock Connect, making it far more accessible to the international investment community.

Interest from global investors accelerated in 2017, when the MSCI announced they would be including A-shares in their equity indices over a phased period through to 2020. Not long after, other major global benchmarks such as FTSE Russell and S&P Dow Jones followed suit and now include A-shares in their respective indices.

The actions of the major index providers signal a market-wide acceptance of A-shares into international portfolios, and is perhaps one of the most important outcomes for Stock Connect to date, particularly for clients that are considering receiving A-shares as collateral. The MSCI Emerging Markets index alone tracks US$1.8 trillion in assets. As a result, we have witnessed billions of dollars flow into A-shares, as both passive and active funds rebalance their portfolios, within a relatively short period of time.

As of 31st December 2019, total north-bound trading turnover on Stock Connect was approximately $2.88 trillion, bringing net capital inflows of $205 billion.

Stock Connect - Northbound Portfolio Value



What financing options are available?

With northbound trading volumes continuing to rise, banks and broker-dealers are building their A-share positions in order to support their market access activity. As a result they will be naturally looking for ways to utilise these securities within securities finance transactions as part of their trading strategies. To that end, there is an opportunity for lenders looking to further enhance their collateral profiles and potentially extract additional value from their securities finance transactions.

As stipulated in the CSRC Stock Connect rules, off-exchange trading is not permitted. Therefore, collateral is required to move under a pledge, rather than a transfer of title structure.

J.P. Morgan has developed two bespoke collateral management solutions that enable banks and broker dealers to utilise their A-shares as collateral through its tri-party collateral management platform. The two models were developed to give clients flexibility in utilizing J.P. Morgan's sub-custodian or their own custodian or clearing participant, based on their existing operating arrangements.

- **Model I** utilises a special segregated account (SPSA) that is opened at J.P. Morgan. The SPSA ensures that Stock Connect shares are captured in the daily presale "snapshot" completed by the HKEX.
- **Model II** was developed to address scenarios where clients would like to hold Stock Connect shares in a tri-party arrangement at their existing custodian. A separate segregated security account is established with the collateral provider's custodian and J.P. Morgan is given exclusive control over the movement of Stock Connect shares in to and out of the account.

For both models, the collateral allocation of Stock Connect shares will be done via pledge (rather than transfer of title) on J.P. Morgan's books and records. Collateral receivers will have a valid and perfected security interest over Stock Connect shares allocated to their collateral account.

What's next?

Foreign investors now have easier access to the world's second largest economy through the Stock Connect model, creating new opportunities to include A-shares in their portfolios – and even more benefits when those securities can be utilised as collateral to meet financing and liquidity requirements. The two models developed by J.P. Morgan were based on in-depth knowledge of pledge structures, market conditions and investor needs and provide a practical way to utilise A-shares as collateral in securities finance transactions.

We expect to see this market continue to evolve, particularly as the HKEX makes further market enhancements, potentially leading to further index inclusions. And, as investor demand continues to provide an incentive for broader access to China, close coordination amongst collateral agents such as J.P. Morgan, global investors, market infrastructure providers and other experts in the region will remain critical to developing new and effective structures and solutions.

Will Jeffries
Vice president, platform sales
J.P. Morgan

Top five legal considerations

1. Who is the beneficial owner of Stock Connect securities?

It is well established that HKSCC holds the shares on trust for investors under Hong Kong law. As such, investors have beneficial ownership of the securities held by HKSCC on their behalf. Under Hong Kong law, it is recognised that a nominee holder has legal interest in securities for which it is a nominee and that the beneficial interest is held by the entity for whom HKSCC acts.

Under the triparty collateral management structure, the collateral provider would be the beneficial owner and the collateral receiver will have a valid and perfected security interest over allocated securities.

2. What law governs the security interest?

The lex situs or "the law of the place where the property is situated" of A-shares held under the Stock Connect program would be where the collateral provider's custody account is located. As a result, the security interest over pledged A-shares would have to comply with the requirements for the creation, perfection and enforcement of security in the lex situs.

3. Would the security interest be recognised by mainland China courts?

The conflicts of laws rules of the Peoples' Republic of China (PRC) would apply the "place of creation" of the security interest as the applicable law for security created offshore.

4. Does the security interest have to be registered to be valid?

The charge should be perfected in accordance with the requirements of the lex situs and any applicable requirements in the jurisdiction of incorporation of the collateral provider. Registration under PRC law should not be required, as Mainland Chinese courts should not apply PRC law to determine the validity and enforceability of the charge.

5. In the event of a collateral provider's default, is there any requirement for regulatory approval? How long does it take to liquidate Stock Connect Collateral?

Liquidation would be done via the preauthorised sale of the Stock Connect shares in the relevant collateral provider's brokerage account. No regulatory approval is required for such sale. In general, investors can send sales orders to the Exchange Participant for trade execution the next business day.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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