Getting Ready for Stock Connect V2 - Shenzhen

Launching 5th December 2016

Markets and Securities Services

Many fund managers, especially those with prior experience in buying shares listed in Mainland China, are getting themselves ready for what many believe may be one of the most exciting investment opportunities this decade. This article aims to provide an explanation why it is so eagerly anticipated and what fund managers are doing to get themselves ready to participate.

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What is Stock Connect?

Stock Connect is a relatively simple and straight-forward way in which all investors globally can, via Hong Kong, trade in Mainland China listed "A" shares (as they are widely known) on the Shanghai and (from 5 December 2016) Shenzhen Stock Exchanges. As the reciprocal of this, for investors in Mainland China, they have direct access to Hong Kong listed stocks.

Stock Connect is a key part of China's aim to open up its financial markets to the rest of the world. This has included securities markets, government bonds, mutual funds, Exchange Traded Funds (ETF), currency and forex transactions.

Stock Connect between Hong Kong (HK) and Shenzhen (SHZN) will launch on 5th December 2016. This follows the modest success of the Hong Kong – Shanghai (SHGH) version of Stock Connect, launched in November 2014. The addition of the HK-SHZN link in effect doubles accessibility for Mainland China investors seeking to buy Hong Kong listed stocks also.

Mainland China "A" Shares

Previously, the only way to buy Mainland China "A" Shares directly was through the so called "QFII or RQFII quota" programme (Qualifying Foreign Institutional Investor or RMB Qualifying Foreign Institutional Investor). An alternative was via some Hong Kong routes, including "H" Shares listed in Hong Kong, these being the same companies as in China, but with a separate listing, with prices that often traded at discounts to the Mainland share price. Another route has been via a variety of ETFs listed in Hong Kong. The original funds tracked the Shanghai FTSE A50 Index, as a benchmark, subsequent ETFs used the CSI300 Index, which covered a wider spread of stocks. But three years ago, China began to allow a number of new ETFs to be set up under their QFII and later their RQFII programmes, which offered direct investment into "A" shares, in portfolios benchmarked against the major China indices.

The advent of more direct access via Stock Connect, however, has enabled fund managers (especially) who might wish to be more selective of stocks, to choose those equities they believe might have a better fit to their portfolios, and exclude those that don't, by not using ETFs or "packaged" products.

Changing Quotas for Stock Connect

Direction	Daily Quota	Aggregate
Northbound HK to SHGH	RMB13 billion (US$1.9 billion)	Removed from August 2016
Southbound SHGH to HK	RMB10.5 billion (US$1.55 billion)	Removed from August 2016
Northbound HK to SHZN	RMB13 billion (US$1.9 billion)	No limit
Southbound SHZN to HK	RMB10.5 billion (US$1.55 billion)	No limit

Eligible Indices for Stock Connect

Location	Index Name	Number of Stocks	Eligible Investors From
Shanghai	SSE 180 Index	180	Hong Kong
	SSE 380 Index	380	Hong Kong
	All dual listed A and H shares		Hong Kong
Shenzhen	SZSE Component Index	270	Hong Kong
	SZSE Small/Mid Cap Innovation Index	410	Hong Kong
	All dual listed A and H shares		Hong Kong
	ChiNext	200	Hong Kong Professional/ institutional investors only
Hong Kong	Hang Seng Composite Large/ Mid Cap Index	318	Shanghai Shenzhen
	Hang Seng Composite SmallCap Index	99	Shenzhen

Why is Shenzhen exciting?

China offers all the possible varieties any stock market investor could possibly require from which to choose. In Shanghai, many of the stocks are those of former State Owned Enterprises (SOE), or the major banks and other firms. Many can be among the largest companies in China, however, due to the nature of the local investor market, which is still 80%+ dominated by retail investors leading to high turnover and sometimes extreme volatility, global investors have generally stayed away from committing money to the market directly.

Shenzhen, on the other hand, has become much better known for the range and depth of the mid and smaller capitalized companies listed on its exchange. It is sometimes referred to as "the NASDAQ of China." Most of these are companies that are owner-managed, they have been more involved in fast growth businesses, such as technology or leisure, services or manufacturing and other modern industries. Not being former SOEs has often allowed them to be better run with greater efficiency, leading to a more attractive investment proposition.

Also, Shenzhen's proximity to Hong Kong has allowed considerable interchange of highly entrepreneurial business leaders to take advantage of China's lower costs and Hong Kong's global reach.

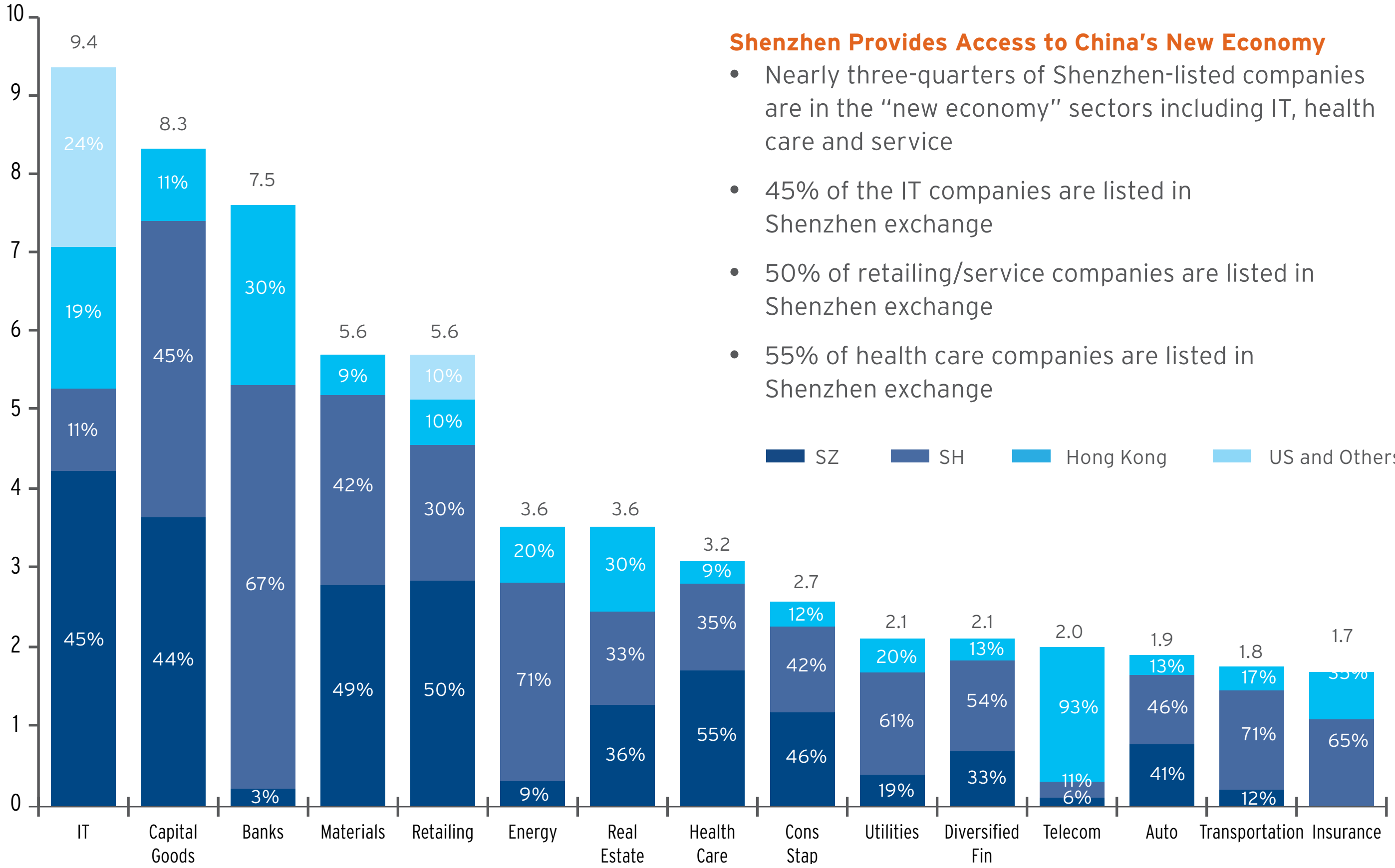
It has helped them as well that the major index providers such as MSCI and FTSE have been slow to include China "A" Shares in the most popular global and emerging markets indices they offer. Although FTSE has now done so in some selected indices, MSCI on the other hand has avoided inclusion of China stocks in its indices citing the poor access, liquidity, currency transferability and some other factors. Many observers believe this will change in 2017. If it does, it can be expected that many institutional investors, especially those in the United States, will seek to rebalance their portfolios to include China, to ensure they continue to invest in line with their chosen benchmark or reference index.

The size and scale of China's markets, when included in the major indices, will compel fund managers to track China stocks, and if they are to invest assets benchmarked against the leading indices, use of both Shanghai and Shenzhen stocks will become essential.

The advent of more direct access via Stock Connect, however, has enabled fund managers (especially) who might wish to be more selective of stocks, to choose those equities they believe might have a better fit to their portfolios, and exclude those that don't, by not using ETFs or "packaged" products.

RMB61 Trillion (US$ 9.4 Trillion) Market Value Geographical Distribution by Sector

RMB in Trillions



Source: Bloomberg, Wind and Citi Research, as of April 14, 2016.

Getting ready to invest directly into "A" Shares in China is therefore top of mind for many in the global fund management business. It has become increasingly important as those involved have realized that trading in Mainland China listed stocks is less straightforward than in say Hong Kong stocks, by comparison, but still quite acceptable. Many fund managers are now acting to get set up ahead of the potential inclusion in major indices, and often as a result of their clients' request for use of China stocks.

Of primary importance to major fund managers when dealing in securities is to ensure maximum efficiency of the transaction together with minimal risk. For this reason, the major global custodian firms such as State Street, JP Morgan, Citi, BNY Mellon, etc., have built highly efficient systems to interface with fund managers' own systems that reduce the extent of human interference. Dealing in China "A" Shares presents a new challenge, however, as the Chinese securities markets operate under different sets of guidelines and practices to those of the rest of the

Key Terms Relating to Stock Connect

DVP	Delivery versus Payment
True DVP	Simultaneous transfer of securities and cash, guaranteed
RVP	Receipt versus Payment
SPSA	Special Segregated Account
SPSA+	SPSA +Custody
"A" Shares	Shares of Mainland China companies listed in Shanghai and Shenzhen
"H" Shares	Shares of Mainland China companies listed in Hong Kong
CCASS	Central Clearing and Settlement System (operated by SEHK)

world. These differences can involve both the timeframe and settlement of individual trades, the beneficial ownership and title of securities bought.

For example, Stock Connect only operates when both the Hong Kong and Mainland China markets are open for trading, and when banks in both markets are open for settlement. There can be occasions when a normal trading day for China "A" shares occurs but Stock Connect transactions can't be carried out as it may be a public holiday in Hong Kong, and vice versa.

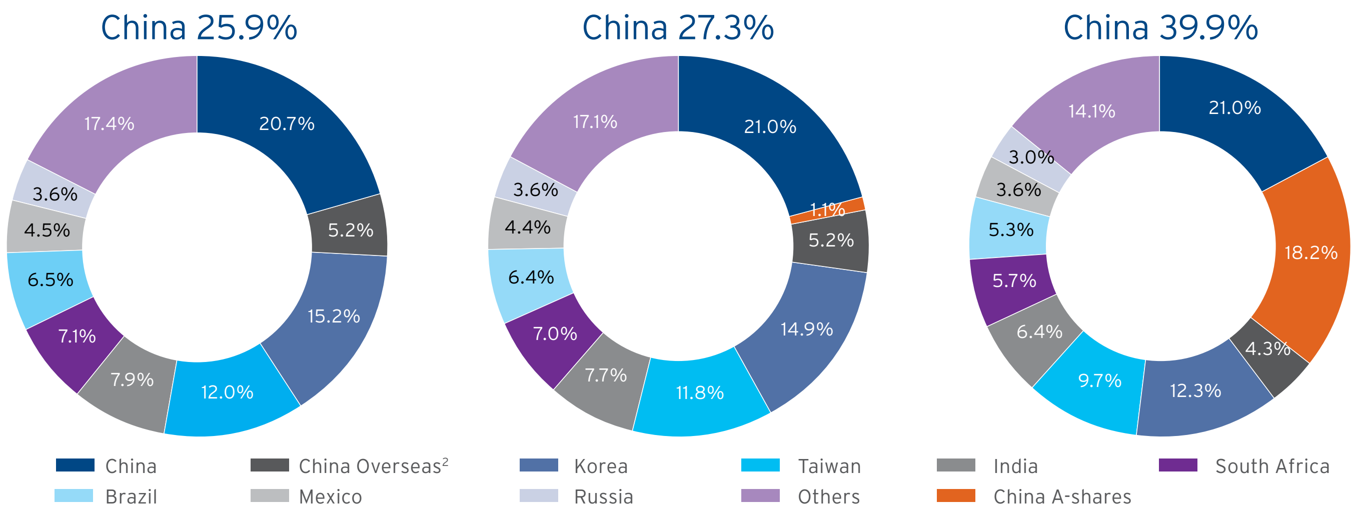
China prohibits the over-selling of "A" shares, therefore brokers are required to do pre-trade checking before placing trade orders. For all Stock Connect sell orders, SEHK imposes pre-trade checking against the broker's account maintained at the CCASS (CSD) to ensure the broker has sufficient shares to settle the sell trade. Thus, if an investor seeks to sell some or all of the China "A" shares it holds through Stock Connect, it is required to transfer them to the account of its broker before 19:30 pm of the prior day (T-1). Failure to meet this deadline means it will not be allowed to sell those shares on the desired trading day. Because of this requirement, a Stock Connect investor may not be able to dispose of its holdings of China "A" shares in a timely manner, with the consequent possible change in the price of the stock.

However, if the Stock Connect investor maintains its China "A" shares with a custodian which is a custodian participant or general clearing participant of the Central Clearing and Settlement System (CCASS) of Hong Kong, the Stock Connect investor can request the custodian to open a Special Segregated Account ("SPSA") in CCASS to maintain its holdings in China "A" shares under an enhanced pre-trade checking model, and can designate up to 20 brokers to effect the sell trade of the securities in that SPSA account. Each SPSA is assigned a unique ID by CCASS to facilitate the pre-trade checking requirement.

Provided there are sufficient holdings maintained in the SPSA when a broker inputs the Stock Connect "A" shares sell order with the investor ID, SEHK will perform pre-trade checking against the investor ID to ensure the broker is one of the designated SPSA brokers, and there are sufficient shares in the SPSA account. Thus an investor can avoid pre-delivery of shares to the broker and only needs to transfer "A" shares from its SPSA account to its broker or the general clearing participant after execution.

For fund managers of Undertakings for Collective Investment in Transferable Securities (UCITS) products in Europe, from January 2018 they will be required to also ensure their Stock Connect transactions are fully compliant with the "Best Practises" requirements of Markets in Financial Instruments Directive (MiFID) II, Article 27.

The Potential Impact of China "A" Shares inclusion in the MSCI Emerging Markets Index



Current Status

- Inclusion of overseas listed Chinese companies such as Baidu and Alibaba in November 2015 Semi-Annual Index Review

Potential Initial Step: Partial Inclusion (5%[1])

- Further improvements in quota allocation mechanism and size of overall quota
- Further relaxation on capital mobility and other market accessibility constraints

Potential Full Inclusion (100%[1])

- Abolishment of the quota system
- Full liberalization of capital mobility restrictions
- Alignment of International accessibility standards

Source: MSCI, Citi Research. Data as of March 30, 2016

[1] The percentage number refers to the Inclusion Factor applied to the free float-adjusted market capitalization of China A-share constituents in the pro forma MSCI China Index. China A-share securities are subject to a foreign ownership limit of 30%.

[2] Overseas listed Chinese companies were included in November 2015.

This may necessitate being able to demonstrate that the trade is carried out at a competitive price, together with having the ability to make a selection from a range of securities brokers when the trade is placed. A key factor is to ensure risks (such as non-receipt of shares, or cash proceeds in the account) are eliminated when carrying out the trade, and that the assets are properly segregated and held correctly in safe-keeping. Providers are being sought that can eliminate risk and maintain control throughout the transaction process under Delivery verses Payment (DVP) standards. (DVP is a security settlement mechanism that links to a security transfer and a fund transfer in such a way as to ensure that delivery occurs only if the corresponding payment occurs, to avoid counterparty risk.)

Clearly, depending on the type of fund, whether it is a UCITS or AIF (Alternative Investment Fund) product located in Europe or United States Investment Company Act of 1940 ('40 Act) mutual fund, a number of fairly similar plans need to be developed to participate in the Mainland China "A" share market.

The recent joint announcement from the CSRC and SFC highlighted that "Investors should be aware of the differences between the laws, regulations, rules and market practices in Mainland China and Hong Kong and should take appropriate action to ensure compliance and to manage their risks when investing under Shenzhen-Hong Kong Stock Connect." The Mainland China "A" share market has a number of unique features, such as pre-trade checking requirements, prefunding, T+0 settlement for shares and T+1 settlement for cash and no DVP settlement. DVP settlement is actually not necessary in Mainland China because everything is prefunded. As a result, there is no counterparty risk with the broker since all the shares are held in the investor's account maintained at the China Securities Depository and Clearing Corporation (ChinaClear) directly. In another unique feature to this market, ChinaClear also acts as the central counterparty between the buyer and the seller (the end investors) meaning there are no failed trades. In other words, the broker does not handle any of the investor's cash or securities and if a broker were to become insolvent, the investor can quickly use another broker.

In Hong Kong and other developed markets such as US, UK and Singapore, the broker plays an important intermediary role which includes handling the client's cash and securities during the clearing and settlement process. Failed trades are possible as there is no prefunding requirement or pre-delivery requirement, thus DVP settlement is important to avoid counterparty risk with the broker.

Currently most UCITs funds are using the Integrated Model to trade Stock Connect A-shares since the Integrated Model provides DVP settlement. Although this is a good initial solution to avoid the pre-delivery of shares to broker, it also has a significant limitation because it restricts the investor to use only one broker. Given the size and volatility of the China A-share market, it is important that investors have a failsafe and are able to access backup brokers in the event their main broker becomes insolvent or has a system issue preventing trades.

Citi's Stock Connect Solutions

Citi has developed solutions such as Integrated Custody (Model C) and Integrated SPSA (SPSA+) to enable clients to access the China "A" share markets through Stock Connect and transact under DVP, to access multiple brokers and provide maximum flexibility. The Mainland China "A" share market has a number of unique features, such as pre-trade requirements, T+0 settlement for shares and T+1 settlement for cash, no DVP settlement, etc., which are incompatible with UCITS requirements. Citi has been a market leader allowing regulated funds to better comply with UCITS and lower the contingency risk by enabling the fund to transact under true DVP with multiple brokers and maintain full control over the shares at all times.

A simple Checklist of specific items will allow the administration and operations teams to identify what they need to prepare, and proceed accordingly. This could potentially involve establishing new counterparty relationships, as not all major custodians are set up to handle China "A" shares.

Fund Manager Checklist to Prepare to Use Stock Connect

Business Issues	Yes	No
Has your internal Investment Committee reviewed and approved use of "A" Shares?		
Has the market analyst done sufficient research?		
Does the fund manager prefer "A" or "H" shares?		
Does the fund manager prefer Shanghai or Shenzhen?		
Are the stocks being selected included on one of the approved indices in Shanghai or Shenzhen?		
Can your securities broker and trader handle portfolio rebalancing efficiently?		
Operational Issues	**Yes**	**No**
Does the usual fund custodian provide direct custody of "A" shares?		
Does the usual fund custodian need to set up sub-custody arrangements?		
Do the usual securities brokers have the ability to provide trade execution for Shanghai and Shenzhen shares via Stock Connect?		
Do you need to establish RMB banking?		
Do you need "funding" for portfolio rebalancing?		
Risk Issues	**Yes**	**No**
Has your internal Risk Committee reviewed and approved use of "A" Shares?		
Can the fund ensure DVP settlement and irrevocable credit of cash proceeds for the sell order on T+0, to avoid counterparty risk with the broker?		
Could the fund have the ability to trade with an alternative broker for both buy and sell trades as contingency to avoid market price risk?		
Do you have a good understanding of all the key risks and risk disclosure requirements?		
Legal Issues	**Yes**	**No**
Do the constitutive documents allow use of "A" Shares?		
Do you need to gain any regulatory approval to use "A" shares or make changes to the constitutive documents?		
Have you verified beneficial ownership issues?		
Will your trading need to be MiFID II compliant?		

How Can Citi Help?

Citi is committed to China business, and offers a full end-to-end solution to enable investing and trading in China "A" shares.

Citi Markets can provide "best-in-class" research on individual securities listed in both Shanghai and Shenzhen.

Citi Markets and Securities Services provide trade execution, post trade and custody services.

Citi is a "Top 3 Provider" of Stock Connect transaction services according to the Hong Kong Stock Exchange.

Citibank provides foreign exchange and banking services.

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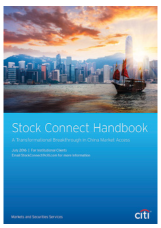

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