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RESEARCH REPORT

PRIMARY EQUITY CONNECT — A BREAKTHROUGH OPPORTUNITY FOR MAINLAND-HONG KONG MUTUAL MARKET CONNECTIVITY AND RMB INTERNATIONALISATION

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SUMMARY

With the launch of the Shanghai-Hong Kong Stock Connect (Shanghai Connect) in November 2014 and the Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) in December 2016 (collectively referred to as the "Stock Connect scheme"), the Mainland-Hong Kong Mutual Market platform was basically formed. However, the platform is currently confined to secondary equity market trading only and investors on either side of the border are barred from the primary equity market on the other side. This has deprived investors of investment opportunities from initial public offers (IPO) across the border and has essentially hindered the pooling of liquidity in the Mutual Market to support its function in fund raising by issuers.

The **Primary Equity Connect (PEC)** initiative[1] put forward in HKEX's Strategic Plan 2016-2018 would provide a breakthrough opportunity to help complete the Mutual Market connectivity in the equity market segment. The concept of PEC is to provide a mechanism to allow Mainland investors to subscribe for IPOs in the Hong Kong market (Southbound) and global investors in Hong Kong to subscribe for IPOs in the Mainland market (Northbound). Upon listing of the IPO shares issued, trading by investors from the other market would be enabled through the existing Stock Connect mechanism. Under this connectivity model, shares subscription under PEC and shares trading under Stock Connect are effectively contained within a closed-loop system.

In respect of the Mainland market and the Hong Kong market separately, PEC is believed to be mutually beneficial to each market given the development bottleneck in the internationalisation of both markets. The current degree of internationalisation of the Mainland stock market is relatively low in multiple dimensions, including investor base, issuer base and institutional structure. The participation of Qualified Foreign Institutional Investors (QFIIs) and Renminbi QFIIs (RQFIIs) in the Mainland stock market remains relatively low (with an aggregate shareholding value less than 0.3% of the total "negotiable market capitalisation", i.e. market value of listed and marketable securities, on the Shanghai and Shenzhen stock exchanges). No foreign companies are yet allowed to list on the Mainland exchanges; and the Mainland market practices are not necessarily in line with international practices. The Hong Kong stock market, on the other hand, is highly internationalised in terms of investor participation but not in terms of listed issuers. Given these weaknesses, PEC would help enhance the international dimensions of both the Mainland market and the Hong Kong market and beyond which the Mutual Market as a whole.

Internationalisation of the Mainland-Hong Kong Mutual Market is not a goal in itself but part of the bigger strategy for China to achieve a better balanced economy, more effective market opening and ultimately a higher degree of RMB internationalisation. The PEC initiative under the Mutual Market model would offer an opportunity to improve the current situation

For the Mainland, PEC would (1) offer new opportunities for Mainland investors' global asset allocation and therefore an improved national balance sheet, (2) facilitate two-way market opening at lower cost, (3) help achieve one more step forward in RMB capital account convertibility, (4) support the development of the market's international investor base, (5) provide more listing opportunities for Mainland enterprises and (6) help nurture the Mainland investor base, while containing potential risks with suitable control measures. For Hong Kong, PEC would help attract the listing of international companies, further activate the market by increasing investor participation and also benefit market intermediaries through more business opportunities.

The implementation of PEC would involve additional issues, including regulatory and operational issues, beyond the Stock Connect scheme. Nevertheless, it is believed that these challenges could be largely overcome with **a suitable model design that could meet the best interests of the Mainland-Hong Kong Mutual Market. This would ultimately benefit China's national accounts and the big strategy of RMB internationalisation.**

[1] Subject to regulatory approvals.

1. A MUTUAL MARKET WITHOUT PRIMARY MARKET CONNECTIVITY

1.1 Secondary market connectivity — Stock Connect

The Mainland-Hong Kong Mutual Market Access pilot programme (the “Pilot Programme”) was launched on 17 November 2014, initially with the commencement of the Shanghai-Hong Kong Stock Connect (Shanghai Connect), allowing cross-border stock investments in the Mainland and Hong Kong markets. The Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) was subsequently launched on 5 December 2016. The (initially applied) aggregate quota for the Pilot Programme was abolished immediately upon the official announcement of the Shenzhen Connect on 16 August 2016. (Hereinafter, the Shanghai Connect and Shenzhen Connect are collectively referred to as the “Stock Connect scheme”.) By then, a **Mutual Market platform** across Shanghai, Shenzhen and Hong Kong was basically formed. This potentially opens up a Mainland-Hong Kong mutual stock market of a combined equity market value of US$10,514 billion (as of end-2016) and an average daily equity turnover of about US$84.3 billion (2016), ranking 2nd by market value (following New York Stock Exchange) and 2nd by equity market turnover among world exchanges[2]. Moreover, the “Mutual Market” model may go beyond equities as eligible trading instruments, including exchange-traded funds (ETFs).[3]

The Stock Connect scheme enables Hong Kong and overseas investors to trade securities listed on the Shanghai Stock Exchange (SSE) or Shenzhen Stock Exchange (SZSE) in the Mainland market (Shanghai (SH) or Shenzhen (SZ) Northbound Trading respectively under Shanghai Connect and Shenzhen Connect) and Mainland investors to trade securities listed on the Stock Exchange of Hong Kong (SEHK) in the Hong Kong market (SH or SZ Southbound Trading respectively under Shanghai Connect and Shenzhen Connect), within the eligible scope of the programme.

Eligible securities in SH Northbound Trading comprise SSE-listed constituent stocks of the SSE 180 Index and SSE 380 Index and otherwise the A shares which have corresponding H shares listed on SEHK, except those which are not traded in Renminbi (RMB) and those under risk alert[4]. **Eligible securities in SZ Northbound Trading** comprise all SZSE-listed constituent stocks of the SZSE Component Index (SZCI) and of the SZSE Small/Mid Cap Innovation Index (SZII) which have a market capitalisation of RMB 6 billion or above, and otherwise 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 by SZSE. **Eligible securities in SH Southbound Trading** comprise SEHK Main Board-listed constituent stocks of the Hang Seng Composite LargeCap Index (HSLI) and 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 dollars (HKD) and H shares which have the corresponding A shares put under risk alert. On top of these, **eligible securities in SZ Southbound Trading** also include all the constituent stocks of the Hang Seng Composite SmallCap Index (HSSI) which have a market capitalisation of HK$5 billion or above, and all SEHK-listed H shares of companies which have corresponding A shares listed

[2] World Federation of Exchanges (WFE) statistics, from WFE website (20 January 2017 for market value data and 1 March 2017 for trading value data). Average daily turnover was calculated from the combined shares turnover value for 2016 from WFE statistics using the total number of trading days (244 days) for the Mainland market. Ranking was based on 2016 up to December combined trading value.

[3] As mentioned in the joint announcement of the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (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 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.

[4] 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.

on the SZSE, except those which are not traded in Hong Kong dollars (HKD) and H shares which have the corresponding A shares put under risk alert.

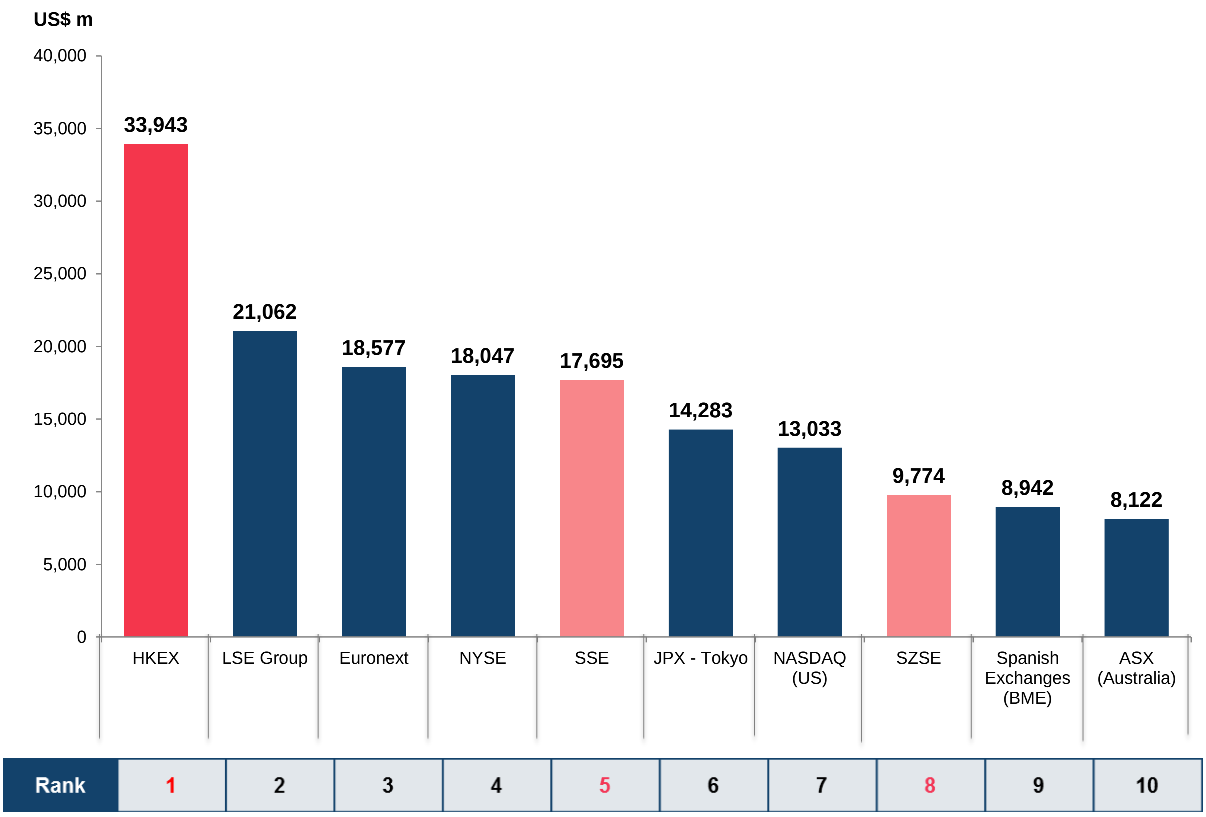
As of 28 June 2017, there were 574 eligible (for both buy and sell) Northbound stocks and 310 eligible Southbound stocks under Shanghai Connect; and 901 eligible (for both buy and sell) Northbound stocks and 418 eligible Southbound stocks under Shenzhen Connect. In other words, around 44% and 45% in number of listed A shares respectively on the SSE and SZSE, and around 24% that on SEHK Main Board are Stock Connect eligible securities[5]. By the end of 2016, the average daily Northbound trading value constituted about 2% of the Mainland A-share market total turnover and the average daily Southbound trading value constituted about 8% of the SEHK Main Board total turnover[6].

1.2 Primary market opportunities

The Stock Connect scheme is an unprecedented mechanism that connects the Mainland stock market with an overseas market. However, currently this is confined to secondary equity market trading only and investors on either side of the border are barred from the primary equity market on the other side. This has deprived investors of the investment opportunities offered by initial public offers (IPO) of newly listed companies in the market across the border. According to the statistics of the World Federation of Exchanges (WFE), Hong Kong, Shanghai and Shenzhen were among the top ten markets by IPO funds raised in the past two years (see Figure 1). Hong Kong itself ranked first by IPO funds raised in 5 out of the past 8 years (see Figure 2).

Figure 1. Top 10 exchanges by IPO funds raised (2015 & 2016)

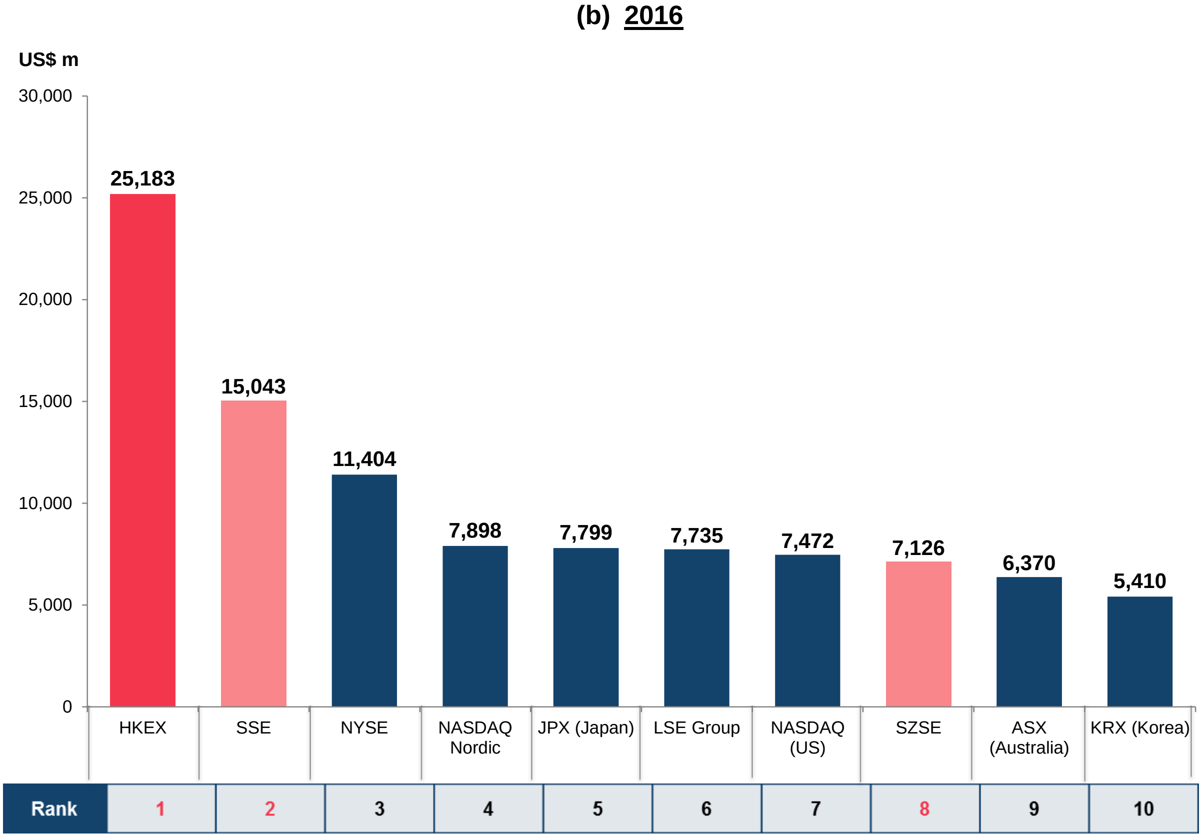
(a) 2015



5 Source: HKEX, SSE and SZSE websites.

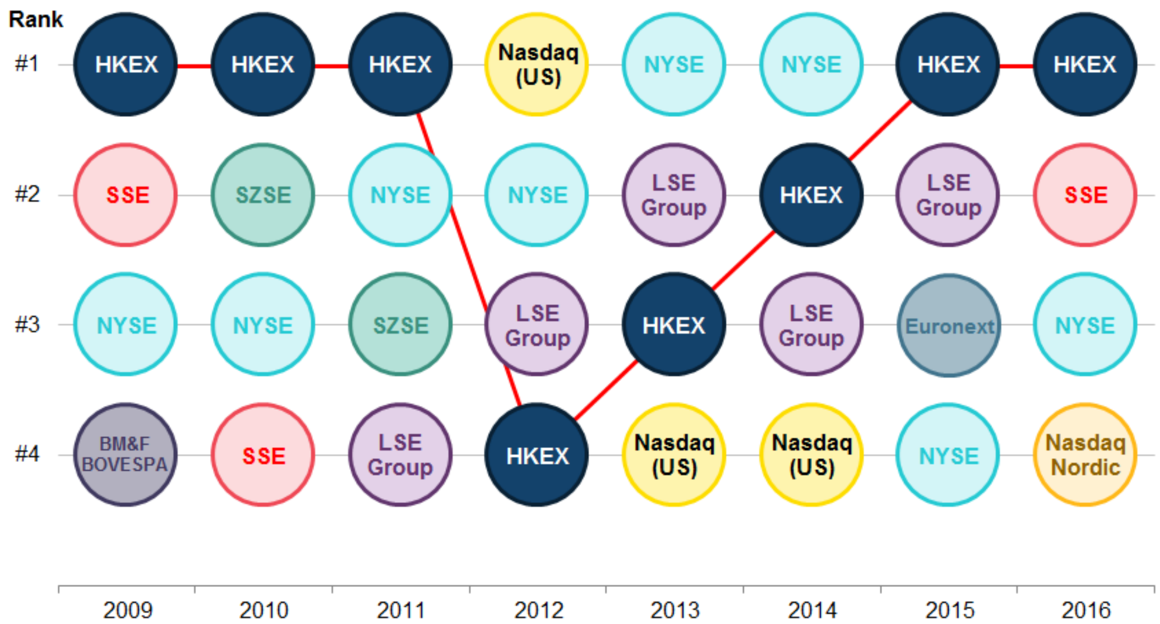
6 See HKEX Research Report, *Shanghai and Shenzhen Stock Connect — A "Mutual Market" for Mainland and global investors*, March 2017, published on the HKEX website.

Figure 1. Top 10 exchanges by IPO funds raised (2015 & 2016)



Source: WFE website.

Figure 2. Top 4 world exchanges by IPO funds raised (2009 – 2016)



Source: WFE website.

In respect of the equity market, the Mainland-Hong Kong mutual market established through secondary market connectivity under Stock Connect is incomplete without primary market connectivity. In fact, the absence of primary market connectivity may harm investor interests under secondary market connectivity and bring about market unfairness. The recent case of the spin-off of BOCOM International Holdings Company Limited (BOCOM International) by Bank of Communications Co., Ltd (BOCOM Bank) was an example. BOCOM Bank has its H shares listed in Hong Kong and its A shares listed on the SSE. BOCOM Bank announced its proposed spin-off and listing of BOCOM International on the SEHK in August 2016. BOCOM Bank would provide its existing shareholders with an assured entitlement to the new shares in BOCOM International. However, due to the impediments arising from legal and policy perspectives, BOCOM Bank could only provide the assured entitlement to its existing H-share shareholders but not to its existing A-share shareholders[7]. As advocated by market participants[8], the introduction of primary market connectivity would help resolve this kind of market unfairness.

In its Strategic Plan 2016-2018, HKEX put forward the Primary Equity Connect (PEC) together with Shenzhen Connect, as initiatives to further expand the mutual market connectivity. After implementation of Shenzhen Connect in December 2016, **the PEC initiative is expected to further open up opportunities for Mainland investors' global asset allocation. It will also support the further internationalisation of the Mainland stock market and help complete the connectivity mechanism, thereby enabling the pooling of liquidity in the Mutual Market to fulfil its function in fund raising by issuers and stock trading by investors. In a broader sense, the Mutual Market with PEC and possibly other connectivity initiatives could assist China's bigger roadmap in economic development and RMB internationalisation. These are elaborated in sections below.**

2. BOTTLENECKS IN MAINLAND AND HONG KONG STOCK MARKET DEVELOPMENT

Further market opening and internationalisation have been key policy directions of the Mainland capital market development. The 13th Five-Year Plan on Economic and Social Development (2016-2020) outlines the initiative of constructing a new pattern of all-round opening, which includes expanding two-way financial industry opening and capital market opening. In particular, it has been the central policy to develop Shanghai into an international financial centre (IFC). For this, initiatives were raised in a plan issued in 2015 by the People's Bank of China (PBOC) jointly with other government departments[9] to speed up the development of the Shanghai IFC. In March 2017, the State Council further issued a plan[10] with financial reform and market opening initiatives in the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ). These include further deepening innovative opening and orderly progress in pilot schemes on capital account opening and internationalisation of financial practices in the zone.

Across the border, Hong Kong has been a well-known IFC[11] with active international investor participation in its capital market which has market practices following international standards.

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7 An explanation was given in BOCOM Bank's announcement dated 12 September 2016. The reasons include the lack of mechanism under Shanghai Connect for A-share shareholders to subscribe newly issues shares in the Hong Kong market.

8 As reported in Oriental Daily News and Hong Kong Economic Times on 18 January 2017.

9 *"Plan on Further Advancing New Financial Market Opening Pilot Schemes in the China (Shanghai) Pilot Free Trade Zone and Speeding Up the Development of the Shanghai International Financial Centre"* (進一步推進中國(上海)自由貿易試驗區金融開放創新試點加快上海國際金融中心建設方案), 30 October 2015.

10 *"Plan for Comprehensive Deepening Reform and Opening of China (Shanghai) Pilot Free Trade Zone"* (全面深化中國(上海)自由貿易試驗區改革開放方案), 31 March 2017.

11 Hong Kong is the top 4th global financial centre according to the ranking by Global Financial Centres Index, March 2017, released by Z/Yen in partnership with the China Development Institute (CDI) in Shenzhen. Shanghai, Beijing and Shenzhen ranked 13th, 16th and 22nd respectively.

With its strengths, the Hong Kong capital market has been supporting the opening and internationalisation of the Mainland capital market through various means including cross-border listing of Chinese enterprises and secondary market trading through Stock Connect. **While internationalisation of the Mainland market is expected to be a long-term process, the Hong Kong market itself also has its weaknesses in the international dimension.** Both sides would need to have some breakthrough in an innovative way, which would be mutually beneficial to each other. The bottlenecks of each market are examined in sub-sections below and the innovative breakthrough is discussed in Section 4.

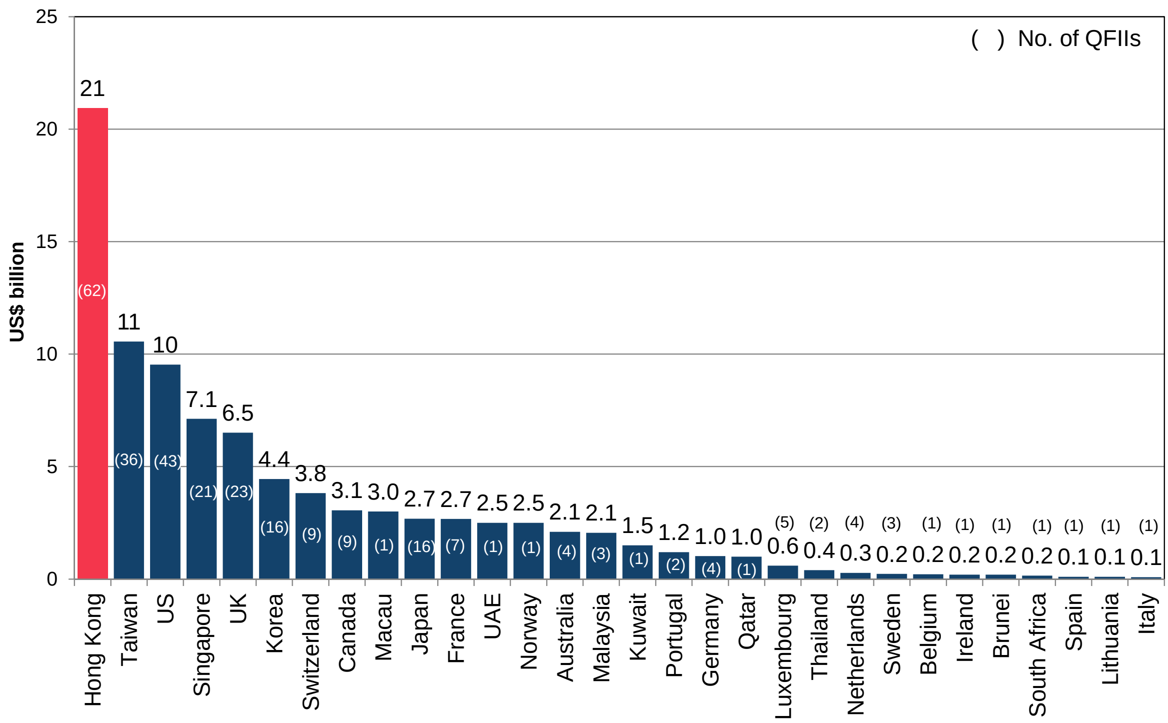
2.1 "Internationalisation" of the Mainland stock market

On the investor side, eligible foreign investors investing in the Mainland stock market before the launch of Stock Connect were confined only to **Qualified Foreign Institutional Investors (QFIIs) and Renminbi Qualified Foreign Institutional Investors (RQFIIs)**. As of 26 April 2017, an aggregate investment quota of US$90,765 million (~RMB 626,638 million) for 281 QFIIs and of RMB 542,004 million for 183 RQFIIs were authorised by the State Administration of Foreign Exchange (SAFE)[12]. Among them, Hong Kong registered institutions got the largest number and quota value — 23% of QFII quota and 49% of RQFII quota (see Figure 3).

However, the total authorised QFII and RQFII quota were less than 3% of the total negotiable market capitalisation of the Shanghai and Shenzhen stock markets[13]. Moreover, not all the QFII and RQFII investment quota would be invested in the stock market.

Figure 3. QFII and RQFII authorised quota by registered location (26 Apr 2017)

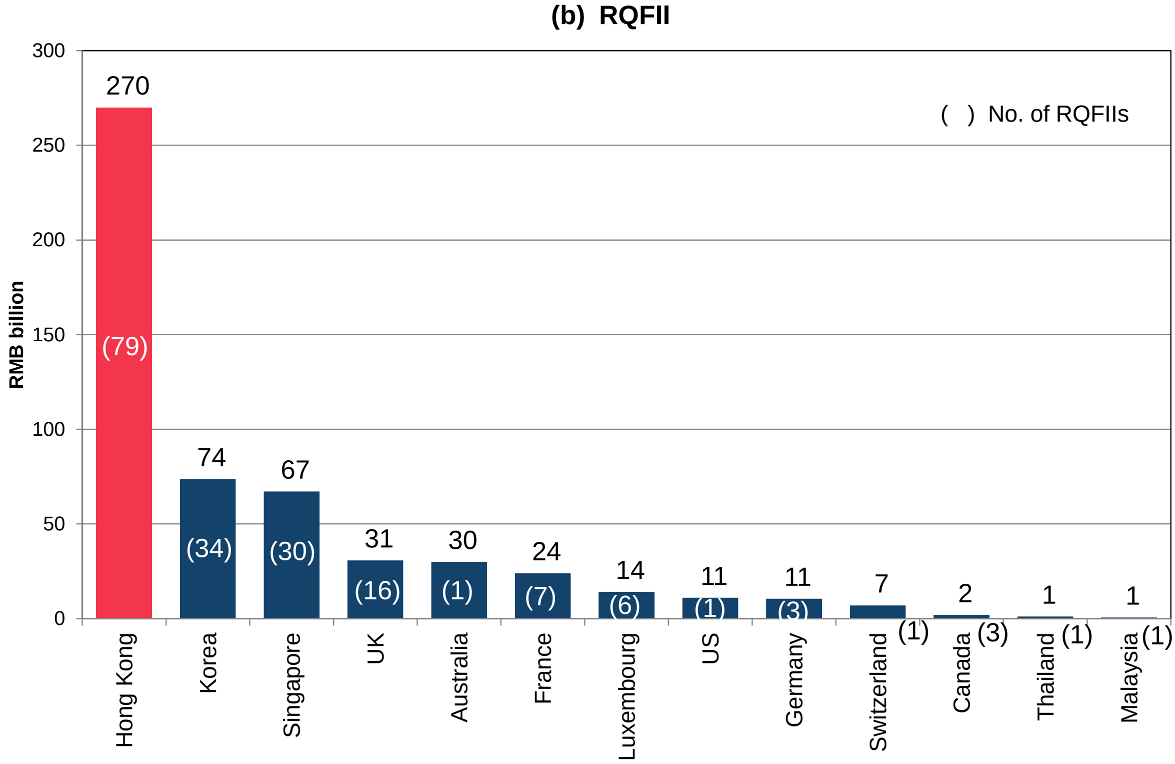
(a) QFII



12 Source: SAFE website.

13 Based on the total authorised quota as of 26 April 2016 compared to the total negotiable market capitalisation of equity securities of RMB41,405 billion on the Mainland exchanges — SSE (RMB 25,410,107 million) and SZSE (RMB 15,995,368 million) — as at the end of March 2017 (source: SSE and SZSE monthly statistics on their respective websites). "Negotiable market capitalisation" is the market value of listed and marketable securities.

Figure 3. QFII and RQFII authorised quota by registered location (26 Apr 2017)



Source: SAFE website.

As at the end of 2016, there were a total of 326 thousand "legal person" investor accounts with the China Securities Depository & Clearing Co., Ltd (CSDC), the central clearing house for the stock markets in Shanghai and Shenzhen. Out of these, there were only 1,088 QFII accounts (543 in Shanghai and 545 in Shenzhen) and 1,078 RQFII accounts (534 in Shanghai and 544 in Shenzhen), i.e. **less than 1% by number of accounts in total**[14].

In terms of market value of shareholdings, the total investment of QFIIs in the Mainland stock market was RMB 114,440 million as at the end of March 2017, **less than 0.3% of the total negotiable market capitalisation on the SSE and SZSE**[15]. Stock Connect has opened another channel for foreign investors to access the Mainland market, yet the participation is still in a small scale — Northbound trading constituted 2% or less of turnover value in Mainland A shares (see Section 1.1 above).

On the issuer side, no foreign companies are yet allowed to list in the Mainland domestic stock market. The initiative of an International Board on the SSE was raised in 2009 by the Shanghai Government[16] and its exploration was supported by the Central Government in its 12th Five-Year Plan for National Economic and Social Development released in 2011. However, little progress has been observed so far.

On the cash product side other than equities, the only foreign products are some ETFs with foreign assets as the underlying. As at the end of 2016, there were 6 cross-border ETFs

14 Source: CSDC Monthly Statistics, December 2016, CSDC website. Note that different QFII and RQFII fund products would have different investor accounts.

15 Source of QFII investment: Southwest Securities research report on QFII 2017Q1 shareholding status, 1 May 2017.

16 The Shanghai Government's *Opinions on the Implementation of the State Council's Policy on Establishing "Dual Centres"* (貫徹國務院關於推進<兩個中心> 建設實施意見), 11 May 2009.

(8%) out of a total of 75 ETFs on the SSE and only two out of 48 ETFs on the SZSE were on foreign underlyings (Hang Seng Index and Nasdaq 100 respectively)[17].

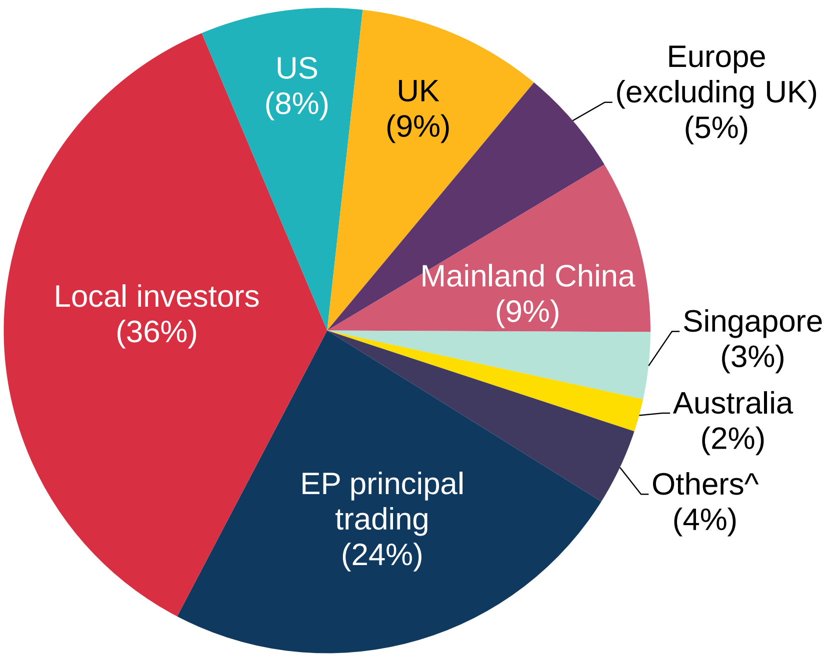
On the market structure side, the Mainland stock market is highly dominated by retail investors. The market practices, rules and regulations are formulated to meet the special needs of the Mainland market in its course of development, which are not necessarily in line with international practices.

In conclusion, **the degree of internationalisation of the Mainland stock market is relatively low in multiple dimensions, including investor base, issuer base and institutional structure.** Increasing foreign participation would be conducive towards Shanghai's goal to be an international financial centre.

2.2 "Internationalisation" of the Hong Kong stock market

In terms of investor participation, the Hong Kong stock market is highly internationalised. Foreign investor trading in the HKEX cash market constituted a bigger proportion than local investor trading (40% and 36% respectively in 2016) (see Figure 4). Origins of foreign investors spread across the world — there were 18 reported origins of overseas investors in Asia and 53 reported origins of overseas investors outside Asia, Europe and the US[18].

Figure 4. Distribution of HKEX cash market trading value by investor origin (2016)



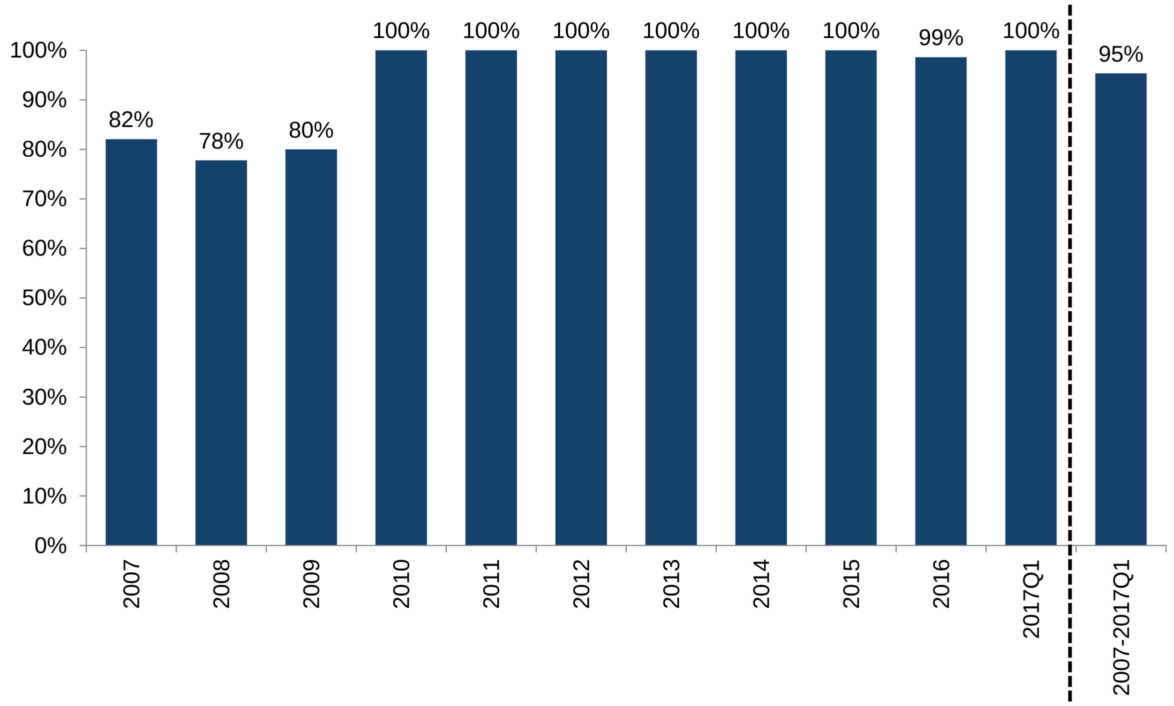
Source: HKEX Cash Market Transaction Survey 2016.
^ Others comprise investors from Japan, Taiwan, Rest of Asia and Rest of the World.
Note: Numbers may not add up to 100% due to rounding.

[17] Source: SSE and SZSE websites.
[18] Source: HKEX Cash Market Transaction Survey 2016.

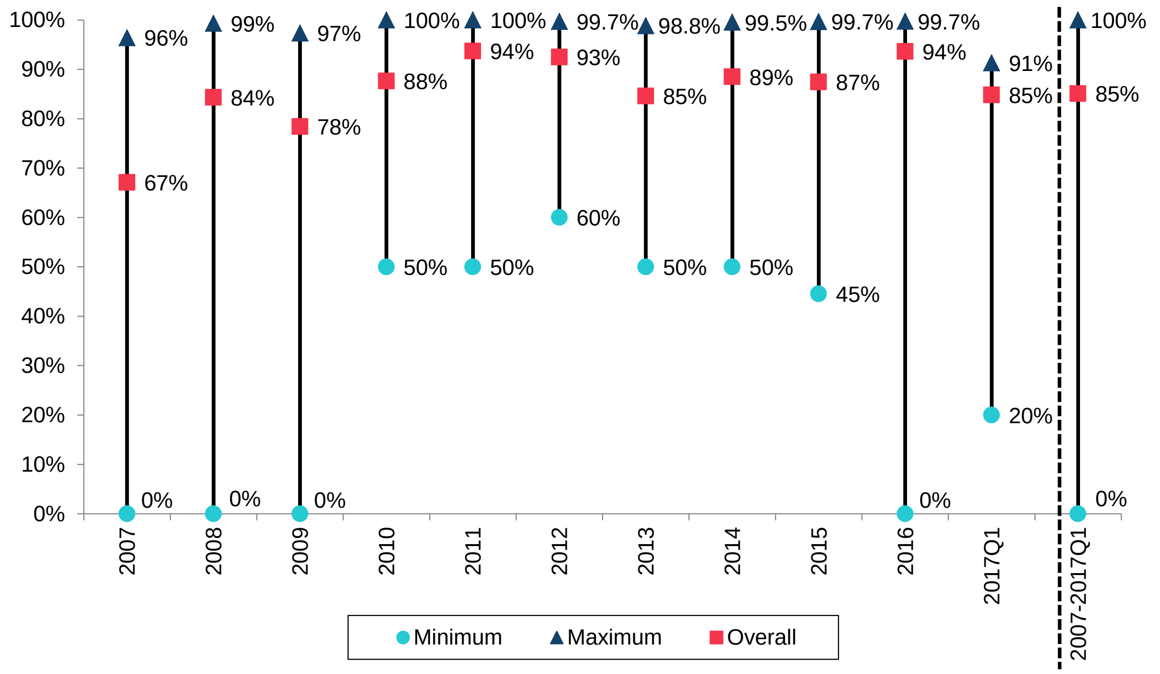
From 2010 to 2017Q1, almost all IPOs in Hong Kong had made international offers to global investors and over 80% of the IPO funds raised came from international offers[19] during the period (see Figure 5). In other words, **global investors are active in both the primary market subscription for IPOs and the secondary market trading in Hong Kong**.

Figure 5. The share of international offers in Hong Kong IPOs (2007 – 2017Q1)

(a) Percentage of IPOs in number with international offers



(b) Percentage of IPO funds raised through international offers



Source: HKEX.

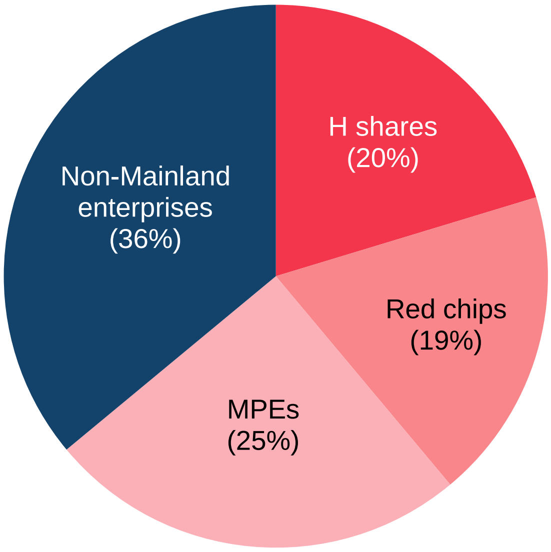
19 Global investors participating in international offers would include Hong Kong investors, investors from Mainland China and other overseas investors; and many institutional investors in Hong Kong have an overseas origin.

In terms of listed issuers, however, the overall HKEX market (Main Board and Growth Enterprise Market (GEM)) comprises, to the majority, Mainland enterprises — H shares, red chips and Mainland private enterprises (MPEs) — by market capitalisation (64% as at the end of June 2017) and turnover value (74% for January to June 2017) (see Figure 6).

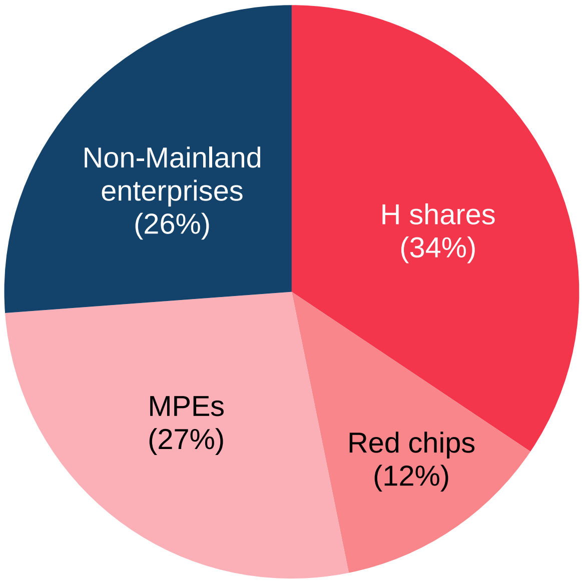
Among the newly listed companies during the past decade (2008 – 2017Q1), only 8% were of origins other than Hong Kong and Mainland China, contributing 20% of total IPO funds raised. The largest share went to MPEs in terms of number (47%) and H-share companies in terms of IPO funds raised (48%) (see Figure 7). In other words, **the Hong Kong primary market serves predominantly Hong Kong and Mainland companies and has not delivered its full potential to serve international companies**.

Figure 6. Composition of listed companies on SEHK Main Board by classification

(a) In terms of market capitalisation (End-Jun 2017)



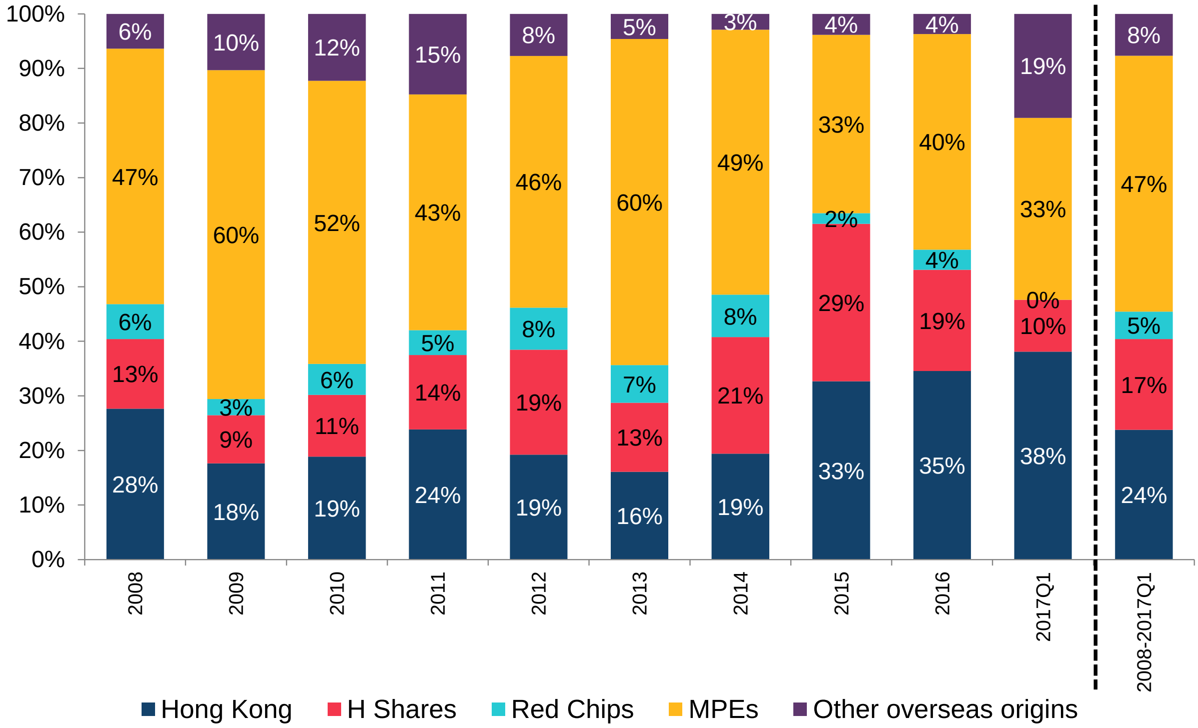
(b) In terms of turnover value (Jan-Jun 2017)



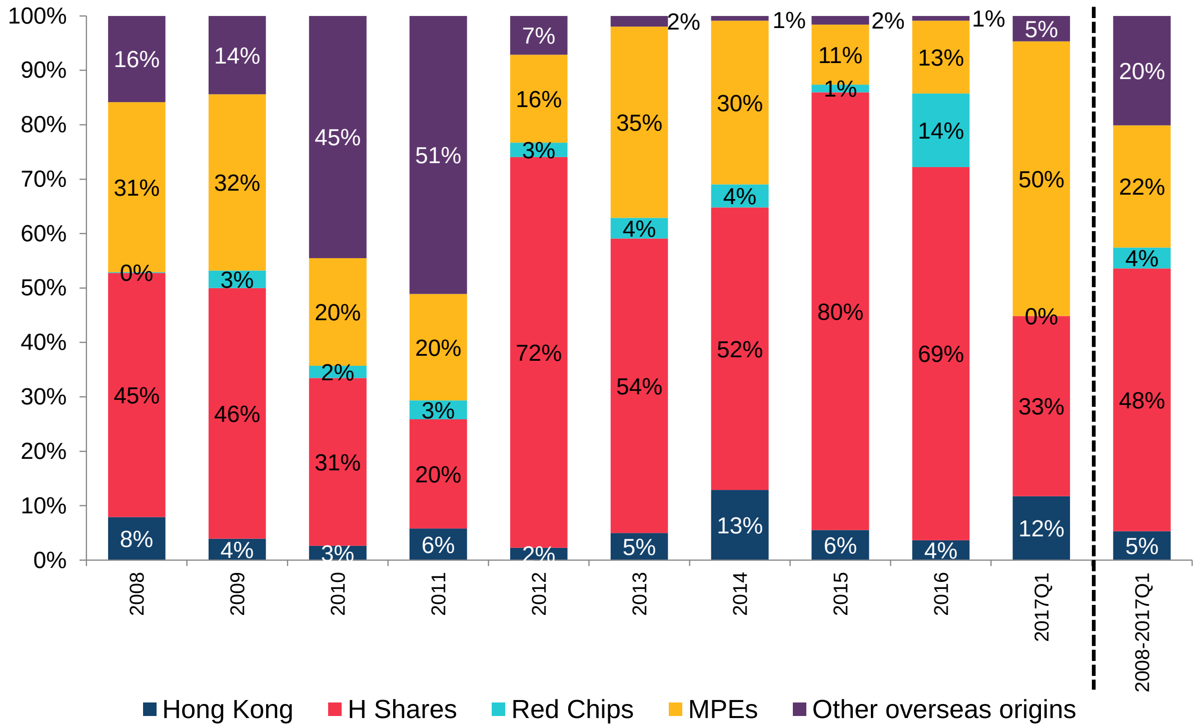
Source: HKEX.

Figure 7. Composition of newly listed companies on SEHK Main Board by classification (2008 – 2017Q1)

(a) In terms of number of companies



(b) In terms of IPO funds raised



Source: HKEX.

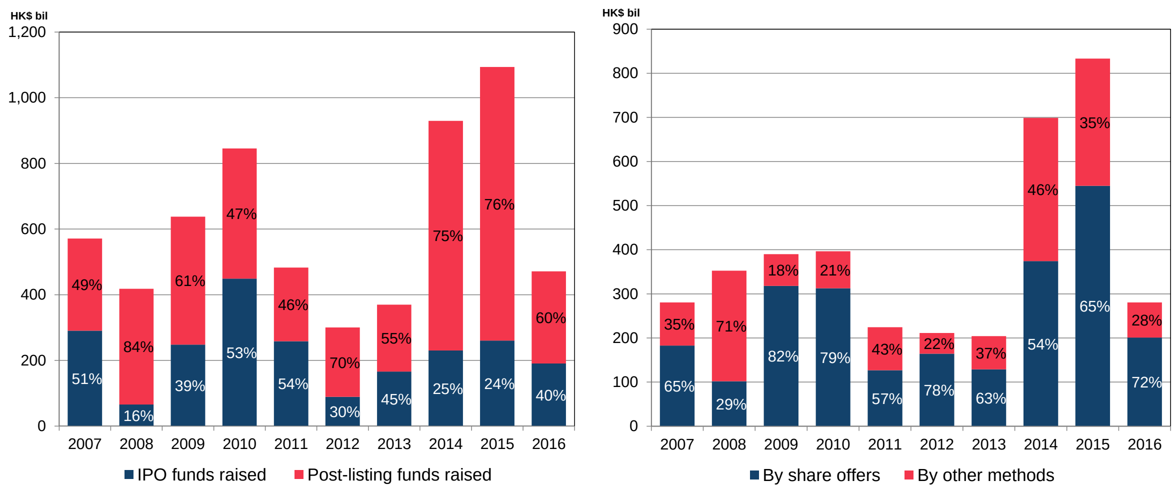
In conclusion, **the Hong Kong stock market is highly internationalised in terms of investor participation but with a relatively low degree of internationalisation in terms of listed issuers.**

2.3 "Internationalisation" of the Mainland-Hong Kong Mutual Market

The concept of the Mainland-Hong Kong Mutual Market is to open up to international and Mainland investors the access to a sizable market with combined Mainland and international elements through a specially design connectivity model. In respect of the equity market segment, the current connectivity of Stock Connect that is limited to secondary market trading only would undermine the potential benefits of the Mutual Market to participants, both issuers and investors. The major function of a stock market is fund raising by issuers. Towards this end, share offers at times of new listing are fundamental as these provide on the one hand the necessary funding for private enterprises to grow and on the other hand the diverse investment opportunities for investors. In the case of the SEHK Main Board, IPO funds raised constituted as high as 54% of total equity funds raised in 2011 and a significant share of 40% in the recent year of 2016; and share offers were the key post-listing fund raising method in the past decade (see Figure 8).

Figure 8. Equity funds raised on SEHK Main Board and percentage share of funds raised by IPO and post-listing issues and share offers (2007 – 2016)

(a) IPO and post-listing funds raised **(b) Post-listing funds raised by method**



Note: IPO fund raising methods comprise offer for subscription, offer for sale and offer for placing. For post-listing equity funds raised, share offer methods comprise placing, rights issue and open offer; other methods comprise consideration issue, warrant exercise and share option scheme.

Source: HKEX.

The internationalisation of the Mainland-Hong Kong mutual stock market would mean the market's possession of an international investor base and an international issuer base. The Hong Kong stock market, possesses an international investor base, but is weak in terms of an international issuer base. The Mainland stock market has yet to see considerable progress in both ends. With secondary market connectivity, a step forward has been made towards internationalisation of the Mutual Market. However, as discussed above, the mutual market connectivity is not complete in the absence of primary market connectivity and this would undermine the efforts towards internationalisation.

3. CHINA'S BIGGER ROADMAP: NATIONAL ACCOUNT, MARKET OPENING AND RMB INTERNATIONALISATION

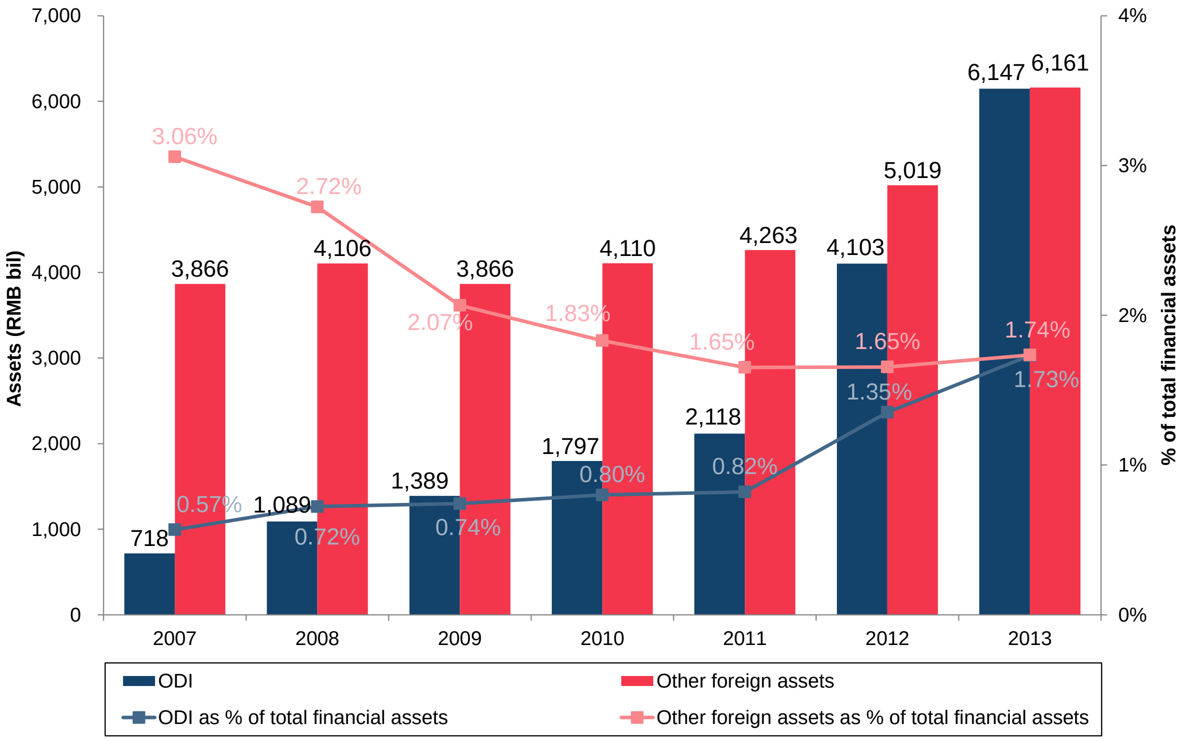
Internationalisation of the Mainland-Hong Kong Mutual Market is not a goal in itself but part of the bigger strategy for China to achieve a better balanced economy, more effective market opening and ultimately a higher degree of RMB internationalisation.

3.1 Possible improvement in the national balance sheet

China's national balance sheet[20] shows that on the assets side the nation had a growing amount of outward direct investment (ODI) and other foreign assets (excluding international reserves) during 2007 to 2013 — ODI grew from RMB 718 billion to RMB 6,147 billion; and the latter grew from RMB 3,866 billion to RMB 6,161 billion. As a percentage of total financial assets, ODI had an increasing share which rose to 1.7% in 2013 while other foreign assets had a similar share but on a decreasing trend. Comparatively, international reserves constituted a more significant percentage share of financial assets (7.5%) in the national balance sheet in 2013. The amount of international reserves maintained at a relatively high level of US$3,010.5 billion in 2016, despite a drop from the recent high of US$3,843.0 billion 2014[21]. On the liabilities side of the balance sheet, foreign direct investment (FDI) and other foreign liabilities also had an increasing amount during 2007 to 2013, while both maintained a steady percentage share of total liabilities of about 4% and 1.5% respectively in recent years (see Figure 9).

Figure 9. China's outward/foreign direct investment and other foreign assets/liabilities (2007 – 2013)

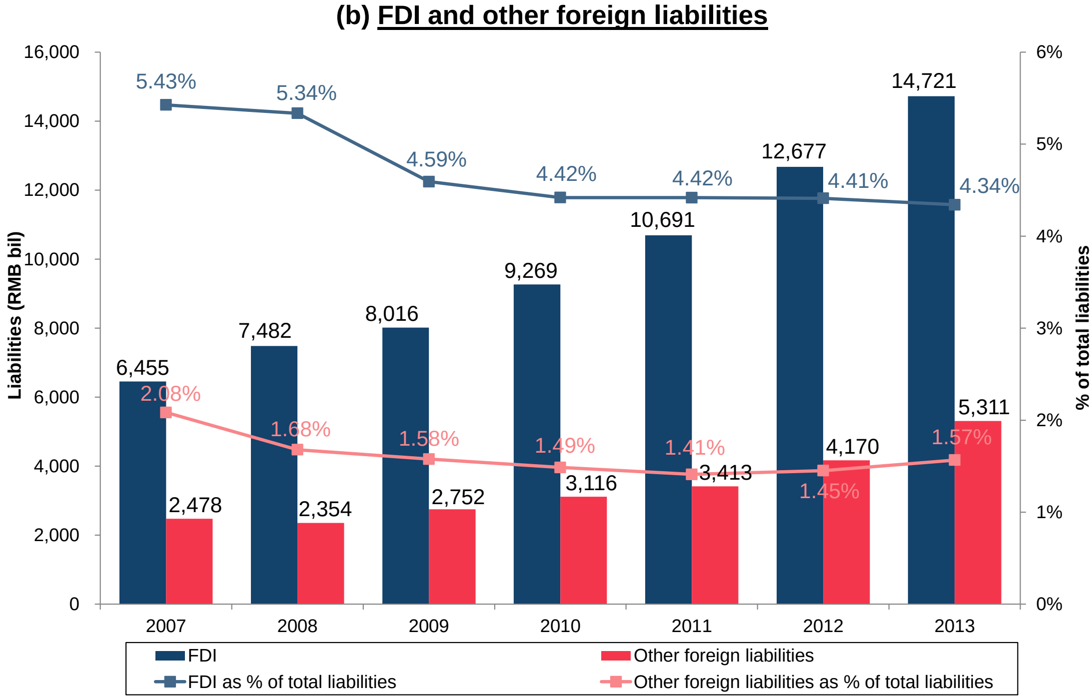
(a) ODI and other foreign assets



20 Source: Wind (primary source: China Academy of Social Sciences).

21 Source: National Bureau of Statistics of the PRC.

Figure 9. China's outward/foreign direct investment and other foreign assets/liabilities (2007 – 2013)

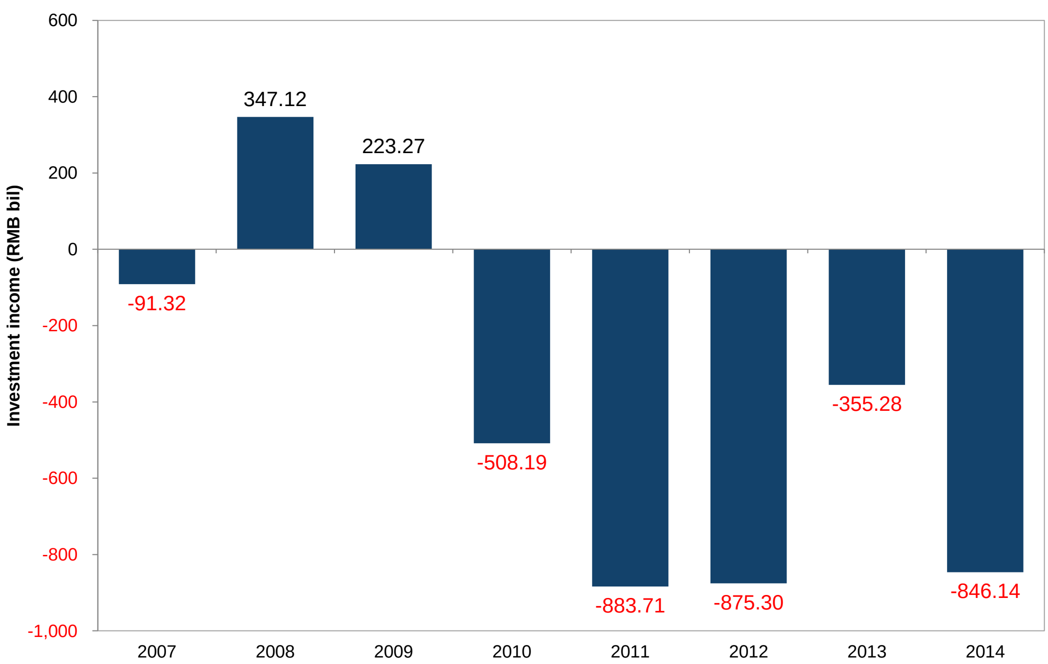


Source: Wind.

Note: All foreign liabilities are financial liabilities.

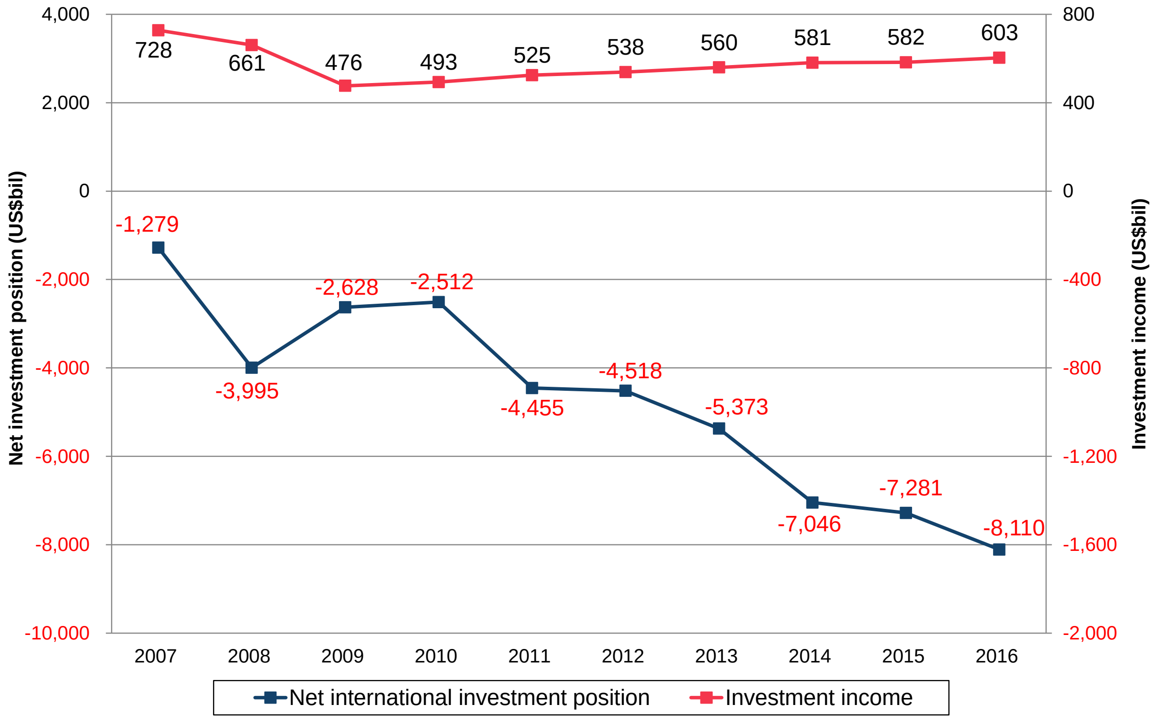
Despite growing foreign investment, current account statistics showed that China achieved negative investment income from 2010 to 2014 (see Figure 10). This is in contrast to the achievement of the US national accounts. Figure 11 shows clearly that the US achieved an increasing negative net international investment position and an increasing trend in positive investment income during the past decade from 2007 to 2016. The majority proportion of the US investment income came from portfolio investment (see Figure 12).

Figure 10. China's investment income under current account (2007 – 2014)



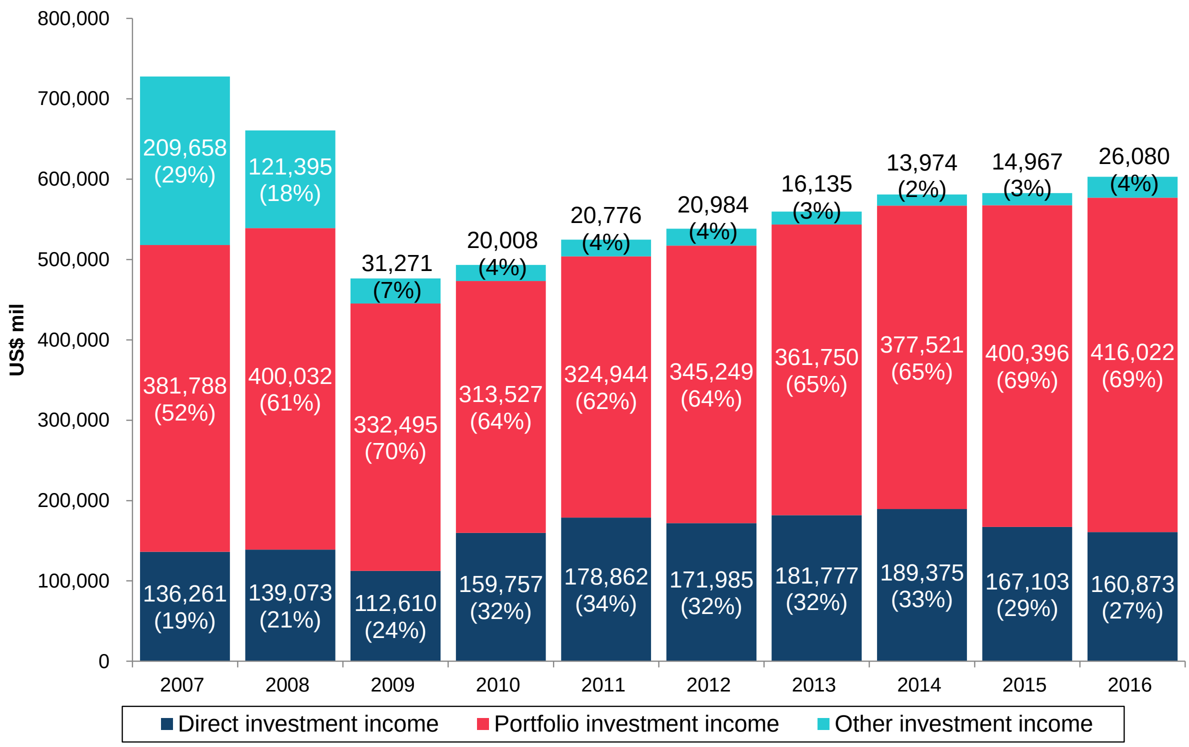
Source: Wind.

Figure 11. US net international investment position and investment income (2007 – 2016)



Source: US Bureau of Economic Analysis (BEA).

Figure 12. Composition of US investment income (2007 – 2016)



Source: US Bureau of Economic Analysis (BEA).

In fact, the US has maintained a positive net income balance for over two decades since the 1990s, while its net international investment position has been deteriorating. This aroused academic interest in solving this longstanding puzzle that the US is a net borrower from the rest of the world and yet manages to receive net income on its external position. Two major factors were identified: (1) the US has a positive net external equity balance and a negative net external debt balance, and the income yield on equity has been higher than the income yield on debt; and (2) the US earns a persistently higher income yield on its FDI assets than foreigners earn on their direct investments in the US[22]. Nobel Laureate, Paul Krugman, commented that "American assets, often taking the form of foreign subsidiaries of US corporations, earn a higher rate of return than US liabilities … when there is a lot of foreign money parked in (US) Treasuries … As a result, income from US-owned assets abroad consistently exceeds payments on foreign-owned assets in the US"[23]. A study found that the differential income earned from US-owned foreign assets relative to income paid to foreign-owned US assets could be attributed to, among other less significant factors, the differential tax treatment (US tax rate is generally higher than that of countries where the US owns foreign assets), and the higher risk in the foreign invested countries (generating higher risk-adjusted returns than foreign-owned US assets)[24]. The same study also found that for portfolio equity and debt, the average yields on claims and liabilities were nearly identical (for the period 1990 to 2010).

The US case is insightful to China, which looks like a mirror image of the US — negative net investment income on positive net foreign assets. China has large international reserves which are mostly invested in US treasuries[25], of which the yield is low. On the other hand, China pays relatively high costs in attracting FDI with its preferential policies, while its ODI has been facing a certain degree of opposition and regulatory obstacles in the target countries. Moreover, China's ODI in developed countries like the US and Europe would have lower risk-adjusted returns than FDI in a developing country like China. **The US case demonstrates a way to improve China's national balance sheet, which is to increase its net international investment income by liberalising outward portfolio investment. Towards this end, developing the Mainland-Hong Kong mutual market platform with a high degree of internationalisation would be a promising approach** (see Section 4 below).

3.2 Further financial market opening

As discussed in Section 2 above, further financial market opening is a major policy line in the 13th Five-Year Plan and much policy support has been put in for developing Shanghai into an IFC. Back in 2009, the idea of establishing an international board on the SSE was raised with government policy support, allowing foreign companies to list on the domestic exchange. This policy initiative and the policies supporting ODI are manifestations of China's economic development policy advancement — moving from *firstly* letting Chinese enterprises go out for fund raising (and foreign capital going in) (since the 1990s) to *secondly* letting domestic capital go out through ODI and portfolio investment channels like Qualified Domestic Institutional Investor (QDII) scheme (since 2006) and Stock Connect (since 2014), and *furthermore* to **the future possible fund raising by foreign enterprises in the domestic market.**

[22] Alexandra Heath, "*What explains the US net income balance?*", Bank for International Settlements, BIS Working Paper No. 223, January 2007.

[23] Source: *"US Net Investment Income"*, 31 December 2011, The Opinion Pages — The Conscience of a Liberal, Paul Krugman, The New York Times (https://krugman.blogs.nytimes.com).

[24] Stephanie E. Curcuru and Charles P. Thomas, "*The return on US direct investment at home and abroad*", Board of Governors of the Federal Reserve System, International Finance Discussion Paper No. 1057, October 2012.

[25] The composition of China's foreign exchange reserves is not officially disclosed. Some sources give the estimates of about 70% in US dollar assets based on China's economic data. (Source: Wikipedia; "揭秘：中國 3 萬億美元外匯儲備是如何配置", http://finance.sina.com.cn/).

The vision of market opening is expected to be two-way (i.e. both inward and outward) comprehensive financial market opening — allowing foreign capital to invest in Mainland China's domestic financial products and allowing domestic capital to invest in foreign financial products. Given the current differences between the Mainland financial market system and practices and those of the international developed markets as well as the Mainland authorities' concern of domestic financial stability, the path from the current limited opening to a comprehensive degree of market opening is not short and easy. The Mainland-Hong Kong Mutual Market platform, being a closed-loop system with a gradual approach in scope expansion, would facilitate this lengthy market opening process (see Section 4 below).

3.3 Towards full capital account convertibility

An orderly realisation of RMB capital account convertibility is a state objective written in the 13th Five-Year Plan and financial market opening is the key towards this objective. An analysis revealed that out of the 40 sub-items of the capital account as classified by the International Monetary Fund (IMF), there are only a few sub-items which remain unconvertible in China [26]. These outstanding sub-items relate mainly to the issuance of equity securities, money market instruments, derivatives and other instruments by non-residents. To help RMB become a convertible and freely usable currency, as stated in the PBOC's 2015 Annual Report, more financial market opening initiatives would include:

- Further liberalisation and facilitation of (1) investment in overseas financial markets by domestic residents and (2) investment in the Mainland financial market by foreign investors; and
- **Allowing qualified foreign companies to issue shares in the domestic market.**

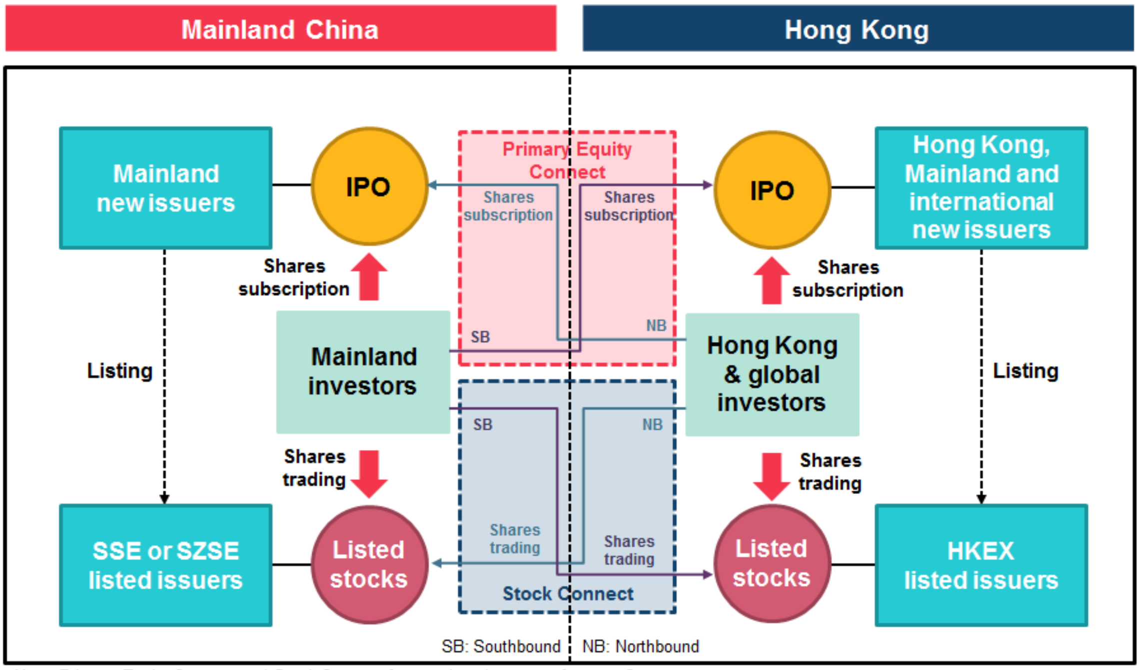
Towards this end, **the Mainland-Hong Kong mutual market platform with connectivity in the primary market would help move one more step towards RMB capital account convertibility** (see Section 4 below).

4. PRIMARY EQUITY CONNECT — A BREAKTHROUGH OPPORTUNITY

Given the development bottleneck for internationalisation of the Mainland and Hong Kong stock markets, the mutual market connectivity model covering both the primary IPO market (Primary Equity Connect) and the secondary stock trading market (Stock Connect) would offer a possible solution. Figure 13 below shows a conceptual model.

[26] The other items are either convertible or basically convertible or partially convertible. Source: "人民幣資本項目開放的現狀評估及趨勢展望", 4 April 2016, 第一財經 (http://www.yicai.com/).

Figure 13. Conceptual model of Mainland-Hong Kong mutual market connectivity in both the primary and secondary markets



Note: Primary Equity Connect and Stock Connect form a closed system of money flow.

The concept of **Primary Equity Connect (PEC)** is to allow Mainland investors to subscribe for IPOs in the Hong Kong market (Southbound) and global investors in Hong Kong to subscribe for IPOs in the Mainland market (Northbound). Upon listing of the IPO shares issued, trading by investors from the other market would be enabled through the existing Stock Connect scheme. Under this connectivity model, **shares subscription under PEC and shares trading under Stock Connect are effectively contained within a closed-loop system**.

Compared to the QFII and RQFII schemes, foreign investors accessing the Mainland stock market through Stock Connect need not apply for special licences or investment quotas from the Mainland authorities, or open accounts with Mainland brokers or custodians. They adopt their familiar trading practices in trading Mainland stocks through Stock Connect as they do for trading in the Hong Kong stock market. Similarly, Mainland investors adopt their familiar Mainland trading practices in accessing the Hong Kong market through Stock Connect. Moreover, Stock Connect enables Mainland retail investors to directly invest in the Hong Kong market without the need to go through products of QDIIs. A seamless link of PEC for primary market shares subscription with Stock Connect for secondary market trading would be particularly beneficial to investors, owing to such trading efficiency and convenience provided by Stock Connect.

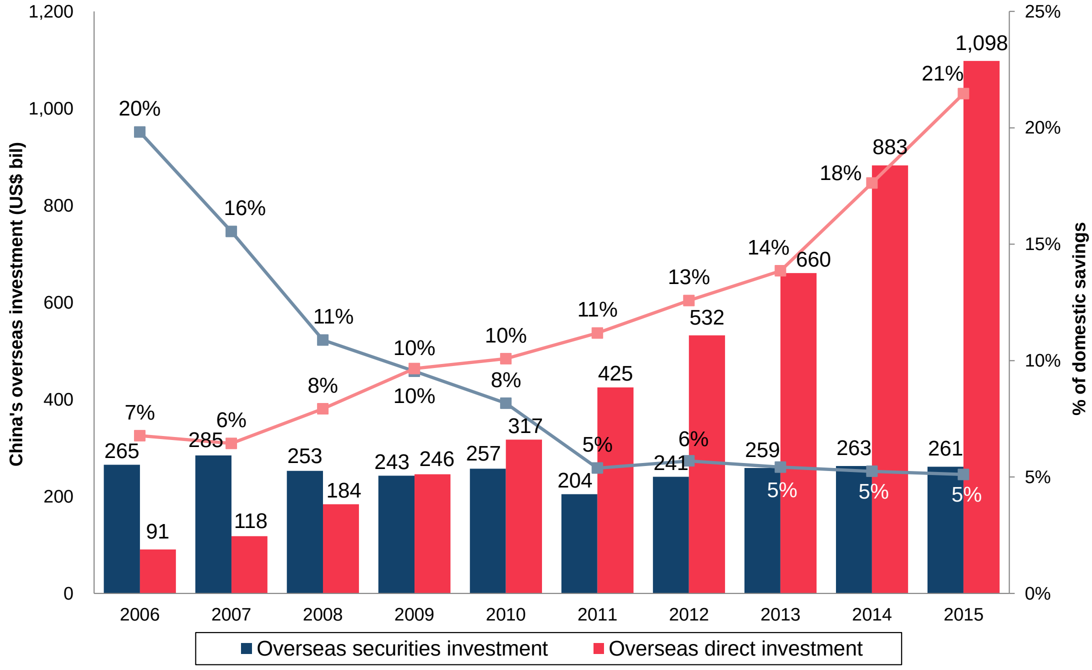
PEC would help enhance the international dimension of the Mainland market by improving international investor participation and the international dimension of the Hong Kong market by broadening the international issuer base. In addition, PEC would open up more investment opportunities to Mainland investors which the Mainland domestic market may not be able to offer in the short term. More importantly, as discussed in Section 3, the Mainland-Hong Kong Mutual Market model could support China's bigger roadmap to achieve a better national balance sheet, further two-way market opening and RMB internationalisation. The expansion of the scope of Mutual Market connectivity to the primary equity market would be a breakthrough. Potential benefits of PEC are discussed below.

Potential benefits of PEC to the Mainland market and investors

(1) New opportunities for global asset allocation and therefore an improved national balance sheet

During the ten years from 2006 to 2015, domestic savings had increased by a compound annual growth rate (CAGR) of 14% to about RMB 33,708 billion (~US$5,115 billion)[27]. In the same period, overseas direct investment (ODI) had achieved a CAGR of 32%, while overseas securities investment had a negative CAGR of -0.2% despite the launch of the QDII scheme in 2006[28]. Since 2011, the ratio of overseas securities investment to total domestic savings had maintained at a relatively low level of about 5% while ODI had shot up to about 21% at the end of 2015 (see Figure 14).

Figure 14. Mainland China's overseas direct investment and securities investment (2006 – 2015)



Source: Wind.

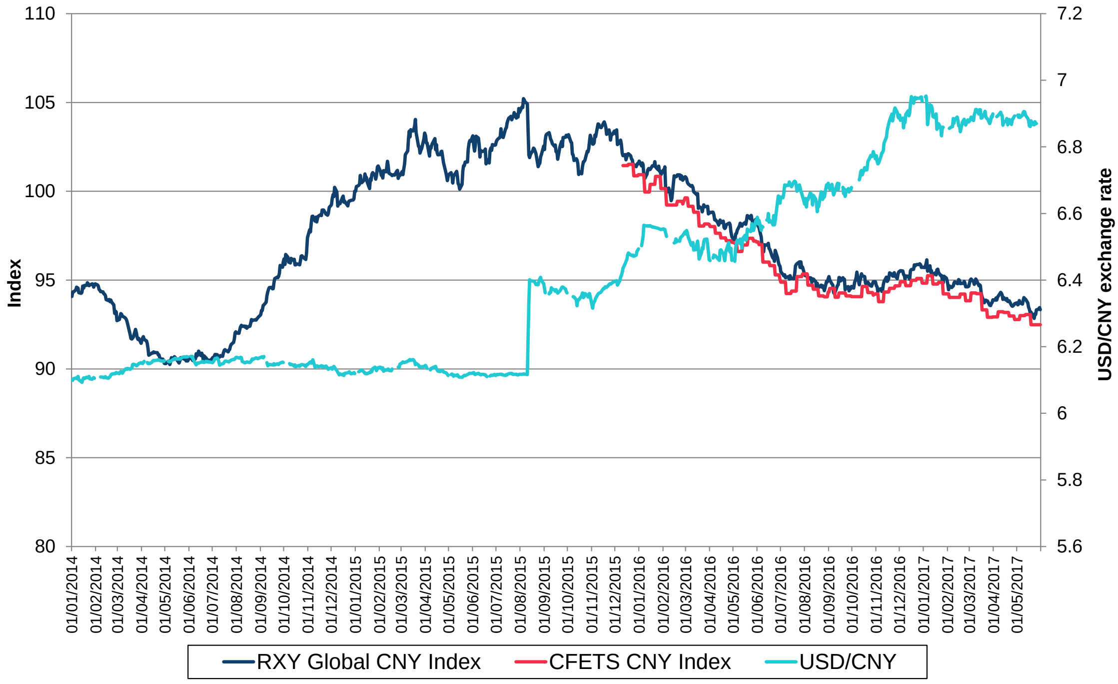
In addition, the RMB has suffered a depreciation trend since August 2015[29] (see Figure 15) and there has been fear that this may continue for a period of time. Mainland investors, including investment arms of government authorities and enterprises, are eager to seek non-RMB assets for portfolio diversification and hedging against further drop in the value of the RMB.

[27] Source: Wind.

[28] CAGR figures were calculated based on annual data obtained from Wind.

[29] This was triggered by the reform of the RMB to USD exchange rate formation mechanism by the PBOC on 11 August 2015 to make it more market-driven.

Figure 15. Daily closings of RMB indices and USD/CNY exchange rate (2014 – May 2017)



Note: RXY Global CNY Index is an index launched by HKEX in partnership with Thomson Reuters that measures the performance of the onshore RMB (CNY) against a basket of major international currencies. CFETS CNY Index is the official index on CNY against a basket of major international currencies published by the China Foreign Exchange Trade System (CFETS).

Source: Thomson Reuters

Relative to the high level of domestic savings, domestic supply of investment products in the Mainland has been inadequate to meet investment demand of Mainland residents for asset value preservation and appreciation. This leads to the situation of asset shortages in Mainland China since 1990 as documented by an academic study, and the consequential phenomenon of asset bubbles, exemplified by price surge in the property market, stock market and even consumer goods [30]. The study explains that asset shortage is measured by the excess in percentage of domestic savings (i.e. the asset demand) relative to the asset supply which is constituted by domestic bonds, shares, loans, change in short-term deposits and net purchase of foreign assets. As a point of reference, the total funds raised by equity issues on the SSE and the SZSE in 2015 was about RMB 1,540 billion[31], which was less than 5% of the domestic savings as at the end of 2015 — similar to the 5% level for total overseas securities investment in 2015 (see Figure 14).

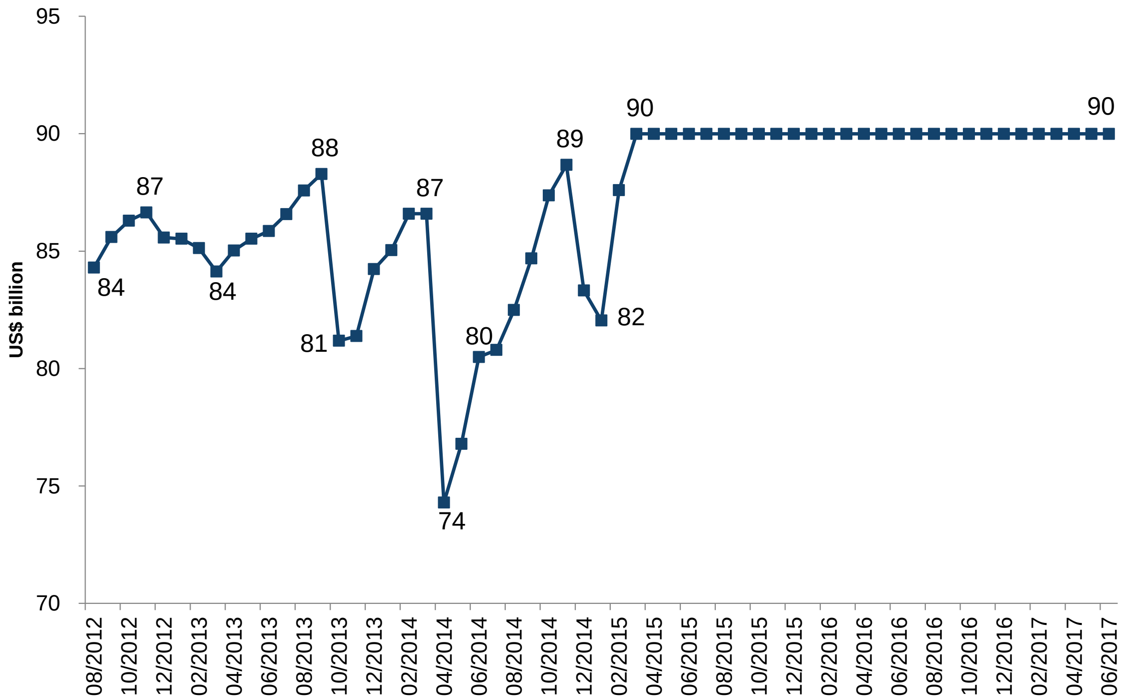
30 YANG Shenggang and LIANG Can, *Asset Shortages in China* (中國資產短缺問題研究), 2015 (http://www.sinoss.net).

31 In 2015, total funds raised by share issuance on the SSE was RMB 871,082 million and that on the SZSE (including Main Board, SME Board and ChiNext) was RMB 668,902 million (source: SSE and SZSE monthly statistics on their respective websites). Domestic savings were RMB 33,708 billion as at the end of 2015 (source: Wind).

Global asset allocation has therefore become an imminent need of Mainland investors. Moreover, there is a need for more income from overseas investments to improve China's national balance sheet. While the One-Belt-One-Road (OBOR) strategy would promote income from ODI by investing in the developing countries[32], increasing overseas portfolio investment could offer potentially significant income.

Currently, apart from Southbound trading under Stock Connect, the QDII scheme is the only legitimate channel for overseas securities investment. However, this is subject to quota limit and approval. As a matter of fact, there has been no increase in QDII investment quota since March 2015, which remained at US$89,993 million by June 2017 (see Figure 16). This was less than 2% of the domestic savings as of end-2015.

Figure 16. Month-end approved investment quota of QDII (Aug 2012 – Jun 2017)



Source: SAFE website.

Besides QDII, there is known to be a "green channel" offered by SAFE under which special authorisation is obtained from SAFE for certain domestic investors (mainly Mainland cornerstone investors) to subscribe for IPO shares offered by Mainland enterprises to be listed in Hong Kong. This practice started from the IPO of the Postal Savings Bank of China Co., Ltd and has been applied to IPOs of several Mainland enterprises since then. However, this is a special practice under special authorisation applied to special enterprises and is subject to special requirements imposed by SAFE[33].

32 OBOR consists of the Silk Road Economic Belt (SREB) and 21st Century Maritime Silk Road (MSR) initiatives. The SREB runs through Central Asia, West Asia, the Middle East to Europe, with extension to South Asia and Southeast Asia. The MSR runs through Southeast Asia, Oceania and North Africa. The report, *"Industrial cooperation between countries along the Belt and Road"* (「一帶一路」沿線國家產業合作報告), released by the China International Trade Institute in August 2015 identified 65 countries along OBOR that will be participating in the initiative.

33 As informed by market participants, under "green channel" permission, SAFE requires remittance back to the Mainland of the funds raised by the issuer from the IPO and part, if not all, of the proceeds received by the investors upon sale of the subscribed shares. This is considered to be a harsh "double-remittance" requirement.

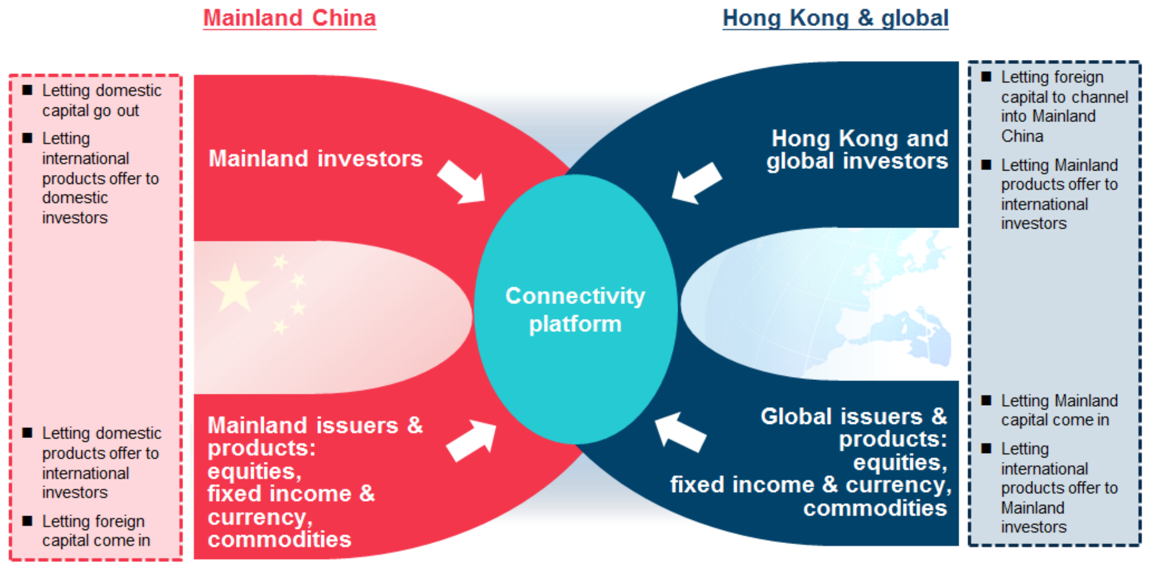
Southbound PEC would open up one more official global asset allocation channel for Mainland investors, possibly in a wider scale than existing channels, by enabling them to subscribe new shares of international companies to be listed in Hong Kong. This would enhance the overseas portfolio investment of Mainland capital to a larger degree than the current only way of secondary market connectivity.

(2) Facilitating two-way market opening

In an attempt to open up the Mainland domestic market for fund raising by international companies, the success factors would lie in the attractiveness of the Mainland market to potential issuers on the considerations of funding needs and the cost of capital. Some big international companies seeking business expansion in China may be interested due to the branding effect offered by a domestic listing status. Nevertheless, there may not be many of these companies to provide a continuous supply of issuers. As the regulatory framework of the Mainland stock market is very different from that of international developed markets, potentially high compliance costs may deter the majority of potential foreign issuers to list in China, even if an international board is available in the domestic market.

In comparison, with PEC under the Mainland-Hong Kong Mutual Market model, foreign issuers would abide by the more familiar, internationalised rules and standards of the Hong Kong stock market for share offerings to the Mainland investors. As illustrated in Figure 17 below, the connectivity platform of the Mutual Market[34] enables Mainland domestic capital and financial products to go out and international capital and financial products to go into China, without the need for investors and issuers on either side of the Mutual Market to adapt to practices on the other side.

Figure 17. The connectivity platform of the Mainland-Hong Kong mutual market



[34] Certain initiatives in developing the platform are subject to regulatory approvals.

(3) One more step in RMB capital account convertibility

Southbound PEC under the Mutual Market would effectively implement RMB convertibility in one more item under the capital account, i.e. the offering of shares or equity-type securities by non-residents to the Mainland domestic investors. In the future, other suitable connectivity initiatives (e.g. the offering of financial derivatives) could be introduced under the Mutual Market model for achieving RMB convertibility under the remaining capital account items.

Although in the long run China could achieve comprehensive RMB convertibility under the capital account by some other means, PEC and other connectivity initiatives under the Mutual Market model could help speed up the process in a controlled manner (see point (7) below).

(4) Development of international investor base

As noted in Section 2.1 above, foreign holding in the Mainland stock market was less than 0.3% of the total negotiable market capitalisation on the SSE and SZSE, compared to 40% of foreign investor trading in the Hong Kong stock market. **Northbound PEC would provide more opportunities to the Mainland for developing the international investor base in the domestic market**, which is vital to achieving its stock market internationalisation.

IPOs with share offerings through Northbound PEC would be open to all international investors. Compared to domestic IPOs that are open only to qualified foreign investors (QFIIs and RQFIIs), IPOs under Northbound PEC are expected to involve more international marketing efforts from the issuers and the securities industry (both Mainland and international). International investors would be provided with intensive issuer information for their better understanding of the investment value, possibly in a more comprehensive way than domestic offers that focus on domestic investors. Moreover, relatively large holdings by foreign investors in Mainland shares could be achieved in the primary market through PEC without the share price impact as it would have for buying large block of shares in the secondary market.

(5) More listing opportunities to Mainland enterprises

The relatively fast economic development in Mainland China has resulted in increasing domestic savings on the one hand and increasing funding needs of existing and new enterprises for growth and expansion on the other hand. This appears to be a perfect match. However, the current pace of IPOs in the Mainland stock market may not be able to satisfy the long queue of enterprise applications on a timely basis. As reported by Bloomberg[35], as of September 2016 there were over 830 IPO applicants waiting for the approval of the CSRC for listing on the SSE or the SZSE. The CSRC had put in efforts to shorten the queue[36], which was reduced to about 700 by February 2017. However, the typical waiting time was still 18 months or longer[37]. Local media reports indicated that there were more than 700 companies still waiting for approval at the provincial level before they could join the IPO queue[38]. Official exchange statistics show that the SSE and the SZSE recorded a total number of new listings of 103 and 124 respectively in 2016

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[35] *"Few in China's IPO queue likely to benefit from fast-track reform"*, Bloomberg, 12 September 2016.

[36] In September 2016, the CSRC allowed companies registered in any one of 592 impoverished regions nationwide to jump the queue but the objective appeared to be wealth redistribution rather than easing the IPO bottleneck (Bloomberg, 12 September 2016); and in February 2017 the CSRC was reported to be considering offering a shortcut for some of the country's largest technology companies to jump the queue.

[37] *"China to let big tech firms jump IPO queue"*, The Straits Times, 25 February 2017.

[38] *"Few in China's IPO queue likely to benefit from fast-track reform"*, Bloomberg, 12 September 2016.

and 103 and 108 respectively in 2017 up to May. Based on the increased speed of IPO processing in 2017 (about 500 per year), the existing queue, including the provincial waiting queue, could be processed in 3 years' time. However, this number does not take into account the continuous new entrants to the queue as the Chinese economy develops, not to say there could be policy suspension of IPOs at times of bearish markets (as in past experiences).

An IPO listing in Hong Kong would be an alternative to the Mainland enterprises waiting in the Mainland IPO queue. Currently, a Hong Kong listing would enable the enterprises to build an investor base mainly of Hong Kong and global investors, with Mainland investors to a much lesser extent. With Southbound PEC in place, Mainland enterprises listed in Hong Kong would also be able to offer shares to Mainland investors. In this way, an IPO listing in Hong Kong would become a practical alternative to Mainland enterprises targeting a Mainland investor base, while opening up the opportunity to reach out to global investors. **PEC thus would help relieve the IPO constraints in the Mainland at the current stage of domestic market development**.

(6) Nurturing the Mainland investor base

The international regulatory framework and market practices in Hong Kong make the Hong Kong market a valuable training ground for Mainland investors. The QDII scheme launched in 2006 has benefited the Mainland institutional investors and indirectly the Mainland retail investors through QDII products. Stock Connect launched in November 2014 further opens up the training ground directly to Mainland retail investors in respect of secondary market trading. In respect of IPO subscription in the primary market, the Mainland market practice is much different from international practice. Partly due to supply-demand imbalance, Mainland investors may have been used to price surge of IPOs at listing in the Mainland. **Southbound PEC would offer opportunities to Mainland investors in gaining international experience of IPO shares subscription and price movements (both upside and downside are possible) upon listing, thereby help nurture the Mainland investor base towards maturity**.

(7) Risks of capital outflow within control

Same as the model design of Stock Connect in the secondary market, money flows involved in PEC would be done in a closed-loop system such that on sale of the subscribed shares (presumably through Stock Connect), the money would flow back to the buying investors in the origin market. This would alleviate the concern of capital outflow from the Mainland market.

<u>Potential benefits of PEC to the Hong Kong market and global investors</u>

(1) Attracting the listing of international companies

Southbound PEC would open up the funding pool from Mainland investors and this would attract potential global issuers to list in Hong Kong. Given the sheer size of Mainland domestic savings and business opportunities in China, a listing in Hong Kong under Southbound PEC is believed to be attractive to international companies in consideration of sizable IPOs and companies with business development strategies in China. Moreover, with Mainland investors as potential subscribers, international companies would have greater confidence in a successful IPO in Hong Kong.

(2) Activating the market by increasing investor participation

To complete the shares offering and trading cycle in the Mutual Market, PEC in the primary market is expected to be operationally linked with Stock Connect in the secondary market so that shares subscribed under PEC by investors on either market could be traded through Stock Connect. The Hong Kong market fuelled by PEC would be further activated by expectedly increased international listings and the enlarged liquidity pool with Mainland investor participation. Increased market liquidity in both the primary market and the secondary market would be welcomed by global investors.

(3) Benefiting market intermediaries with vibrant primary and secondary market activities

The increased primary and secondary market activities would provide more business opportunities to market intermediaries in Hong Kong including investment banks, law firms, accounting and auditing firms, and securities brokers.

Potential benefits of PEC to the Mainland-Hong Kong Mutual Market

The implementation of PEC would help fulfil the Mainland-Hong Kong Mutual Market ecosystem in the equity market segment. This would be a breakthrough opportunity for linking up international investors with Mainland companies and Mainland investors with international companies, thereby helping achieve the vision of the Mutual Market in the international dimension. **Being scalable, the Mainland-Hong Kong Mutual Market could ultimately become a financial supermarket for Mainland and international investors, offering to them different kinds of financial products from all over the world**.

5. ISSUES FOR CONSIDERATION IN IMPLEMENTING PEC

Like Stock Connect, PEC is a brand new concept which would require careful consideration of practical issues and market implications for its implementation. Nevertheless, with a suitable model design, the challenges could be largely overcome and the benefits would outweigh the costs. These challenges are discussed below.

(1) Potential increase in market competition

The increased foreign participation in Mainland IPOs under Northbound PEC may be regarded as a booster on top of the strong domestic demand for Mainland IPOs. There may therefore be the concern of further boosting the considerably active IPO subscription market in the Mainland. Quite the contrary, it is believed that, with proper model design, **PEC could contribute to a fairer pricing in, and a more healthy development of, the Mainland primary market**. Under the current market practice in the shares allocation process, QFIIs and RQFIIs could only get a minute portion of the Mainland IPO shares subscribed. The shares allocation mechanism in the Mainland market is quite different from international market practice and constrains foreign participation in the primary market. Northbound PEC could be designed to allow greater foreign participation, in both new shares subscription and allotment, as well as in the pricing process. This would help bring the Mainland primary market to gradually align with international practice.

Secondly, there may be the concern from the Mainland markets about increased competition from Hong Kong for the listing of Mainland issuers under PEC, as the Mainland issuers may have higher intention to opt to list in Hong Kong instead of in the domestic markets. This, however, would not be a major issue since the existing regulatory requirements for overseas listing of Chinese enterprises, particularly for H-share companies, would not be affected under PEC. The additional attraction under PEC would be the availability of Mainland investor demand. **PEC would in fact help alleviate the overwhelming pressure on IPO processing in the Mainland**.

Thirdly, there may be concern about the potential competition from Hong Kong with the planned International Board in the Mainland for the listing of international companies. In this respect, **PEC in its conceptual model is believed not to have any impact on the International Board** for which the issuer eligibility requirements and operational details are yet to be ascertained. On the contrary, market views consider that it would probably be the overseas exchanges that might face the competition from Hong Kong under Southbound PEC for the listing of international companies. The internationalisation of the Mainland stock market in fact would need multiple initiatives for trial implementation, to be modulated as appropriate as the market develops in time. **The Mutual Market with PEC would effectively act as a kind of China's offshore international board, that could run in parallel with its onshore international board.**

For the Hong Kong market, the increased liquidity pool under Southbound PEC is generally considered beneficial rather than competitive for IPO subscriptions in Hong Kong.

(2) Regulation and investor protection

Market regulation for PEC would be a major area that requires careful consideration. This would include eligibility criteria for issuers and investors, and the obligations and liabilities of exchanges, market regulators, intermediaries, issuers and investors on both sides of the Mutual Market. **The ultimate objective would be to provide a level-playing field with adequate investor protection and risk control.**

Mainland and Hong Kong stock markets have different primary market regimes, including IPO eligibility criteria, listing requirements and disclosure requirements in IPO prospectus. For IPOs under Southbound PEC targeting Mainland investors, additional issuer eligibility and disclosure requirements may need to be imposed[39]. Conversely, additional disclosure requirements may also be needed for IPOs under Northbound PEC to be offered to local and global investors in Hong Kong. Moreover, there may be certain state-level restrictions on foreign ownership of Mainland enterprises in strategic industries. As a result, certain specific IPO eligibility criteria or restrictions on foreign subscription for Northbound PEC may apply.

In case of any incident relating to regulatory matters of issuers under PEC that might impact investors' interests, the application of which market's investor protection regime, the roles of the market regulators on either side, the liabilities of the issuers, exchanges and intermediaries would need to be clarified. In addition, cross-border investors' credit risk would be a concern to market intermediaries. Nevertheless, these could be tackled by a clear and sound regulatory framework and suitable operational design.

Moreover, **extensive investor education** would need to be done in order to equip investors on each side of the Mutual Market with knowledge of the primary market practices and investment behaviour on the other side for self-protection.

(3) Operational issues

Whether it is Northbound or Southbound, PEC would involve an extension of IPO shares subscription to investors on the other side of the Mutual Market. In contrast to secondary market trading under Stock Connect where there are no changes in the listed stocks' home market trading, clearing and settlement practices, the shares subscription and

[39] As reference, cross-border offerings of shares to investors in markets like the US and the UK would need to follow certain regulatory requirements, including information disclosure requirements, of the market where the cross-border offering is made.

allotment practices under PEC in the IPO home market would need to be carefully designed to accommodate cross-border investors.

Questions to be answered would include but are not limited to: (1) Would cross-border retail investors be allowed to subscribe for PEC shares or would PEC be opened only to cross-border institutional investors? (2) How would PEC shares be allotted to cross-border investors? (3) Would there be a separate subscription pool for cross-border subscription or a combined pool with domestic market subscription? (4) Would cross-border subscription be subject to different market rules or follow the IPO home market rules? (5) Would cross-border investors be served by intermediaries in the IPO home market or in the investor's market? (6) Would intermediaries which serve cross-border investors be subject to different regulatory requirements, e.g. Know-Your-Client (KYC) rules and placement guidelines?

Since IPO procedures and market practices are very different between Hong Kong and the Mainland, **considerable efforts are expected to formulate the PEC operating model design in order to meet the interests of both issuers and investors, as well as to maintain the basic principles of market fairness, openness and integrity**.

Besides, the post-IPO shares trading support for PEC by **a seamless link with Stock Connect** is necessary. A proper regulatory and operational framework will have to be prepared for this arrangement. Given the usual market practice of funding offered by brokers to investors for IPO shares subscription in Hong Kong, there is advocacy from the market for enabling block trades in Stock Connect to facilitate such funding service support. The reason is that, without block trade facility, there would be market impact on the stock price for investors to sell a large volume of their subscribed shares in the secondary market in order to repay the brokers for the funding. Implementing PEC without a corresponding block trade facility in Stock Connect would be a deterrent to IPO subscriptions by cross-border investors who need funding support from brokers. These kinds of operational detail would need to be catered for in linking PEC with Stock Connect.

6. CONCLUSION

The Mainland-Hong Kong Mutual Market established upon the launch of the Stock Connect scheme in respect of the secondary market trading dimension is incomplete in the absence of primary market connectivity. The introduction of PEC would fulfil the fundamental functions of the Mutual Market in fund raising by issuers in addition to stock trading by investors. It could also improve the current deficiencies in the international dimension of the Mainland and Hong Kong stock markets and therefore of the Mutual Market. With PEC, the Mutual Market could offer more effective support to China's bigger roadmap to achieve a better balanced economy, further market opening and ultimately a higher degree of RMB internationalisation.

PEC would offer mutual benefits to the both sides of the Mutual Market. To the Mainland, PEC would (1) offer new opportunities for Mainland investors' global asset allocation and therefore an improved national balance sheet, (2) facilitate two-way market opening at lower costs, (3) help achieve one more step in RMB capital account convertibility, (4) support the development of the market's international investor base, (5) provide more listing opportunities for Mainland enterprises and (6) help nurture the Mainland investor base, while containing potential risks with suitable control measures. To Hong Kong, PEC would help attract the listing of international companies, further activate the market by increasing investor participation and also benefit market intermediaries with more business opportunities.

The implementation of PEC would involve additional issues, including regulatory and operational issues, beyond the Stock Connect scheme. Nevertheless, it is believed that these challenges could be largely overcome with a suitable model design that could meet the best interests of the Mainland-Hong Kong Mutual Market. This would ultimately benefit China's national accounts and the big strategy of RMB internationalisation.

ACRONYMS

CSRC	China Securities Regulatory Commission
ETF	Exchange-traded fund
FDI	Foreign direct investment
IFC	International Financial Centre
IPO	Initial public offer
ODI	Overseas direct investment
PBOC	People's Bank of China
PEC	Primary Equity Connect
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
RQFII	Renminbi Qualified Foreign institutional Investor
SAFE	State Administration of Foreign Exchange
SEHK	Stock Exchange of Hong Kong
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
WFE	World Federation of Exchanges

Remark

This research report has made reference to views and feedback on the PEC concept sought from primary market participants in Hong Kong, including investment banks, broker firms, law firms, accounting firms and fund managers.