



Hong Kong

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MAINLAND-HONG KONG BOND MARKET CONNECT TO BE ESTABLISHED

On May 16, 2017, the People's Bank of China and the Hong Kong Monetary Authority made a joint announcement¹ approving the China Foreign Exchange Trade System & National Interbank Funding Centre, China Central Depository & Clearing Co., Ltd, Shanghai Clearing House, together with Hong Kong Exchanges and Clearing Limited and Central Money Markets Unit to collaborate in establishing mutual bond market access between Hong Kong and Mainland China. Among the 5 things announced, details which will be discussed below, the main issue is the fact that regulators of the Hong Kong and Mainland bond markets will enter into a memorandum of understanding on supervisory cooperation to establish effective supervisory cooperation arrangements and liaison mechanisms in order to maintain financial market stability and fair trading. This joint announcement mainly focuses on announcing that northbound trading which will abide with the current policy framework for overseas participation in the China Interbank Bond Market and respect international norms and practices will commence first in the initial phase with no investment quota, followed by southbound trading.

This follows the launch of the innovative Shanghai-Hong Kong Stock Connect in 2014, which connects the Shanghai and Hong Kong stock markets, with Mainland and Hong Kong investors being able to trade and settle shares listed on the other market, and the report entitled "Proposal on the Mainland-Hong Kong Bond Market Connect"², released by the

Hong Kong Financial Services Development Council (**FSDC**) in November 2016, which makes recommendations regarding the connecting of the Mainland and Hong Kong's bond markets for retail investors.

The Hong Kong Stock Exchange's 2016-18 Strategic Plan includes the establishment of a '**Bond Connect**' scheme so as to facilitate cross-border capital flows in the underlying RMB cash bond market, and it is hoped that this scheme will provide cross-border cash bond trading and settlement connectivity with China's major onshore bond market infrastructures.

Mainland China's Bond Market

The Mainland's bond market is the third largest in the world, with a total depository balance of USD 8.7 trillion as at the end of July 2016. The bond market is generally divided into (a) the interbank bond market and (b) the exchange-traded bond market.

China's interbank bond market (**CIBM**) is an over-the-counter (**OTC**) wholesale market and constitutes over 90% of outstanding value and 80% of trading settlement of the Mainland's overall bond market. Participants principally include financial institutions, as well as various investment vehicles, whilst non-financial companies are able to trade through settlement agent banks.

Exchange-traded bonds are mainly traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The exchange-traded bonds market comprises less than 10% of the overall bond market. Qualified investors are permitted to

1 Hong Kong Monetary Authority Press Release: <http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170516-5.shtml>

2 Financial Services Development Council, FSDC Paper No.24, 29 November 2016, http://www.fsd.org.hk/sites/default/files/Bond%20connect%20_E.pdf

invest in all types of corporate bonds, whereas retail investors are only allowed to invest in large public offering bonds, which are required to comply with more onerous listing requirements. The latter requirements include absence of debt default or delayed payments over the previous three years, an AAA credit rating, and a minimum annual average disposal profit of no less than 1.5 times the annual bond interest rate in the latest three financial years.

There are three different methods for Mainland investors to invest in the Mainland's bond market, namely: (i) invest in the interbank bond market through commercial banks, subject to certain eligibility criteria, (ii) invest in exchange-traded bonds, and (iii) invest indirectly in the interbank bond market through investing in commercial banks' wealth management products.

Hong Kong Bond Market

The Hong Kong bond market, valued at over USD 400 billion, is an open market for domestic and foreign issuers and investors, and offers a wide range of products. Corporate bonds are issued in Hong Kong dollars or foreign currency, listed on the Hong Kong Stock Exchange or unlisted (most are listed), offered to retail and professional investors, and traded on the OTC market or the Hong Kong Stock Exchange (most trading takes place on the OTC market, including listed bonds). A more comprehensive prospectus is required for public offers (i.e. for both retail and professional investors), while a relatively simple form of offer document or term sheet is sufficient for private placements.

Cross-border investment in the Mainland Chinese and Hong Kong bond markets

Investment in Mainland China's bond market by foreigners

In terms of foreign institutional investors, Qualified Foreign Institutional Investors (**QFIIs**) and RMB Qualified Foreign Institutional Investors (**RQFIIs**) were among the first to be permitted to invest in the Mainland's exchange-traded bond market as well as its interbank bond market. Following the liberalisation of the interbank bond market in 2015, most foreign financial institutions and institutional investors are now able to invest in the market without pre-approval requirements and individual quotas for medium-to-long term investments.

Foreign retail investors are only able to invest in the Mainland's bond market indirectly by investing in QFII or RQFII funds which focus on the Mainland's bond market. Another new channel for foreign investment into the Mainland's bond market is the

Mutual Recognition of Funds (**MRF**) scheme implemented on 1 July 2015 between Hong Kong and China. Under the MRF scheme, the China Securities Regulatory Commission (**CSRC**) and Hong Kong's Securities and Futures Commission (**SFC**) authorise Mainland and Hong Kong domiciled funds that meet the eligibility requirements to be subject to a streamlined authorisation process for offering to retail investors in each other's market. As at the end of June 2016, the SFC had approved 12 Mainland funds which invest in the Mainland's bond market, including four bond-only funds.

The Mainland interbank bond market has been further liberalised. Since February 2016, there is no longer a requirement for QFIIs and RQFIIs to obtain prior approval to invest in the interbank bond market. In relation to the overall quota, there is no longer a requirement for QFIIs to obtain approval from the China's State Administration of Foreign Exchange for an application of investment quota that is within the basic quota; although any quota that is in addition to the basic quota still requires separate approval.

Current market developments

There is low demand by QFII and RQFII investors for Mainland bonds, with only 10% of QFII's total portfolios being invested in Mainland China's bond market as at the end of 2014, and only four of 25 RQFII ETFs investing only in Mainland China's bond market. Reasons for the low demand include that the CIBM was relatively closed until 2015; that a large spread in prices between A-shares (RMB-denominated shares traded on the Shanghai and Shenzhen stock exchanges) and H-shares (Mainland-incorporated companies listed on the Hong Kong Stock Exchange) has attracted most foreign investor attention, reducing the attractiveness of bond investments; and that investors' appetite for RMB-denominated investment products has decreased due to the depreciation of the RMB, which investors expect to remain weak in the near-to-medium term. Further, the low demand is reflected in the low usage rate of the allocated quota for QFIIs and RQFIIs.

As a result of the attractiveness of stock returns when the Qualified Domestic Institutional Investor scheme (**QDII**) was launched, the majority of QDII funds are invested predominantly in the equity market. Indeed, as at the end of the second quarter of 2016, bond-only funds under the QDII program accounted for than 3% of the USD 90 billion QDII quota.

There are limited vehicles for Mainland investors to invest in debt markets overseas. One year following the launch of the MRF scheme, the CSRC had only approved six Hong Kong

funds, only two of which have fixed-income products. The shortage of foreign bond funds has worsened recently as a result of a sudden increase in demand from Mainland investors attributable to the depreciation of the RMB and the weak A-share market.

Investment in Hong Kong's bond market by Mainland investors

Mainland investors are able to invest in Hong Kong's bond market through QDII and RMB Qualified Domestic Institutional Investor (**RQDII**) funds, as well as through the MRF scheme.

The Proposed Mainland-Hong Kong Bond Market Connect

Issues

Given that China's capital account has not yet fully opened, cross-border capital investment must be properly tracked and repatriated back to the Mainland origin upon sale or divestment. Once a holding is sold, funds are repatriated to the origin-account held by the investors. This satisfies the capital restriction requirement that funds are not allowed to be diverted for other purposes outside the country upon divestment.

There are different requirements for retail investors investing in the CIBM and Hong Kong's bond market. Domestic retail investors in the Mainland are able to purchase various government related bonds through commercial banks' OTC market provided that they satisfy the minimum requirements: for individual investors, an annual income of RMB 500,000, financial assets of RMB 3 million and over 2 years of securities-investment experience; and for corporate investors, net assets of RMB 10 million. Hong Kong does not have such requirements for investors to trade in the local or overseas bond markets, as long as the bonds are also offered to retail investors.

Recommendations

1. Allow mutual market access for both Mainland and Hong Kong retail investors to invest in each other's exchange-traded bond market under the model of the Shanghai-Hong Kong Stock Connect scheme

Mutual market access can be achieved through the same trading mechanism as the Shanghai-Hong Kong Stock Connect (**Stock Connect**) scheme, and will be limited to bonds that are available to retail investors in both exchanges and CCASS-settled bonds traded on the Hong Kong Stock Exchange.

Under the Stock Connect scheme, the Hong Kong Stock Exchange's Shanghai subsidiary acts as the general broker for Hong Kong Stock Exchange participants who are eligible to trade through the Stock Connect scheme. The Hong Kong Securities Clearing Company Limited (**HKSCC**) acts as the "clearing agency" to settle trades in relation to northbound trades. Investors hold Shanghai Stock Exchange securities through their brokers/custodians' own record, but the HKSCC is the shareholder on record of Shanghai Stock Exchange listed companies. It is the HKSCC that also provides nominee and other related services for the northbound trades.

2. Allow mutual market access for both Mainland and Hong Kong retail investors to invest in each other's OTC bond market by opening and maintaining a special trading account with designated banks (designated "Bond Connect" account)

The FSDC recommends that the Mainland may waive overseas investors from the local investor criteria, where investors seek to invest in the interbank bond market through designated commercial banks which operate in both Hong Kong and the Mainland (including both Mainland and foreign banks) and are members of the CIBM.

Similar local investor criteria can also be applied to Mainland investors seeking to invest in Hong Kong's OTC bond market; that is, investors who satisfy the criteria for investing in the CIBM through the commercial banks' OTC market, are allowed to invest in all OTC-traded bonds available to retail investors in Hong Kong. Investors who do not satisfy the criteria are allowed to invest only in bonds with a minimum of AAA credit rating.

In both northbound and southbound trades, the designated banks will be responsible for: placing orders, trading, as well as clearing and settlement on behalf of their customers; the provision of depository/custodian services for bonds being traded; and all cross-border fund flows, including investment, interest payment and principal repayments, in respect of their customers.

In Hong Kong, investors are able to transfer without limitation custody of their bond investment, represented by global certificates. Given the increased difficulties authorities would face in tracing bond holders, the FSDC suggests restricting investors from changing custody under the pilot stage of the Bond Connect scheme.

Proposed Operating Model and Implementation Issues of the Bond Connect scheme (southbound investment by Mainland investors)

The following concerns the operating model of investment by Mainland investors into Hong Kong under the proposed Bond Connect scheme. An opposite and similar operating model may be applied for investment by Hong Kong investors into the Mainland.

1. Proposed Operating Model

Mainland investors should be allowed to open only one designated Bond Connect account at one authorised bank in the Mainland, with the designated bank being responsible for conducting an “eligibility check” and the Know Your Customer (KYC) process, which should comply with the requirements of both the Mainland and Hong Kong. Once the designated account has been opened, the bank will provide the requisite documents to the counterparty bank in Hong Kong to open the customer’s investment account (for custodian of the bonds) as well as a cash account (for settlement).

The designated Mainland bank will monitor and action the quota for each eligible customer, while the counterparty bank in Hong Kong will take direct instructions from the investor on currency exchange, bonds subscription and redemption, and cash remittance back to the designated Bond Connect account in the Mainland.

2. Implementation Issues

The FSDC suggests that retail investors should be allowed to open only one designated Bond Connect account at one authorised bank in the Mainland, with a corresponding investment account in the authorised bank in Hong Kong.

Customer communications regarding the designated Bond Connect account activities (for designated banks in the Mainland), or investment account activities, transaction history and balance summary (for connected banks in Hong Kong) should be sent from the designated bank or the connected bank, respectively, to the customer in compliance with the local regulations.

Eligibility of retail investors would depend on the requirements of the regulators of the Bond Connect scheme. Both banks at account opening should conduct KYC and further checks so as to ensure full compliance with local regulations on investment services in the applicable jurisdiction. Designated banks in

the Mainland would be responsible for conducting both the eligibility check and the KYC process, which should comply with the requirements of both the Mainland and Hong Kong.

The FSDC would prefer to make available the full list of bonds currently on offer on the Hong Kong retail market, and that eligible bonds are reviewed regularly for addition and removal. The FSDC also stated that the current sales and distribution model of bonds in Hong Kong should prevail. Further, both the Mainland and Hong Kong need well-established tax policies for the Bond Connect scheme so as to clearly address how tax laws apply to investors under the scheme.

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Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com