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RESEARCH REPORT

STOCK CONNECT - TOWARDS A "MUTUAL MARKET" FOR THE INTERESTS OF MAINLAND AND GLOBAL INVESTORS

CONTENTS

SUMMARY

The Shanghai-Hong Kong Stock Connect (“Shanghai Connect”), the first initiative under the Mutual Market Access pilot programme (the “Pilot Programme”) between Mainland China and Hong Kong launched in November 2014, offers a brand new official channel for overseas investors to invest in the Mainland stock market and for Mainland investors to invest in the Hong Kong stock market. The channel enables closed-loop Renminbi funds flow across the border in an orderly manner, thereby reducing the potential risk impact on the Mainland domestic market. The extended initiative — Shenzhen-Hong Kong Stock Connect (“Shenzhen Connect”), with an expanded scope of eligible securities — will be launched shortly and expected to be before the end of 2016, subject to final regulatory approval. By then, the “Mutual Market” model across Shanghai, Shenzhen and Hong Kong will be basically formed. The Mutual Market model between Mainland China and Hong Kong is a symbolic breakthrough in the capital account opening process of Mainland China, under which global investment opportunities will be increasingly opened up to Mainland investors and more Mainland investment opportunities will be opened up to global investors.

Experience of the Shanghai Connect shows that Mainland investors have an increasing appetite for investment in Hong Kong stocks through Southbound trading. Their investment interest is not limited to large-cap blue chips but also in smaller-sized stocks in various industries. In Northbound trading, global investors also have an increasing interest in smaller-sized Mainland stocks of diversified industries. The Shenzhen Connect will cover more small-sized stocks to meet the needs of both Mainland and global investors. The Mutual Market Access scheme, subject to regulatory approval, will be extended to exchange-traded funds (ETFs) in due course and possibly in the future to bonds and other securities, commodities and derivative products. Through Southbound trading under the “Mutual Market” model, Mainland investors are open to global asset allocation opportunities for potentially better risk-adjusted returns and an increasingly diversified scope of investment and risk management instruments than in the domestic market. Trading experience in an international market would also help nurture the maturity of Mainland investors, especially the retail investors.

With increasing cross-border investment activities, there will likely be increasing investor demand for the inclusion in the Mutual Market model of related cross-border portfolio hedging tools such as RMB equity derivatives, RMB interest rate and currency derivatives.

1. THE STOCK CONNECT PILOT PROGRAMME — UNPRECEDENTED CONNECTIVITY WITH THE MAINLAND STOCK MARKET TOWARDS A “MUTUAL MARKET”

The Mutual Market Access pilot programme (the “Pilot Programme”), launched in November 2014 with initially the **Shanghai-Hong Kong Stock Connect (Shanghai Connect)**, is an unprecedented mechanism that connects stock trading, albeit within a confined scope, between the Mainland stock market and an overseas market. Prior to this, foreign participation channels in the Mainland stock market had been limited mainly to the Qualified Foreign Institutional Investor (QFII) scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme and foreign retail investors could only participate through investment funds offered by QFIIs and RQFIIs[1]. In the opposite direction, the Qualified Domestic Institutional Investor (QDII) scheme and the Renminbi Qualified Domestic Institutional Investor (RQDII) scheme had been the only national official channels of Mainland participation in overseas stock markets[2]. Following successful and smooth operation of the Shanghai Connect, the Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) was announced in August 2016.

The Pilot Programme is in fact a milestone step in the capital account opening of Mainland China. With daily quota imposed and a closed loop of cross-border funds flow, it allows cross-border capital investment activities to take place and develop in an orderly way with close monitoring, thereby reducing the potential financial risk impact onto the Mainland domestic stock market. The programme is scalable in size, scope and market segments to match with the pace of the opening of the Mainland market as it further develops. The vision is to establish a “Mutual Market” of Mainland China and Hong Kong for the interests of Mainland and global investors.

Sub-sections below give a brief on the two Stock Connect schemes. Section 2 presents the hitherto performance of the Shanghai Connect and Section 3 discusses the opportunities that the “Mutual Market” model offers.

[1] The B-share market (traded in foreign currency and separated from the A-share market) on the Shanghai and Shenzhen Stock Exchanges, which was launched in 1992 as the Mainland’s first attempt of stock market opening to foreign investors, had become virtually obsolete in the new wave of market opening.

[2] There are special pilot schemes launched by local governments, e.g. the Qualified Domestic Limited Partnership (QDLP) programme in Shanghai and the Qualified Domestic Investment Enterprise (QDIE) in Shenzhen Qianhai. However, these are limited to mainly privately offered funds or investment vehicles not widely accessible by general investors as these target mainly the institutional investors and high-net-worth individuals, compared to QDII products which target general investors.

1.1 Shanghai Connect

The pilot programme for the establishment of mutual stock market access between Mainland China and Hong Kong — Shanghai Connect — was jointly announced by the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (SFC) in April 2014. Mutual order-routing connectivity and related technical infrastructure (Trading Links) were built by the Stock Exchange of Hong Kong (SEHK), a wholly-owned subsidiary of HKEX, and the Shanghai Stock Exchange (SSE). Correspondingly the clearing and settlement infrastructure (Clearing Links) was established by the Hong Kong Securities Clearing Company Ltd (HKSCC), also a wholly-owned subsidiary of HKEX, and the securities clearing house in Mainland China — China Securities Depository and Clearing Corporation Ltd (ChinaClear). After several months' market preparation and system testing, the Shanghai Connect was formally launched on 17 November 2014. The theme of the programme is to enable Hong Kong and overseas investors to trade SSE-listed securities in the Mainland (SH Northbound Trading) and Mainland investors to trade SEHK-listed securities in Hong Kong (SH Southbound Trading), within the eligible scope of the programme.

In the initial phase, **eligible securities in SH Northbound Trading** comprise SSE-listed A shares (the SSE-listed “Northbound stocks”) which are:

- Constituent stocks of the SSE 180 Index and SSE 380 Index; or otherwise
- A shares which have corresponding H shares listed on SEHK;

except those which are not traded in Renminbi (RMB) and those under risk alert[3].

Eligible securities in SH Southbound Trading comprise SEHK-listed shares on the Main Board (the SEHK-listed “Southbound stocks”) which are:

- Constituent stocks of the Hang Seng Composite LargeCap Index (HSLI); or
- Constituent stocks of the Hang Seng Composite MidCap Index (HSMI); or otherwise
- H shares which have corresponding A shares listed on the SSE;

except those which are not traded in Hong Kong dollar (HKD) and H shares which have the corresponding SSE-listed A shares put under risk alert.

Among the Northbound stocks, the SSE 180 Index constituents are the most representative 180 A shares on the SSE while the SSE 380 Index constituents are the 380 stocks with modest scale, high growth and profits potential, representing the segment of emerging blue chips outside the SSE 180 Index on the SSE[4]. The Northbound stocks in SSE 180 Index are therefore considered “large-cap” stocks in parallel with the Southbound HSLI stocks and the Northbound stocks in SSE 380 Index are considered “mid-cap” stocks in parallel with the Southbound HSMI stocks.

Within the eligible scope of securities, there were 685 SSE-listed Northbound stocks as of 13 September 2016 (including 117 stocks eligible for sell only[5]) and 312 SEHK-listed Southbound stocks[6].

In respect of **investor eligibility**, all Hong Kong and overseas investors are allowed to participate in Northbound trading while only Mainland institutional investors and those individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts are allowed to participate in Southbound trading.

In Northbound trading, investors in Hong Kong will trade through Hong Kong brokers and trades are executed on the SSE platform. In Southbound trading, Mainland investors will trade through Mainland brokers and trades are executed on the SEHK platform. Northbound trading and Southbound trading follow the market practices of their respective trade execution platforms. In particular, day trading is not allowed for Mainland A shares market while being permissible in the Hong Kong market. Notably, Northbound SSE stocks are traded and settled in RMB only and Southbound SEHK stocks are traded in HKD and settled by the Mainland investors with ChinaClear or its clearing participants in RMB.

3 Shares which are placed under “risk alert” by SSE, including shares of “ST companies” and “*ST companies” and shares subject to the delisting process under the SSE rules.

4 Source: SSE website.

5 Originally eligible SSE-listed stocks which subsequently ceases to be eligible according to the set criteria.

6 Source: HKEX and SSE websites, viewed on 14 September 2016.

Trading under the Shanghai Connect is subject to investment quota, initially with an Aggregate Quota on the maximum cross-border investment value and a Daily Quota. The Aggregate Quota was set at RMB 300 billion for Northbound trading and RMB 250 billion for Southbound trading. This Aggregate Quota was subsequently abolished on the announcement date (16 August 2016) of the Shenzhen Connect. The Daily Quota, which is currently still applicable, limits the maximum net buy value to RMB 13 billion for Northbound stocks and RMB 10.5 billion (~HKD 12 billion as at end-August 2016) for Southbound stocks.

Investor interest in Northbound and Southbound trading fluctuated over time. Since launch, Northbound trading was more active than Southbound trading for most of the time. However, the recent trend shows that Southbound trading value has picked up and surpassed Northbound trading in recent months. (See section 2.)

1.2 Shenzhen Connect

On 16 August 2016, the CSRC and the SFC jointly announced the establishment of the Shenzhen Connect — the mutual stock market access between Shenzhen and Hong Kong. This is an extended version of the Mutual Market Access pilot programme between Mainland China and Hong Kong on the foundation of the Shanghai Connect which has been running successfully since launch. The Shenzhen Connect will be established by the Shenzhen Stock Exchange (SZSE), SEHK, ChinaClear and HKSCC in a similar way as for the Shanghai Connect. With this in place, the Pilot Programme will comprise the following Trading Links:

Stock Connect

Trading type		Shanghai Connect	Shenzhen Connect
	Northbound	Northbound Shanghai Trading Link	Northbound Shenzhen Trading Link
	Southbound	Southbound Hong Kong Trading Link under Shanghai Connect	Southbound Hong Kong Trading Link under Shenzhen Connect

Northbound eligible securities under the Shenzhen Connect comprise the following:

- All constituent stocks of the SZSE Component Index and of the SZSE Small/Mid Cap Innovation Index which have a market capitalisation of RMB 6 billion or above; and
- All SZSE-listed A shares of companies which have corresponding H shares listed on SEHK;

except those which are not traded in RMB and those under risk alert[7].

On top of Southbound eligible securities of the Shanghai Connect, the scope of **Southbound eligible securities** under the Shenzhen Connect is expanded to include the following:

- All constituent stocks of the Hang Seng Composite SmallCap Index (HSSI) which has a market capitalisation of HK$5 billion or above; and
- All SEHK-listed H shares of companies which have corresponding A shares listed on the SSE or the SZSE;

except those which are not traded in HKD and H shares which have the corresponding A shares put under risk alert.

While Mainland eligible investors for Southbound trading under Shenzhen Connect will be the same as that under Shanghai Connect, eligible investors for Northbound trading of shares listed on the ChiNext board of SZSE will be limited, at the initial stage, to institutional professional investors as defined in the relevant Hong Kong rules and regulations[8].

[7] Shares which are placed under "risk alert" by SZSE including shares of "ST companies and "*ST companies" and shares subject to the delisting process under the SZSE rules.

[8] See the definition of "Institutional Professional Investor" in the Securities and Futures (Professional Investor) Rules under the Securities and Futures Ordinance.

The same daily quota as for the Shanghai Connect will be applied to the Shenzhen Connect and no aggregate quota will be applied.

Table 1 below summarises the common and different key features for the Shanghai and Shenzhen Connect schemes.

<table>
<tr><th colspan="3">Table 1. Key features of Shanghai Connect and Shenzhen Connect</th></tr>
<tr><th>Feature</th><th>Shanghai Connect</th><th>Shenzhen Connect</th></tr>
<tr><td rowspan="3">Northbound eligible securities</td><td>• Constituents of the SSE 180 Index and SSE 380 Index
• SSE-listed A shares which have corresponding H shares listed on SEHK</td><td>• Constituent stocks of the SZSE Component Index and of the SZSE Small/Mid Cap Innovation Index which have a market capitalisation of RMB 6 billion or above
• SZSE-listed A shares of companies which have corresponding H shares listed on SEHK</td></tr>
<tr><td colspan="2">• Excluding risk alert stocks and stocks not traded in RMB</td></tr>
<tr><td>• 568 eligible stocks for buy and sell (as of 13 Sep 2016)</td><td>• ~880 stocks (Main Board: ~270, Small and Medium Sized Enterprise (SME) Board: ~410, ChiNext: ~200)</td></tr>
<tr><td rowspan="4">Southbound eligible securities</td><td colspan="2">• Constituents of the Hang Seng Composite LargeCap Index (HSLI)
• Constituents of the Hang Seng Composite MidCap Index (HSMI)</td></tr>
<tr><td>• H shares which have corresponding A shares listed on the SSE</td><td>• Constituents of the Hang Seng Composite SmallCap Index (HSSI) which has a market capitalisation of HK$5 billion or above
• H shares which have corresponding A shares listed on the SSE or the SZSE</td></tr>
<tr><td colspan="2">• Excluding H shares where the respective A shares are risk alert stocks and stocks not traded in HKD</td></tr>
<tr><td>• 312 stocks (as of 13 Sep 2016)</td><td>• ~417 stocks (some 100 on top of SH-HK Southbound stocks)</td></tr>
<tr><td>Northbound eligible investors</td><td>• All Hong Kong and overseas investors (individuals and institutions)</td><td>• ChiNext eligible stocks are initially open only to institutional professional investors
• All Hong Kong and overseas investors (individuals and institutions) for other eligible stocks</td></tr>
<tr><td>Southbound eligible investors</td><td colspan="2">• Mainland institutional investors, and individual investors with an aggregate balance of ≥RMB 500,000 in their securities and cash accounts</td></tr>
<tr><td>Daily quota</td><td colspan="2">• Northbound: RMB 13 billion
• Southbound: RMB 10.5 billion</td></tr>
<tr><td>Aggregate quota</td><td colspan="2">• Nil</td></tr>
<tr><td>Northbound trading, clearing and settlement</td><td>• Following SSE and ChinaClear Shanghai market practice</td><td>• Following SZSE and ChinaClear Shenzhen market practice</td></tr>
<tr><td>Southbound trading, clearing and settlement</td><td colspan="2">• Following SEHK and HKSCC market practice</td></tr>
</table>

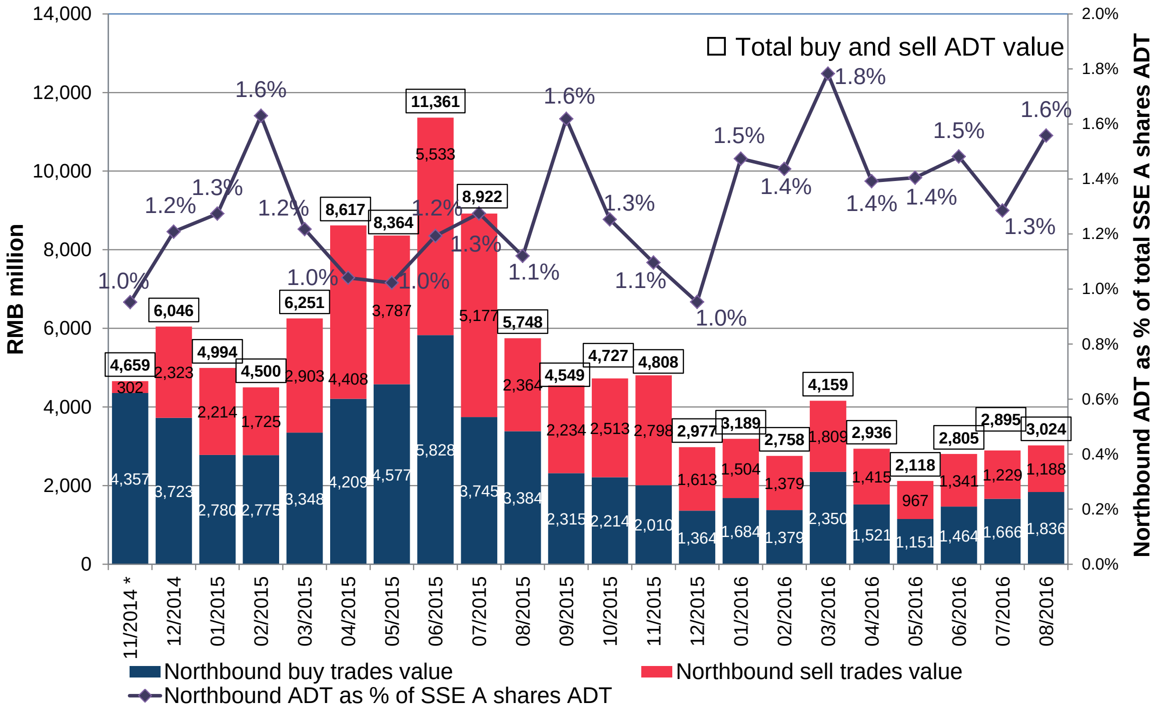
2. HITHERTO PERFORMANCE OF SHANGHAI CONNECT (UP TO AUGUST 2016)

2.1 Overall Northbound and Southbound trading

Both Northbound and Southbound trading value have fluctuated over time, along with changes in market sentiment. Yet, the average daily trading value (ADT) of Northbound trading has maintained a relatively steady level between 1% and 1.6% of the ADT of the SSE total A-share market. On the other hand, after a rise and fall of Southbound trading in the first 9 months after launch, a strong upward trend was observed for Southbound trading relative to the SEHK Main Board total market trading in the past year, rising from 2.1% of the Main Board ADT in September 2015 to 6.1% in August 2016. For the first time after April 2015, Southbound ADT exceeded Northbound ADT in June 2016 and again in August 2016. (See Figures 1 and 2 below).

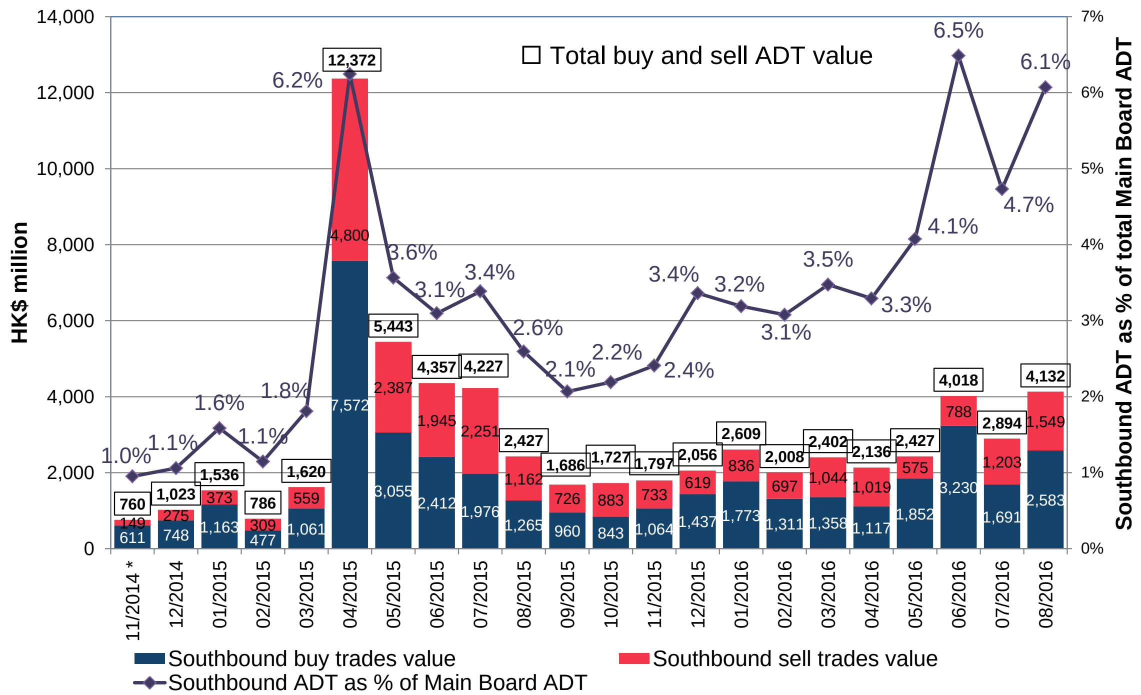
Figure 1. Shanghai Connect average daily trading value (Nov 2014 – Aug 2016)

(a) Northbound



* Starting from 17 Nov 2014 when Shanghai Connect was launched.

(b) Southbound

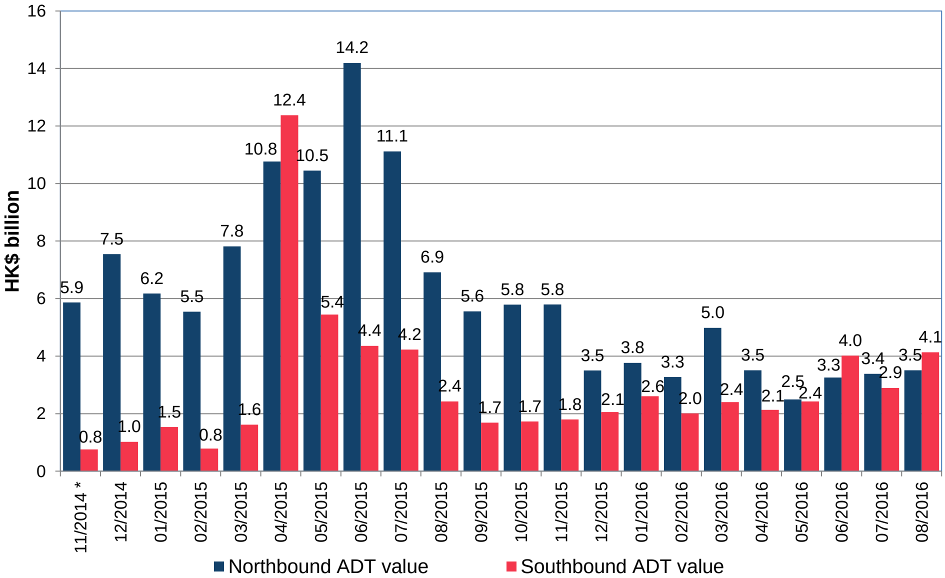


* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: In calculating the ratio to the total market ADT, Northbound/Southbound trading values were two-sided (buy and sell values counted separately) while the total market trading values were one-sided transaction values (buy and sell counted in a single transaction value).

Source: HKEX

Figure 2. Average daily Shanghai Connect Southbound total trading (buy and sell) value in comparison with Northbound (Nov 2014 – Aug 2016)



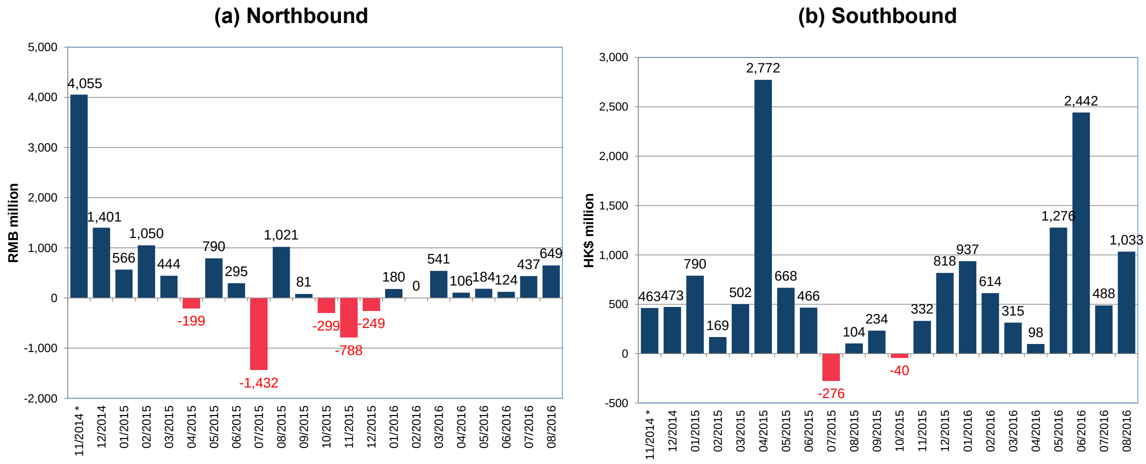
* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: Northbound trading values are converted to HKD using month-end exchange rates from Hong Kong Monetary Authority website.

Source: HKEX

Moreover, Southbound trading had much higher average daily net buy values than Northbound trading since late 2015. Net sell value was recorded for Southbound trading in only two months since launch up to the end of August 2016, vis-à-vis 5 months for Northbound trading (see Figure 3). Of the 413 Southbound trading days during the period, 87% had a net buy value (vs 56% for Northbound out of its 420 trading days). However, the net-buy daily quota consumption has been low for both Northbound and Southbound trading — only 20% of the Northbound trading days and 16% of the Southbound trading days had a daily quota usage exceeding 10%; and 7% of the Northbound trading days and 3% of Southbound trading days had the usage exceeding 20%.[9] (See Figure 4 and Table 2 below.)

Figure 3. Average daily net buy/sell value in Shanghai Connect Northbound and Southbound trading (Nov 2014 – Aug 2016)

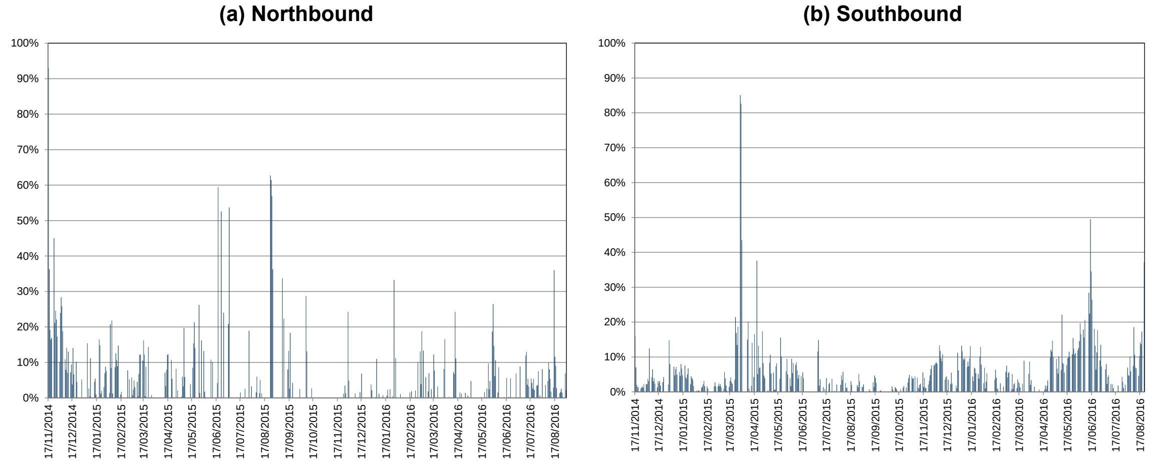


* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Source: HKEX

[9] For Northbound trading, a daily quota usage exceeding 10% means that the net-buy value exceeds 10% of the given Northbound daily quota of RMB 13 billion, i.e. net-buy value amounts to over RMB 1.3 billion. The same applies to Southbound trading, but with reference to the Southbound net-buy daily quota of RMB 10.5 billion and currency converted to HKD based on the daily RMB/HKD exchange rate as obtained from Thomson Reuters.

Figure 4. Net-buy daily quota consumption in Shanghai Connect (17 Nov 2014 – 31 Aug 2016)



Source: HKEX; daily trading value converted to RMB at daily exchange rates obtained from Thomson Reuters for calculating Southbound quota consumption

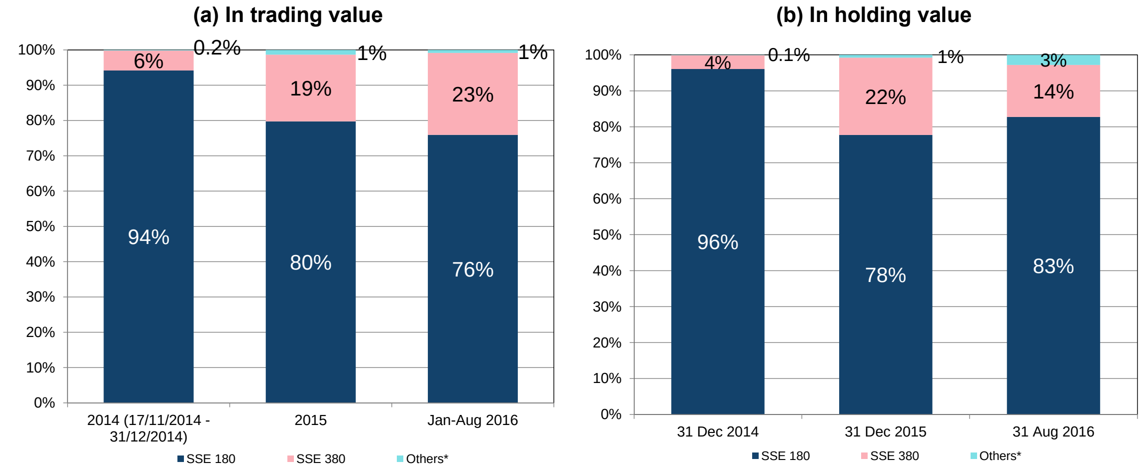
Table 2. The usage of daily quota in Shanghai Connect (17 Nov 2014 – 31 Aug 2016)

	Northbound	Southbound
Total no. of trading days	420	413
% of trading days with net buy	56%	87%
Daily quota usage range	**Northbound (no. of days / % of total)**	**Southbound (no. of days / % of total)**
>0% - 10%	153 / 36.4%	290 / 70.2%
>10% - 20%	53 / 12.6%	54 / 13.1%
>20% - 30%	17 / 4.0%	7 / 1.7%
>30% - 40%	5 / 1.2%	3 / 0.7%
>40% - 50%	1 / 0.2%	2 / 0.5%
>50% - 60%	4 / 1.0%	0 / 0%
>60% - 70%	2 / 0.5%	0 / 0%
>70% - 80%	0 / 0%	0 / 0%
>80% - 90%	0 / 0%	2 / 0.5%
>90% - 100%	1 / 0.2%	0 / 0%

2.2 Global investors’ interest in Northbound stocks

At the initial stage after the launch of Shanghai Connect, global investors’ trading and holding of Northbound stocks were predominantly in the large-cap SSE 180 Index constituents (94% of trading value in 2014 and 96% of holding value at the end of 2014). Northbound trading in the mid-cap SSE 380 Index constituents gradually increased from 6% during 2014 to 23% during 2016 up to August. Northbound holding of these mid-cap stocks jumped to 22% at the end of 2015 and decreased to 14% at the end of August 2016, still much higher than the 4% at the end of 2014. Nevertheless, global investors’ main interest was in the Mainland large-cap blue chips. (See Figure 5.)

Figure 5. Shanghai Connect — Distribution of Northbound trading value and investor holding value by stock type (Nov 2014 – Aug 2016)



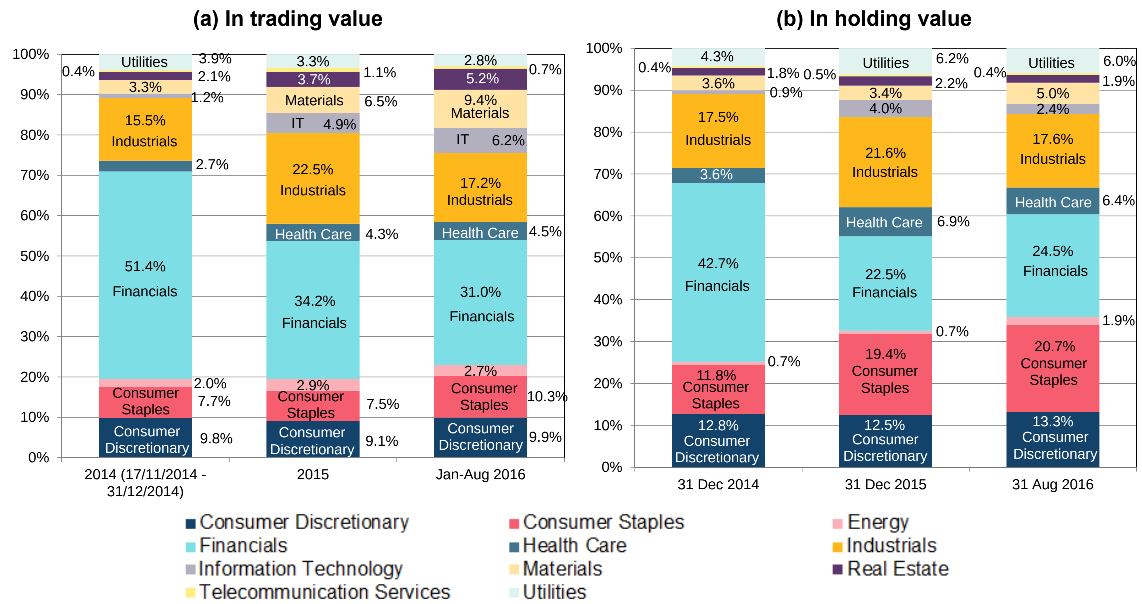
* Others include non-SSE180 and non-SSE380 A shares with SEHK-listed H shares and stocks removed from SSE 180 and SSE 380 constituent lists during the period (sell-only stocks).

Note: Percentages may not add up to 100% due to rounding.

Source: HKEX

Global investors maintained a steady interest in Mainland consumer stocks (Consumer Discretionary and Consumer Staples) — these stocks constituted close to 20% share of Northbound trading value since launch and had an increasing percentage share of Northbound holding value. Mainland Industrial stocks also attracted considerable interest — over 17% of Northbound trading value and period-end holding value in 2016 up to August. The degree of dominance of Financial stocks (all were large-cap SSE 180 constituents) gradually reduced — from 51% of Northbound trading value and 43% of period-end Northbound holding value in 2014 to 31% and 25% respectively in 2016 up to August. (See Figure 6.)

Figure 6. Shanghai Connect — Distribution of Northbound trading value and investor holding value by industry sector (Nov 2014 – Aug 2016)

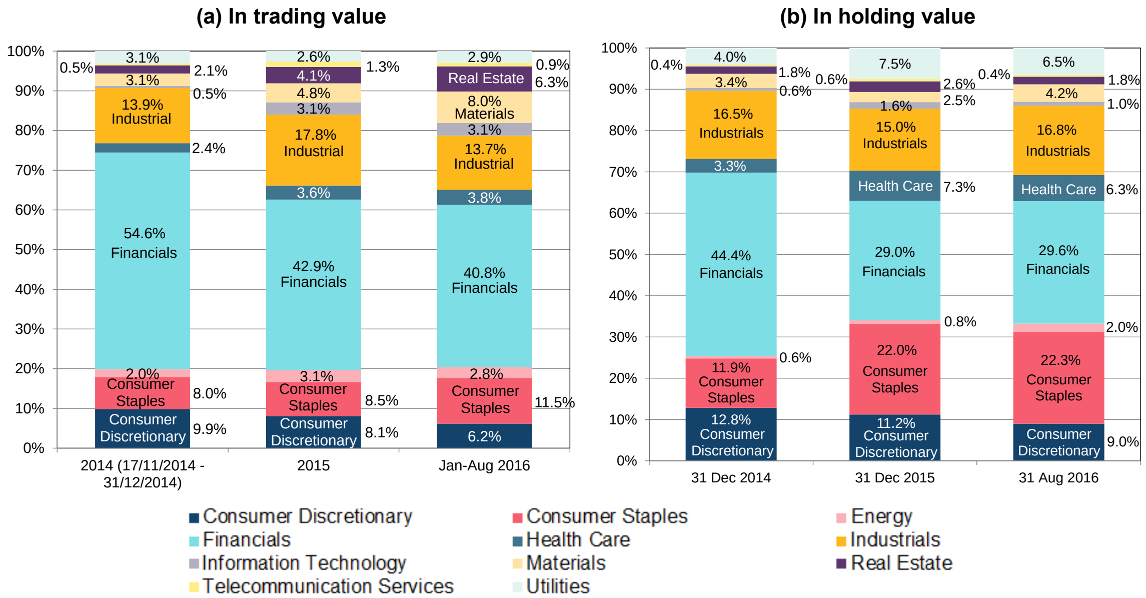


Note: Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg

While the majority share of Northbound trading in the large-cap SSE 180 stocks was contributed by Financial stocks, considerable share of Northbound trading in the mid-cap SSE 380 stocks was contributed by Industrial and Information Technology (IT) stocks. Consumer stocks contributed a significant share of Northbound trading in the large-cap SSE 180 stocks and even more so in the mid-cap SSE 380 stocks. Notably, Northbound trading and holding in the mid-cap SSE 380 stocks were relatively more diversified by industry than in the large-cap SSE 180 stocks (albeit without financial stocks). (See Figures 7 and 8.)

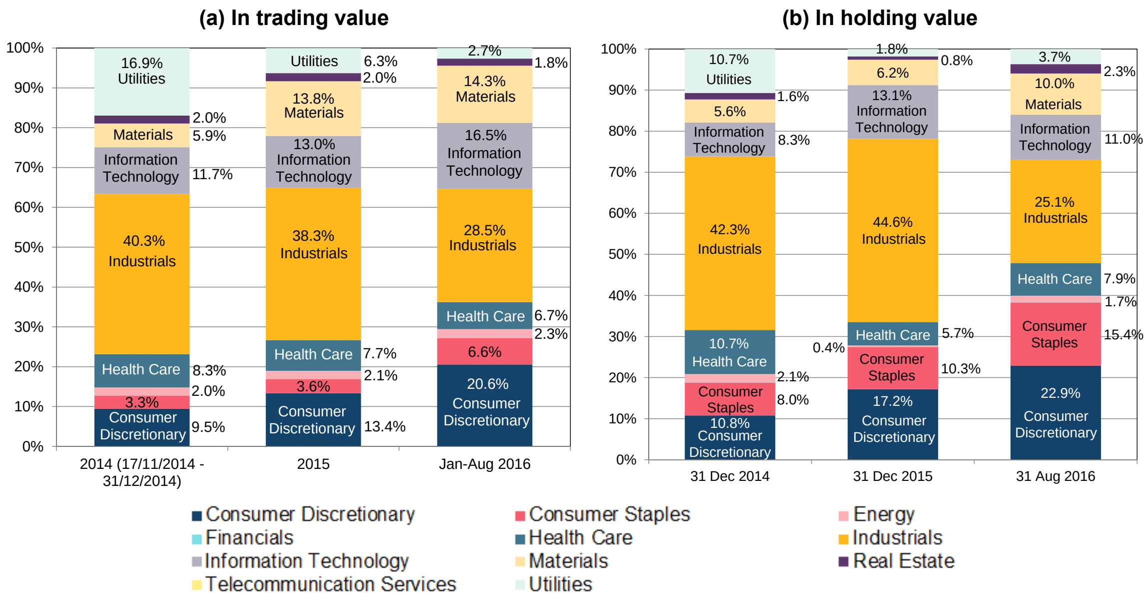
Figure 7. Shanghai Connect — Distribution of Northbound trading value and investor holding value by industry sector for SSE 180 Index constituents (Nov 2014 – Aug 2016)



Note: Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg.

Figure 8. Shanghai Connect — Distribution of Northbound trading value and investor holding value by industry sector for SSE 380 Index constituents (Nov 2014 – Aug 2016)



Note: Percentages may not add up to 100% due to rounding.

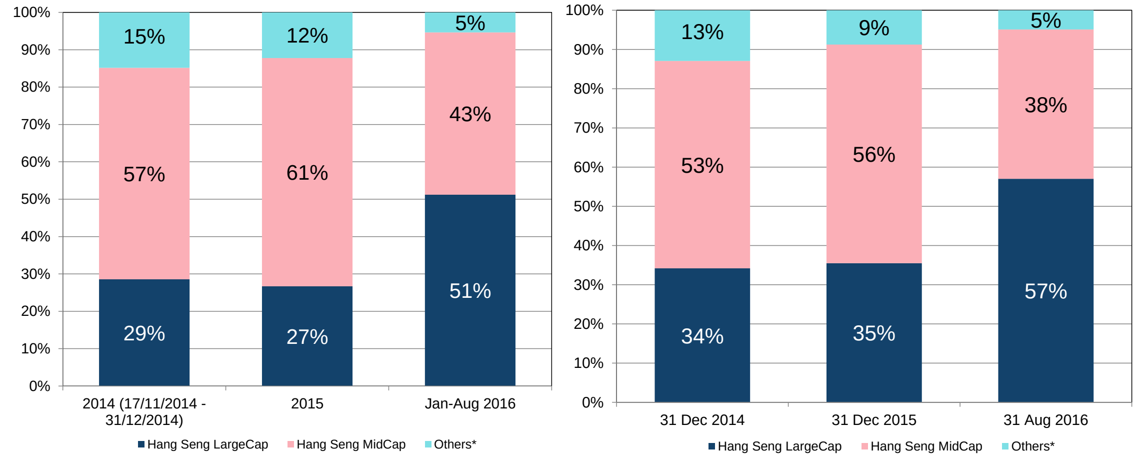
Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg.

2.3 Mainland investors' interest in Southbound stocks

Figure 9 shows the Southbound trading and investor holding in SEHK-listed stocks by eligible stock type. In contrast to Northbound investment, the majority of Southbound trading value and period-end holding value was in the mid-cap HSMI constituents at the launch of the scheme in 2014. This had shifted to some extent to HSLI constituents in 2016 up to August. Nevertheless, HSMI stocks still maintained a considerable share in 2016 up to August (~40%).

Figure 9. Shanghai Connect — Distribution of Southbound trading value and investor holding value by stock type (Nov 2014 – Aug 2016)

(a) In trading value **(b) In holding value**



* Others include (1) non-HSLI and non-HSMI H shares with SSE-listed A shares and (2) HKEX-listed stocks received by Southbound investors which were distributed by Southbound eligible stocks and were "sell-only" stocks under Stock Connect.

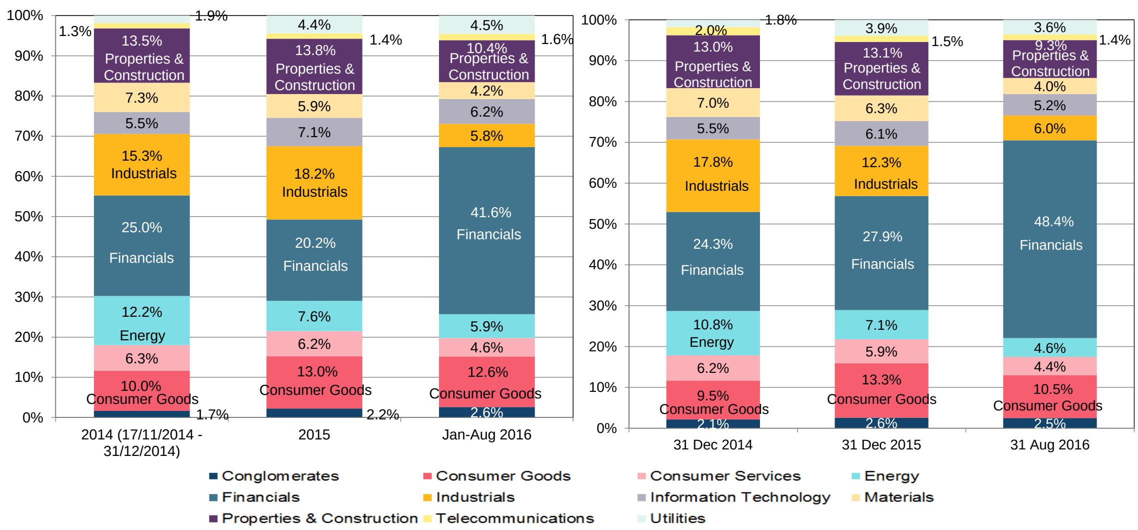
Note: Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who's Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

In terms of industry sector, there had been increasing concentration in the trading and holding of Financial stocks, displacing to a large extent Industrial stocks over the past year. Other more popular sector stocks were Consumer Goods, and Properties and Construction. (See Figure 10.)

Figure 10. Shanghai Connect — Distribution of Southbound trading value and investor holding value by industry sector (Nov 2014 – Aug 2016)

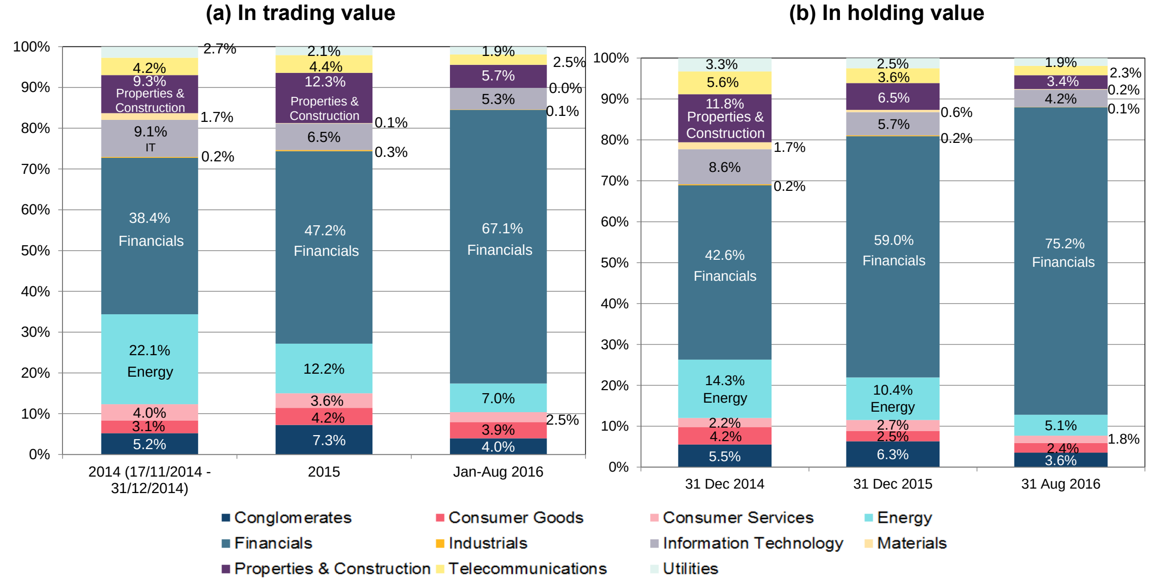
(a) In trading value **(b) In holding value**



Note: Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who's Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

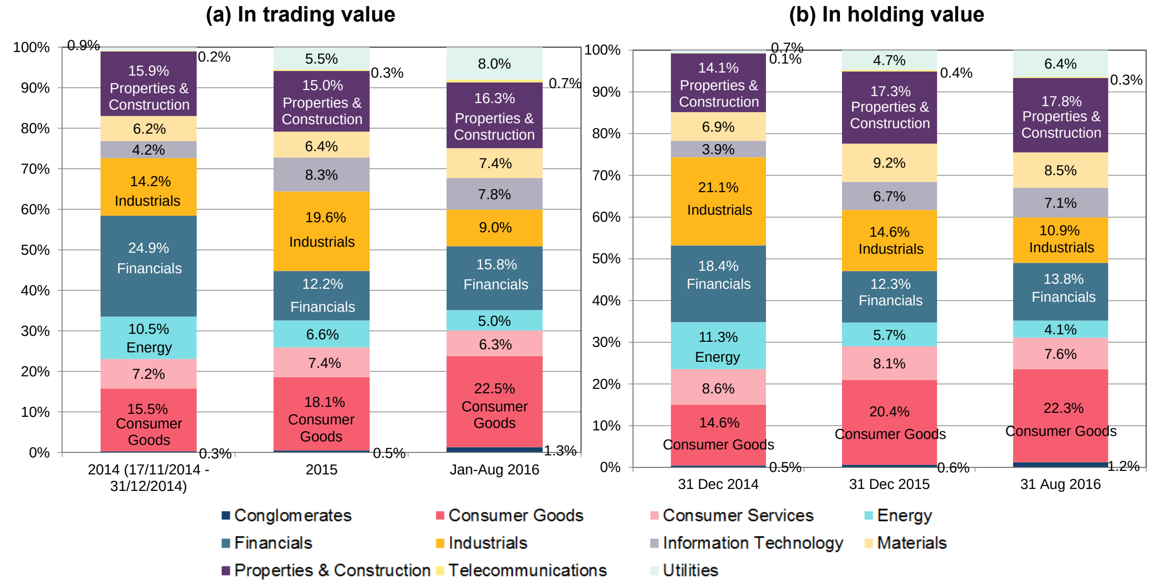
Figure 11. Shanghai Connect — Distribution of Southbound trading value and investor holding value by industry sector for HSLI constituents (Nov 2014 – Aug 2016)



Note: Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who's Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

Figure 12. Shanghai Connect — Distribution of Southbound trading value and investor holding value by industry sector for HSMI constituents (Nov 2014 – Aug 2016)



Note: Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who's Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

However, the dominance of Financial stocks in Southbound investment was mainly in respect of HSLI stocks. For Southbound investment in the mid-cap HSMI stocks, Mainland investor trading and holding were very much diversified across different industrial sectors. In 2016 up to August, Southbound trading and period-end holding had considerable share in Consumer Goods stocks (~22%, and close to 30% when including Consumer Services stocks) and Property and Construction Stocks (~16-17%) among HSMI constituents. Financial stocks ranked third in Southbound trading and holding of HSMI constituents, in contrast to their dominance in that of HSLI constituents. (See Figures 11 and 12 above.)

In other words, as far as Shanghai Connect offers, Mainland investors have considerable investment interest in Southbound trading of mid-cap stocks of a variety of industry sectors. While large-cap stocks would have high concentration in Financial stocks, **smaller-sized stocks in fact could offer a diversified scope of stocks by industry sector of interest to the Mainland investors**.

3. THE "MUTUAL MARKET" MODEL — OPPORTUNITIES TO MAINLAND AND GLOBAL INVESTORS

After the launch of Shenzhen Connect, the basic model of "**Mutual Market**" across Shanghai, Shenzhen and Hong Kong will be established, albeit within the limited scope of eligible securities. As the mutual stock market access scheme is scalable, this potentially opens up a Mainland-Hong Kong mutual stock market of a combined equity market value of US$10,611 billion (as of end-August 2016) and an average daily equity turnover of about US$87 billion (2016 up to August), ranking 2nd by market value (following New York Stock Exchange) and 2nd by equity market turnover among world exchanges[10]. Moreover, the "Mutual Market" model may go beyond equities in multiple dimensions. As mentioned in the joint announcement of the CSRC and SFC on 16 August 2016 regarding the in-principle approval for the establishment of Shenzhen Connect, the two authorities have reached a consensus **to include exchange-traded funds (ETFs) as eligible securities** under the scheme. A launch date will be announced in due course after Shenzhen Connect has been in operation for a period of time and upon the satisfaction of relevant conditions. In addition, the CSRC and the SFC will jointly study and introduce other financial products to facilitate and meet the need of Mainland and global investors to manage price risks in each other's stock markets.

Under the "Mutual Market" model, overseas products of interest to Mainland investors could be offered to the Mainland investors and vice versa for offering Mainland products of interest to global investors. Southbound trading opens up **a regularised channel for Mainland investors, both individuals and institutions, to invest in overseas assets**. The channel is a closed system with prudential monitoring of the usage of the daily quota, and yet with considerable flexibility in the absence of an aggregate quota. Without the limitation of an aggregate quota, investors may allocate their portfolio investment in cross-border assets more freely than before. This offers **valuable global asset allocation opportunities to Mainland investors**. Since the system is closed in the sense that the RMB (after converted into HKD) used to purchase overseas assets under the model will be reverted back to Mainland China (after being converted back to RMB) upon the sale of the overseas assets, there is essentially no capital outflow problem in the long run. **The model effectively extends the universe of investable assets for Mainland investors.** Under such an environment, the connectivity channel compensates the relative shortage of investable assets in the Mainland, allowing the large sum of investment monies to **obtain possibly better returns** from investing in overseas than in the domestic market. Acknowledging the advantage of this, the China Insurance Regulatory Commission (CIRC) issued a policy document[11] in early September 2016 to allow insurance funds to participate in Southbound trading under the Shanghai Connect.

In addition, Southbound trading is effectively investment in a foreign currency, i.e. HKD which is pegged to the US dollar, for Mainland investors. At the time of expected depreciation of the RMB, Southbound investment could offer **a possibly better protection of investment returns in terms of currency value**.

As the eligible instruments under the "Mutual Market" model are expandable, this will offer **an increasingly diversified scope of investment tools to Mainland investors**, albeit in the short term the available instruments may only be cash market securities including equities and possibly ETFs. After the launch of Shenzhen Connect, Southbound eligible securities will include the HSSI constituents with a market capitalisation of HK$5 billion or above, in addition to HSLI and HSMI constituents. All H shares with A shares listed in the Mainland market will be included, not just those with SSE-listed A shares. HSLI and HSMI already cover up to 95% of the total market capitalisation of the Hang Seng Composite Index (HSCI), which in turn covers the top 95% of the total market capitalisation of the Hong Kong market[12]. As a result, some further 100 stocks will be added to the eligible list. More importantly, the expanded scope will include stocks in a large variety of industries, including new economy sectors of information technology and consumer goods and services.

10 World Federation of Exchanges (WFE) statistics, from WFE website, 21 September 2016. Average daily turnover was calculated from the combined shares turnover value for 2016 up to August from WFE statistics using the total number of trading days (164 days) for the Mainland market. Ranking was based on the year-to-month combined trading value.

11 "關於保險資金參與滬港通試點的監管口徑", 9 September 2016.

12 The Hong Kong market universe of the HSCI refers to all stocks and real estate investment trusts ("REITs") that have their primary listings on the SEHK, excluding securities that are secondary listings, foreign companies, preference shares, debt securities, mutual funds and other derivatives. (Source: Hang Seng Indexes Co Ltd website)

Moreover, **the trading experience offered by an international stock market** like Hong Kong where the dominant participants are international professional institutional investors is valuable to Mainland domestic investors, especially the retail investors. Professional investment strategies in a mature market are usually based on stock fundamentals, and economic and industrial factors. These are crucial in balancing the short-term speculative trading behavior of Mainland retail investors. **Southbound trading experience is therefore expected to help nurture the maturity of the Mainland investor base.**

Apart from secondary market trading, **connectivity in the primary market**, i.e. the initial public offering (IPO) market, can be offered under the model subject to regulatory approval, allowing investors on either market to subscribe for IPOs in the other market. Products to be covered in the future (subject to regulatory approval) may also extend to **bonds, commodities and risk management tools including equity derivatives, RMB interest rate and currency derivatives**. In fact, in view of the successful implementation of the Stock Connect scheme, a more imminent issue is to meet the needs of investors for hedging their cross-border stock portfolios. In the Mainland, investors are allowed to trade Hong Kong stocks but there are no **Hong Kong index/stock futures and options for hedging**. Similarly in Hong Kong, there is also the lack of **A-share hedging tools like A-share index futures and options**. While the related derivatives on either market may be included in the Mutual Market model in the future, before that investors may consider using proxy instruments in their home markets.

The "Mutual Market" model in fact is a symbolic breakthrough in Mainland China's capital account opening process. In the long run, a highly diversified suite of investment and risk management tools could be offered under the "Mutual Market" model before the potential full opening of the Mainland capital market. Mainland investors will thereby benefit from enhanced asset allocation and investment portfolio management, and global investors will benefit from an open channel to more Mainland investment opportunities with related risk management tools available.