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New Pre-Trade Checking Model for Trading A Shares under Shanghai-Hong Kong Stock Connect

Introduction

Rule changes to allow fund managers holding A shares through special accounts to settle A share trades after execution will come into effect on 30 March 2015. The move comes in response to complaints about the application of China's pre-trade checking requirement to A share trades under the pilot Shanghai-Hong Kong Stock Connect Programme (**Stock Connect**), the programme allowing mutual market access between the Shanghai and Hong Kong stock exchanges. Under the rule amendment, sellers will no longer need to transfer their A shares to brokers the day before they want to sell in order to comply with China's pre-trade checking requirement.

The aim behind the Chinese requirement is to prevent failed trades. However it is out of sync with practices on other exchanges, including Hong Kong, which allow settlement to take place within two business days of trades. The requirement has been criticised for preventing investors from reacting quickly to market events and also for preventing some overseas fund managers from participating in Stock Connect as their rules prohibit them from complying with the pre-trade checking requirement.

The Hong Kong Exchanges and Clearing Limited (the **Exchange**) has issued a circular[1] on rule amendments aimed at improving the pre-trade checking model currently used in trading A shares under Stock Connect.

1 Stock Exchange of Hong Kong Limited Circular "Amendments to the Rules of the Exchange" of 17.03.2015 available at http://www.hkex.com.hk/eng/market/partcir/sehk/2015/Documents/13-15-SEHK-PreTradeChecking.pdf.

Rationale for the Change

Stock Connect was launched on 17 November 2014 and for the first time allows global investors direct access to mainland China's Shanghai stock market. The rules governing Stock Connect currently require the delivery of sufficient shares to the Exchange one trading day before placing a relevant sell order (**the existing rule**). This reflects China's rule that investors can only sell shares listed on the SSE that are available in their ChinaClear accounts at the end of the previous trading day. A sell order not backed by sufficient shares in the investor's account will be rejected by the SSE.

Under the current model, investors using a custodian must transfer the relevant shares to his executing Exchange Participant (**EP**) before the market opens. The Exchange conducts checks at the EP-level and EPs are responsible for ensuring clients' compliance with the existing rule. The Central Clearing and Settlement System (**CCASS**) makes a record of each EP's holdings of Shanghai Stock Exchange (**SSE**) securities and sends the shareholding records to the China Stock Connect System (**CSC**) before the start of each CSC trading day. If an EP's accumulated sell quantity of a stock for the day exceeds its shareholding at market open, its sell orders will be rejected.

Criticisms of the current model include the operational burden and cost of frequent movement of shares between custodians and brokers and that it give banks operating both custody and brokerage business an edge, while brokerages without a custody arm are at a disadvantage. A further problem is that many fund managers hold their shares through different brokers and banks.

The Enhanced Model

Only investors using custodians will be able to enjoy post-trade settlement under the new model. They will be able to ask their custodians to open Special Segregated Accounts (**SPSA**s) with CCASS to keep their shareholdings separate to which a unique investor identification number (**Investor ID**) will be assigned. CCASS will record the SSE shareholdings in the SPSA and forward the information to CSC for pre-trade checking. When placing sell orders, an investor need only give its EP its investor ID and custodians may then transfer the relevant shares from the SPSA to the relevant Clearing Participant for settlement after execution.

The executing EP is responsible for ensuring that:

- the client has an SPSA account and Investor ID assigned by CCASS
- it has been authorised by its client to execute the sale of securities in the client's SPSA;
- it has received confirmation from the client or advised the client to ensure that there are sufficient shares in the SPSA to settle the delivery obligations on settlement; and
- delivery of the shares from SPSA to it or its CCASS General Clearing Participant.

The maximum number of a given A share which can be the subject of an SPSA order on a trading day is the number of such A shares in the SPSA immediately before market open.

Although trades can be settled after execution of orders, settlement must still take place on the same day as execution occurs. This is relatively rushed compared to the 2-3 trading days allowed for settlement in most developed markets. If settlement does not take place leading to an overdue short stock position, the Exchange will be required to deduct the amount of overdue stock from the sellable balance of the relevant SPSA.

Market Response

The change has been welcomed by market participants and is seen as a good attempt to deal with the problems created by China's pre-trade checking requirement. It should also help to create a level playing field for brokerages without custody businesses and allows fund managers to continue to use multiple brokerages and custodians. However, although the pre-trade checking issue has been dealt with, there are still concerns about the requirement to settle A share trades on the date of execution.

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