

ETFs to be included in Hong Kong-China Stock Connect

On 27 May 2022, the Securities and Futures Commission of Hong Kong (the **SFC**) and the China Securities Regulatory Commission (the **CSRC**) published a [joint announcement](#) with details for implementing plans to include eligible exchange-traded funds (**ETFs**) in Stock Connect (the **ETF Connect**). On the same day, the Stock Exchange of Hong Kong (the **HKEx**) published a [circular on a further update on the inclusion of ETFs in Stock Connect](#), setting out detailed eligibility criteria for the inclusion of ETFs. However, these eligibility criteria remain subject to regulatory approval from the SFC and the CSRC. The list of eligible ETFs available for Northbound trading will be published by the HKEx in due course [on its website](#).¹

According to the SFC and CSRC joint announcement, the proposed arrangements are expected to be implemented about two months after the announcement. Investors will be able to start using the ETF facility once the necessary trading and clearing rules and systems have been finalised, all regulatory approvals have been granted, market participants have adapted their operational and technical systems, necessary arrangements for cross-boundary regulatory and enforcement cooperation have been put in place, and investor education measures have been determined.

Charltons has published extensive insights on Stock Connect, launched in 2014, which are available [here](#), with a brief introduction to the Shanghai-Hong Kong Stock Connect available [here](#) and a brief introduction to the Shenzhen-Hong Kong Stock Connect available [here](#).

Additional relevant information published by the HKEx on the inclusion of ETFs in the Stock Connect is available [on its website](#), and includes [Frequently Asked Questions \(FAQs\) on the inclusion of ETFs for Northbound Trading in Stock Connect](#) published by the HKEx on 27 May 2022.

Exchange-Traded Funds

ETFs are passively-managed and open-ended funds that are an efficient and low-cost option for investors to obtain exposure to a diverse range of underlying market themes. They are a popular choice for diversification among investors and ETF Connect should enable Hong Kong investors to gain targeted exposure to China's domestic equity market.

ETFs are a type of investment fund that contain a pool of investment securities that operates like a mutual fund and are traded on an exchange in the same way as stocks. Their share price may fluctuate during the trading day as they are bought and sold. This is in contrast to mutual funds which are bought and sold from the issuer based on their price at the end of the trading day. ETFs' risk level is therefore slightly more volatile than a mutual fund. ETFs can contain any type of investment including stocks, bonds or commodities. They can offer domestic holdings or international holdings and can be actively or passively managed. The HKEx has published further information regarding ETFs [on its website](#).

ETFs listed on the Shanghai Stock Exchange (the **SSE**) held RMB1.14 trillion (USD180 billion) in assets as at the end of 2021, an increase of 26% during the year. The percentage of ETF-only retail investors who made financial gains in 2021 exceeded the percentage of investors who invested in both stocks and ETFs.²

Development of Trading ETFs through the Stock Connect

In order to expand the variety of traded products and to provide more investment opportunities and increased convenience for domestic and overseas investors, the CSRC and the SFC floated the idea in 2016 of including ETFs as eligible securities under the Stock Connect.³ The first Hong Kong/Mainland ETF Cross-Listing was established in late 2020 under the then ETF Cross-listing Scheme,⁴ which employed a model involving the listing of a 'feeder' ETF in its home market, with the feeder ETF investing 90% or more of its total net assets in an ETF listed in the other market. However, the amount traded through this mechanism has not been significant.

In December 2021, the SSE, the Shenzhen Stock Exchange (the **SZSE**), the HKEx, China Securities Depository and Clearing Corporation Limited (**CSDCC**) and Hong Kong Securities Clearing Company Limited (**HKSCC**) reached an agreement on an overall proposal to include eligible ETFs in the Stock Connect.⁵ The new ETF Connect will allow investors to trade certain ETFs listed on each other's exchanges by employing the same trading, clearing and settlement arrangements as are used for the Stock Connect.

According to the Hong Kong Government, in the period commencing with Stock Connect's 2014 launch to May 2022, Northbound trading on Stock Connect brought net inflows of RMB1,600 billion to the Mainland stock markets, and Southbound trading brought net inflows of HK\$2,300 billion to the Hong Kong stock market.⁶

Eligibility Criteria

Under the updated arrangements, investors in Mainland China and Hong Kong may trade ETFs (and eligible stocks) listed on each other's exchanges through local securities firms or brokers. ETFs will be included in the Stock Connect by using connections between the infrastructures supporting the mutual market access scheme. The main arrangements for the regime are made with reference to those under the Stock Connect and follow existing fund operations, in addition to the laws, regulations and operational models governing trading and clearing in the two markets.

The HKEx has published [details of the eligibility criteria for Mainland and Hong Kong ETFs](#) for inclusion in Northbound and Southbound trading (discussed below). However, these eligibility requirements are still subject to SFC and CSRC approval. According to the SFC and CSRC joint announcement, the eligibility requirements will be based on several factors, such as fund size and whether the index tracked by the fund mainly comprises eligible stocks under the Stock Connect. The exchanges may also adjust the scope of eligible ETFs under the Stock Connect framework in light of operational performance, but only with CSRC and SFC approval. Under ETF Connect, investors will only be allowed to trade ETFs on secondary markets and no subscriptions or redemptions will be allowed. The investment quota for ETFs and stocks will be aggregated for calculation and administrative purposes.

ETFs to be included for Northbound trading in the Stock Connect will be reviewed periodically to determine eligibility,⁷ based on the relevant data. Although the particulars have not been approved yet, investors who want to know whether a security eligible for Northbound trading under the Stock Connect is an A share or an ETF, will be able to refer to the [lists available on the HKEx website](#).

According to the HKEx, Northbound Trading of ETFs will be open to all Hong Kong and overseas investors including institutional and individual investors.

Further issues that have not yet been determined, such as the applicable trading and clearing rules, investor eligibility, cross-boundary regulatory and enforcement cooperation and liaison mechanisms, will be set out in further SFC and CSRC joint announcements.

Eligibility Criteria for Northbound ETFs

Subject to regulatory approval, it is proposed that ETFs listed on the SSE or SZSE that satisfy all the criteria listed below may be accepted as eligible ETFs for Northbound trading:

1. the ETF must be traded in RMB and have a daily average Assets Under Management (**AUM**) in the last six months of at least RMB1.5 billion (USD225 million);
2. the ETF must be listed for a minimum of six months;
3. the benchmark index must be launched for at least one year;
4. the total weighting of SSE-listed and SZSE-listed A shares in the benchmark index must not be less than 90% and the total weighting of Stock Connect Northbound eligible constituents in the benchmark index must not be less than 80%; and

5. the benchmark index or the index methodology of the benchmark index must satisfy one of the following criteria:

- a. for broad-based indices:⁸ a constituent stock must not be greater than 30% of the index's weighting; or
- b. for non-broad-based indices:
 - the number of index constituent stocks must be at least 30;
 - a constituent must not be greater than 15% of the index's weighting and the total weighting of the top five weighted constituents must not be greater than 60%; and
 - the constituent stocks comprising no less than 90% of the index's weighting must be the top 80% shares by average daily turnover ranking in the relevant stock exchange in the past 12 months.

It is further proposed that eligible ETFs that subsequently satisfy any of the following criteria upon regular review will be designated as sell-only securities and will be restricted from buying:

1. the ETF's daily average AUM in the last six months is below RMB 1 billion;
2. the total weighting of SSE-listed and SZSE-listed A shares in the benchmark index falls below 85% or the total weighting of Stock Connect Northbound eligible constituents in the benchmark index falls below 70%; or
3. the benchmark index and the index methodology of the benchmark index satisfy either of the following criteria:
 - a. for broad-based indices: a constituent stock exceeds 30% of the index's weighting; or
 - b. for non-broad-based indices:
 - the number of index constituent stocks falls below 30;
 - a constituent exceeds 15% of the index's weighting or the total weighting of the top five weighted constituents exceeds 60%; or
 - the constituent stocks which are the top 80% shares by average daily turnover ranking in the relevant stock exchange in the past 12 months falls below 90% of the index's weighting.

Trading through Shanghai Stock Connect and Shenzhen Stock Connect is subject to a daily quota of RMB52 billion for each of the exchanges. This daily quota will apply to, and be shared among, ETFs and A shares. The daily quota is applied on a "net buy" basis, meaning that investors are always allowed to sell their cross-boundary securities or input order cancellation requests irrespective of the quota balance.

Further details such as the list of SSE and SZSE securities, including ETFs, eligible for Northbound trading will be found [on the HKEx's website](#) and will be updated from time to time. The list of eligible ETFs available for Northbound trading will be published in due course.

Eligibility Criteria for Southbound ETFs

Subject to regulatory approval, it is proposed that ETFs that are primarily regulated by the SFC and are listed on the HKEx that satisfy all of the following criteria at any regular review will be accepted as eligible ETFs for Southbound trading:

1. the ETF must be traded in HKD and have a daily average AUM in the last six months of at least HKD1.7 billion (USD 217 million);
2. the ETF must be listed for a minimum of six months;
3. the benchmark index must be launched for at least one year;
4. the ETF must not be synthetic ETFs or Leveraged and Inverse Products;
5. the total weighting of HKEx-listed stocks in the benchmark index must not be less than 90%;
6. the total weighting of Stock Connect Southbound eligible constituents in the Hang Seng Index (**HSI**), Hang Seng China Enterprises Index (**HSCEI**), Hang Seng TECH Index (**HSTECH**) and Hang Seng Hong Kong-Listed

Biotech Index (**HSHKBIO**) must not be less than 70% and the total weighting of Stock Connect Southbound eligible constituents in the other benchmark indices must not be less than 80%; and

7. the benchmark index or the index methodology of the benchmark index must satisfy one of the following criteria:

- a. for broad-based indices: a constituent stock must not be greater than 30% of the index's weighting; or
- b. for non-broad-based indices:
 - the number of index constituent stocks must be at least 30;
 - a constituent must not be greater than 15% of the index's weighting and the total weighting of the top five weighted constituents must not be greater than 60%; and
 - the constituent stocks comprising no less than 90% of the index's weighting must be the top 80% shares by average daily turnover ranking in the relevant stock exchange in the past 12 months.

It is further proposed that eligible ETFs that subsequently satisfy any of the following criteria upon regular review will be designated as sell-only securities and will be restricted from buying:

1. the ETF's daily average AUM in the last six months falls below HKD1.2 billion;
2. the ETF becomes a synthetic ETF or Leveraged and Inverse Product;
3. the total weighting of HKEx-listed stocks in the benchmark index falls below 85%;
4. the total weighting of Stock Connect Southbound eligible constituents in HSI, HSCEI, HSTECH and HSHKBIO falls below 65% or the total weighting of Stock Connect Southbound eligible constituents in the other benchmark indices falls below 70%; or
5. the benchmark index and the index methodology of the benchmark index satisfy one of the following criteria:
 - a. for broad-based indices: a constituent stock exceeds 30% of the index's weighting; or
 - b. for non-broad-based indices:
 - the number of index constituent stocks falls below 30;
 - a constituent exceeds 15% of the index's weighting or the total weighting of the top five weighted constituents exceeds 60%; or
 - the constituent stocks which are the top 80% shares by average daily turnover ranking in the relevant stock exchange in the past 12 months falls below 90% of the index's weighting.

Additional Arrangements

Other additional arrangements, including for margin trading, voting rights, securities borrowing and lending and covered short selling will be the same as the arrangements set out in the Stock Connect rules.⁹

In respect of client agreements, exchange participants are encouraged to review their client agreements to ensure that they sufficiently cover the trading of ETFs eligible for Northbound trading, including the risks involved. Investors should consult their brokers on the detailed arrangements for participating in trading ETFs eligible for Northbound trading, including whether they are required to enter into a separate client agreement for trading China Connect Securities.

In relation to trading hours, the Opening Call Auction hours remain the same for the Northbound trading of both A shares and ETFs (i.e. 9:15 to 9:25). The Continuous Auction (Morning) hours are also the same (i.e. 9:30 to 11:30). The Continuous Auction (Afternoon) session is from 13:00 to 14:57 for the Northbound trading of A shares (SSE/SZSE) and the Northbound trading of ETFs (SZSE), with 14:57 to 15:00 reserved for the Closing Call Auction. There will be no Closing Call Auction for the Northbound trading of ETFs (SSE) and the Continuous Auction (Afternoon) session will continue from 13:00 to 15:00.

The table below summarises the trading hours:

Trading Hours	Northbound Trading of A Shares (SSE/SZSE)	Northbound Trading of ETFs (SSE)	Northbound Trading of ETFs (SZSE)
09:15 – 09:25	Opening Call Auction		
09:30 – 11:30	Continuous Auction (Morning)		
13:00 – 14:57	Continuous Auction (Afternoon)	Continuous Auction (Afternoon)	Continuous Auction (Afternoon)
14:57 – 15:00	Closing Call Auction		Closing Call Auction

Most ETF Northbound trading arrangements will follow the practices in Northbound trading of A shares under the Stock Connect,¹⁰ but there will be some slight differences that apply to Northbound ETF trading only. The ETF spread will be RMB 0.001, as compared to the A share spread of RMB 0.01. The daily price limit will be $\pm 10\%$ (and $\pm 20\%$ for some ETFs specified by SSE and SZSE) based on the previous closing price. This compares to the SSE Main Board and SZSE Main Board of $\pm 10\%$ (and $\pm 5\%$ for ST and *ST stocks), and the SSE STAR Market and SZSE ChiNext Market of $\pm 20\%$ for all stocks. The dynamic price limit imposed by the SSE/SZSE will not be applied, whereas a limit of $\pm 2\%$ applies to A shares listed on the SSE STAR Market and SZSE ChiNext Market. Further, the fees and levies applied to ETFs will be different, with the full list of fees and other transaction costs set out in Part 4 of the [HKEx FAQ on the inclusion of ETFs for Northbound Trading in Stock Connect](#).

Regarding the current 24-spread rule and 9 times restriction imposed on the quotation of orders on HKEx-listed securities, the rule and restriction will not apply to SSE-listed and SZSE-listed ETFs orders.

It should be noted that the Northbound trading of eligible SSE-listed and SZSE-listed ETFs will follow the same clearing arrangements and the same settlement cycles as the Shanghai and Shenzhen securities markets respectively. The securities positions of ETFs will be settled on T-day, and the money positions of ETFs will be settled on T+1 day. The trading of SSE-listed and SZSE-listed ETFs will follow the SSE and SZSE 6-digit stock code.

Investors in Hong Kong and overseas will be allowed to exercise their voting rights with respect to the ETFs eligible for Northbound trading held on their behalf through HKSCC. They may cast their votes to HKSCC through their China Connect Clearing Participants. HKSCC will inform CCASS Participants of the number of proposed resolutions.

The Orion Central Gateway will be utilised to support the trading of SSE-listed ETFs through the Shanghai Stock Connect and SZSE-listed ETFs through the Shenzhen Stock Connect. This is to provide a consistent interface to exchange participants who will be able to trade eligible ETFs using the same central gateway session that they use for trading eligible A shares. Orders for ETFs will also be routed through the Orion Trading Platform – China Stock Connect (**OTP-CSC**) for auto-matching.

Going Forward

As this will be the first time that financial derivatives are included in the Stock Connect programme, it is expected that there will be an increase in trading. The number of investors may also increase. However, with details of the ETF Connect not yet fully released, the long-term market impact of ETFs' inclusion in the Stock Connect remains uncertain. Nevertheless, the implementation of ETF Connect will be a positive step in enhancing Hong Kong's position as an asset management centre and ETF market.

With the current lack of a published list of eligible ETFs, there are concerns that an absence of a wide variety of products in the ETF Connect will mean that Hong Kong and PRC investors will not be offered anything different to what they can presently access through products currently offered by local securities firms. Ashley Alder, the chief executive of the SFC, has expressed hope that the eligibility requirements will be relaxed as the programme gains traction.¹¹

Further relaxing the scope of eligibility requirements would attract more players and stronger growth, which would be backed by Mainland Chinese investors' appetite for offshore investments. In December 2021, the Shenzhen Stock Exchange and the Singapore Exchange agreed to establish a cross-border ETF link, with the two exchanges to jointly develop and promote the ETF markets in Singapore and China through the listing of feeder ETFs.¹²

- [1] Northbound refers to Hong Kong investors investing northwards towards the Mainland markets. In this case, to Shanghai and Shenzhen.
- [2] <https://www.ft.com/content/2392fbd8-5ce5-482d-8c46-4719140b676c>
- [3] <https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=16PR80>
- [4] https://www.hkex.com.hk/News/News-Release/2020/201023news?sc_lang=en
- [5] https://www.hkex.com.hk/News/News-Release/2021/211224news?sc_lang=en
- [6] <https://www.info.gov.hk/gia/general/202205/27/P2022052700547.htm>
- [7] The regular review data cut-off dates will be the first trading day following the 2nd Friday of each of June and December annually. The list of eligible ETFs for Northbound trading will be published on the fourth Friday after the data cut-off dates after completion of the regular review, or the preceding Hong Kong Securities Market trading day if it is not a Hong Kong Securities Market trading day. Such lists of ETFs eligible for Northbound trading will become effective on the second Monday after the publication of the lists, or the next CSC trading day if it is not a CSC trading day.
- [8] Broad-based index refers to an index whose constituent selection is not limited to a specific industry or investment theme but reflects the performance of a certain market or a certain size of stocks.
- [9] Further details regarding these matters are set out in the [HKEx FAQ on "Inclusion of Exchange Traded Funds \("ETFs"\) for Northbound Trading in Stock Connect"](#) (27 May 2022).
- [10] Such as lot size, allowed order type, quantity limit, and the arrangements on order cancellation, order amendment, assignment of Broker-to-Client Assigned Number ("BCAN"), short selling and pre-trade checking.
- [11] <https://www.ft.com/content/2392fbd8-5ce5-482d-8c46-4719140b676c>
- [12] <https://corp.sgx.com/media-centre/20211228-sgx-and-szse-sign-mou-link-etf-markets-singapore-and-china>

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