**2nd Shanghai Hong Kong Stock Connect meeting summary**

**Date & Time: 11th July 2014 (Friday) – 03:30 pm to 05:30 pm**

**Venue: SWIFT HK office**

**Participating Institutions:**

|  |
| --- |
| HSBC HK |
| CITI HK |
| Deutsche |
| Invesco |
| State Street, Hong Kong |
| Standard Chartered, Hong Kong |
| Societe General, Hongkong |
| JPMC Asset Management |
| JPMC |
| Franklin Templeton, Singapore |
| Schroders, Singapore |
| SWIFT |

**Summary:**

With above mentioned institutions, we had participants who serve as sub-custodian, global custodian, brokerage, fund accounting, and investor (asset manager, fund house).

The ultimate goal of this group is to ensure STP message flows for the end-to-end processing chain amongst all participants who play different role for Shanghai Hong Kong Stock Connect (SHHKSC) transaction.

The key findings of the meeting are:

* Risk exposure for investors and brokers
* Broker has to handle corporate actions
* Hong Kong Stock Exchange still keeps provide updates to the market, market players are difficult to lay down their plan to support SHHKSC transactions
* Pre-delivery of stock and pre-funding are not the usual practice in HK market and it causes big change for information and instructions exchange amongst market players
* Alternate channel to invest A-Share exists, market players have to find value to support SHHKSC trading

**Highlight of discussion points**

* Clarification for the restriction for the change of beneficiary ownership (CBO)
  + Hong Kong Stock Exchange (HKEx) confirmed that when stock pre-deliver to broker, it does not allow CBO. It is mentioned on June 13, 2014, CSRC publication, article – see document ‘P020140623298276719171’ or check here [www.csrc.gov.cn/pub/zjhpublic/zjh/201406/t20140613\_256078.htm](http://www.csrc.gov.cn/pub/zjhpublic/zjh/201406/t20140613_256078.htm) (Thank you Jo Tong of JPMC to provide the link).
* Additional information from HKEx, over the counter (OTC) trade is not allowed for northbound trade.
* Sub-custodian needs to determine whether to act as the gate keeper to block CBO settlement instruction for SHHKSC trades. Market servicers should discuss the set up process to stop CBO in certain servicing area(s) for this kind of trades.
* Suggest the group to study other business rules in CSRC publication and establish proper business practice for SHHKSC product, including taxation, etc. before the group to move on next phase of discussion about messaging rules in detail.
* Discussion for pre-delivery of stocks
  + The intension/strategy of investor to sell stock is exposed to brokers even with HKEX new arrangement for pre-delivery of stock on the same trade day at 7:30am to 7:45am.
  + To allow broker to track the holding of investor at their custodian is not feasible because Hong Kong market allows multiple custodians to serve one investor.
  + There are concerns of risk exposure on investor side when moving stock to broker without collateral.
  + Investors concern the increase of transaction cost for the scheduled return left over stock of non-executed order(s) by the end of the day.
  + Compared the free of payment arrangement in QFII settlement with SHHKSC stock, QFII trade has control and guarantee by China clearing account but there is no similar kind of guarantees for SHHKSC trade.
  + Expressed from risk perspective, the arrangement of pre-delivery and pre-funding of SHHKSC trade is highly discourage because there are certain requirements on investor side that don’t allow free of payment instruction. Expect certain products on investor side may not engage in SHHKSC market. Investors concern the ownership of stocks once they are transferred to brokers.
  + Concern the account set up on broker side is not the same as today. CSRC, SFC, and HKEx imposed rules that broker has to establish internal controls to segregate accounts of end clients and operation for SHHKSC trades.
  + One fund house indicated that as long as there is governance to control their SHHKSC stocks, there is no issue to send for free of payment (FOP) settlement instruction (SI). However for Hong Kong funds, there are concerns to issue FOP SI. They need to obtain the approval from fund trustees.
* Discussed in how to handle FOP SI for the pre-delivery and FOP SI after execution of the trade by broker issued by investor to custodian.
  + Sub-custodian cannot differentiate the nature of SI. On global custodian side, since the pre-delivered stock already moved to broker, to manage the holding balance of FOP SI for executed trade is required for further investigation, as well as the SI sent to sub-custodians.
  + Investigate the possibility to suppress FOP SI for executed trade. JPMC Asset Management will follow-up with their trade support team for the handling (see Post meeting follow-up section).
    - Standards comment: In settlement instruction and confirmation message, there are different settlement type indicators for trade and stock transfer. It may help to determine the handling of received instruction.
* Pre-funding and pre-payment, market has following concerns
  + If investor doesn’t need to receive stock on trade date (T), pre-funding can be done on the second day after trade (T+1).
  + Although the settlement cycle is stock to deliver on T and cash is by T+1, if investor needs to receiving stock by T, broker has to receive payment by T. Otherwise CCASS will put the settlement instruction on hold, if payment is not ready.
  + The pre-payment obligation (4:00pm to 6:00pm) on broker side, investor may only know their orders execution status until the close of trading session at 3:00pm. For T day payment, investor has to pay the broker almost at the same time. Time allows for investor to organize the FX to prepare the funds for settlement may be an issue.
  + Explained the trading practice of A-share in China. There are cash and stock check before placing order because regulators stipulate the assignment of broker and custody service for investors while Hong Kong market doesn’t mandate to have. It puts all the risks on brokers and investors.
  + Approval procedure of pre-funding for SHHKSC trading needs to be established. HK issued funds have to involve trustee and non HK domiciled funds are supported by portfolio manager or proper team(s).
  + Clarification for the readiness of fund for settlement is on T+1, the schedule to pay by noon and stock be delivered by 7:30 pm. Investors will discuss internally in how to manage this schedule to optimize the liquidity of holdings.
  + Question to investors for stock delivered on T and pre-funding on T, whether they are highly discourage or impossible because this will incur FX exposure. Also want to know whether brokers have ways to help investors to minimize the risk exposure of pre-funding.
  + One fund house shared their concern of pre-funding may not be approved by compliancy and internal audit. If all fund houses has the same concern, T+1 is the only way for settlement. Fund houses have to confirm with involved parties.
* Discussion about pre-delivery of stock to broker when it attracts corporate actions (CA)
  + Clarification the entitlement of pre-delivered stock to broker on T and record date is T+1, investor entitles for CA benefit because CBO of stock is not allowed.
  + Brokers may need to provide CA support and services for left over non executed stock and non-pre-paid buy trade. HKEx is working on this issue because brokers used not to serve custodian’s function in HK.
  + Proposed to use standing settlement instruction practice to solve CA activities for SHHKSC stocks.
  + If auto-return of non-executed stocks from broker is implemented to help CA support, global custodians have concern of how can they determine the instruction is an auto-return stock. Another concern is the account set up at global custodian for brokers are in omnibus structure. Global custodian has issue to tie the return stock to original pre-delivered trade.
  + Explored if investors agreed the settlement of cash and stock on T+1, the impact on CA.
    - It will complicate the situation. In China, splitting and consolidation events will happen on the same day. If settlement is T+1, sub-custodian doesn’t know the quantity of the share.
    - To pay on T+1, payment has to be done before noon. Global custodian not sure their cash correspondents have arrangement to pay per requested time.
  + Investors will bring CA market claim to discuss internally and discuss their preference in next meeting.
  + Suggest the group to prepare the general flows of transaction cycle and explore how market players serving different roles to support CA for T+1 pre-delivery of stock and pre-funding, if to trade this product is under slight disadvantage situation for institutional market (we need meeting participants to provide scenarios to build the flows).
  + Suggest to get confirmation amongst broker community; ASIFMA or so, that broker can take care of CA issues and support T+1 settlement. Broker representative at our meeting requested delegates who are different roles in this group to join broker community meeting and share issues discussed here.
* Suggest investors for funds launching in HK to consult trustee for any concern when stock purchase on T and calculation of NAV on T while stock is still held at broker that delivers on T+1. The reason why to raise this question to trustee because regulation for HK associated funds, the asset needs to be kept at eligible custodian.
* While investor collecting the opinions from trustee, the group can continue the discussion on T+1 scenario is feasible from a local regulation point of view.
* Commented to use single broker in HK is not a concern. Although the practice is far from perfect, market should create the flows and discuss with this group for refinement.
* Sub-custodians wanted to know whether investor will send free of payment instruction or against payment instruction to global custodians on T and/or T+1 for settlement.
  + Global custodians commented that is determined by the processing capability of sub-custodian. For example, when sub-custodians received against payment instruction and they are able to split the stock and payments settlement, or the receiver needs to separate the FOP and a clean payment instruction for northbound trade. Global custodians will request investors to do corresponding action as per the request from sub-custodian.
  + Sub-custodians require free of payment instruction together with clean payment instruction from global custodian, the group wanted to compare the settlement of QFII A-Share and SHHKSC A-Share. The finding was QFII is a delivery verses payment (DVP) market and in SHHKSC the arrangement between broker and sub-custodian is FOP.
  + Investor shared their concern to use the same ISIN to deal QFII A-share, where DVP SI is used and with SHHKSC, it requires another set of instructions.
    - Standards comment: Even with same ISIN, we can check the place of settlement (PSET) in settlement instruction message to separate QFII and SHHKSC trade. The PSET of QFII is China and SHHKSC is CCASS.
* Post meeting comments
  + There will have another round of industry briefing done by HKEx to clarify outstanding questions. Expected HKEx won’t provide any solutions for issues raised in previous briefings.
  + Commented the approach of HKEx is to launch the project in time and will continue to monitor market activities. If the market is not running well, they will enhance their services in future versions.
  + Concern another show stopper – the capital gain tax. Learnt HKEx is still seeking clarification from China, the product launch in October 2014 will not implement this tax. As a general practice in the past, there is no retrieval for historical claims from market. It may provide grace period for tax exemption. Guessed it should be clarified before SHHKSC launch.
  + Investor commented the topic of northbound trade doesn’t have rights entitlement hadn’t been discussed. Members commented that there is no exact financial instrument called rights issue in China. Entitlements will be presented in cash or stock form. Investor is able to buy/sale those entitlement with some restrictions, therefore rights issue is not a concern for SHHKSC A-Share.
  + Another reason for northbound trade that SHHKSC doesn’t allow investors in HK for rights issue is because once it allows, the Securities and Futures Ordinance (SFO) and all the company ordinances have to be changed. The company ordinance stated that whenever there is a rights issue where it has more than 15 shareholders, they have to issue a prospectus in Hong Kong. It is not worth for Shanghai stock to issue prospectus in Hong Kong.
  + Expected there will have more CA issues to resolve. China is using record date for market claim. Portfolio calculation of funds is measured on trade date. They are on different rulers. It is expected there is funding issue for T settlement and if with T+1 settlement, there will have corporate actions issues to be resolved.
  + Some of the limitation is because CCASS doesn’t support DVP settlement at the moment. Understood that they have a plan to support it. However there is no announcement from HKEx about the plan. This will be one of the concerns in the market to decide whether to invest to support institutional clients with pre-funding and pre-delivery of stock arrangement now or to wait.
  + Commented that when role out DVP, it is likely be T+1 settlement with option to support receive against payment (RVP) on T. Investor can receive stock on T. It means investors should establish agreements in how to issue the settlement instructions. Fund houses may not have concerns on T+1 settlement but hedge funds may. Proper guidelines may need to set for different investment markets.
  + Behind story of why to implement SHHKSC is that the current Chinese market is 80% retail business and China wants to liberalize the stock market and attract more international investors.
  + Idea to suggest China to follow Taiwan institutional broker (IB) model. However HK sub-custodian doesn’t have the cash management support but Taiwan sub-custodian has.
  + Broker delegate at our meeting will suggest ASIFMA to organize one day workshop that covers the concerns of end-to-end flow of information. Will propose ASIFMA to invite market players who plays different role in the servicing chain to participate and share their report to the market.
* Pre-condition to have next meeting
  + There should have some proposal of agreeable steps between investors and brokers to handle SHHKSC trade before the group to discuss settlement practice

**Next meeting**

To be confirmed until pre-condition of next meeting met.

Reply from JPMC Asset Management trade support team:

+++ quote +++

I’ve discussed the case with our Trade Support Team colleague on whether to suppress our settlement instruction for sale trade to global custodian after we make pre-delivery of stock, my colleague advised that we would prefer to send our settlement instruction as usual because of below reasons :

1. Number of shares pre-delivered may not be the executed number of shares.
2. We still need to report the trade details such as quantity, trade price, settlement amount and name of counterparty to the global custodian for settlement purpose.

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