The Implications of CEPA for the Hong Kong Securities Industry

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A Note From The Editor

In the previous issue (No. 54) of the SFC Quarterly Bulletin, the SFC discussed the implications of CEPA on market professionals. In this issue, Mr Matthew Harrison discusses the implications of CEPA for the securities industry. We are grateful to Mr Harrison for his contribution to the SFC Quarterly Bulletin[2].

Summary

The direct impact of Closer Economic Partnership Arrangement (CEPA) on the Hong Kong securities industry has been relatively minor. Nonetheless, the indirect impact of other measures to open Mainland markets has probably been quite significant. As the Mainland economy opens further, Hong Kong's securities industry needs to reposition itself to benefit from the opportunities.

Introduction

CEPA between the Mainland and Hong Kong is a free trade agreement that offers Hong Kong products, companies and residents preferential access to the Mainland market. CEPA became effective on 1 January 2004. Now, provided rules of origin requirements are met, the Mainland allows duty free import of Hong Kong products under 374 tariff codes. Companies in 18 service industries enjoy varying degrees of improved access. In some areas, the concessions go further than China's commitments under its accession agreements to the World Trade Organisation (WTO).

The benefits to Hong Kong service businesses vary according to the sector. Hong Kong service suppliers can enter the Mainland market between one and five years earlier than under the WTO schedule. They may obtain higher equity shares in Mainland service companies. Lower capital requirements apply than under the WTO protocol. And Hong Kong professionals such as legal practitioners, accountants and medical staff are allowed to practice in the PRC provided they have passed the local professional exams and traineeship requirements.

It should be noted that CEPA is only an agreement; in many cases regulations have to be changed to give it effect, including regulations at the local level in Mainland China. Nonetheless, CEPA is not a closed agreement. The Mainland and Hong Kong authorities are holding continuing discussions on the implementation details and on further concessions.

Among the leading beneficiaries of CEPA were eight local Hong Kong banks, which were unable to meet the WTO asset requirement of US$20 billion, but which qualify for Mainland access under the CEPA US$6 billion asset requirement. These banks not only get Mainland access, which they would otherwise not have had, but they get it earlier than other overseas banks and so have first-mover advantage.

Otherwise, the response of Hong Kong businesses to the CEPA was initially muted, but it may now be picking up. A survey published by the Hong Kong General Chamber of Commerce found that nearly 60% of its members expected to take advantage of CEPA opportunities[3]. By 19 March 2004, some 431 applications for place of origin certificates had been received by the Hong Kong customs[4].

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[2] This paper was prepared by Mr Matthew Harrison in early April 2004. The views expressed in the paper are his own and do not represent those of the SFC or HKEx. Whilst data contained in this paper are sourced from HKEx or other sources which are believed to be reliable, it is not guaranteed as being accurate and the most current. Readers are free to use the information contained in this paper, but any usage should not be attributed to the SFC.
[3] *Business Prospects Survey 2003*, Hong Kong General Chamber of Commerce, December 2003.
[4] *CEPA export applications accelerate after a slow start*, South China Morning Post (SCMP), 31 March 2004.

Securities Sector Measures

At first glance, compared with other sectors, the Hong Kong securities industry gained only modestly from CEPA. There were only two specific measures: the authorization of HKEx's Beijing representative office, and the recognition of Hong Kong securities professionals' qualifications for the purposes of practicing on the Mainland.

HKEx's representative office, which opened on 17 November 2003, is a platform for promoting the Hong Kong securities market on the Mainland as a listing and trading venue. The office helps bring benefits to the Hong Kong securities industry as a whole, and not merely to HKEx. Discussions are currently in progress to achieve HKEx representation in other major Mainland cities.

As regards recognition of securities professional qualifications, in the course of the negotiation, this became mutual recognition by each authority of the professional qualifications of the other side. The SFC and the China Securities Regulatory Commission announced mutual recognition at the regulatory level in 2003[5]. Recognition of professional content rests with the respective industry associations. Securities professionals still have to pass exams in local knowledge, eg local securities regulation, but their technical knowledge and experience would be recognized by the other regime. Traders' and dealers' professional experience would generally be easier to recognize; corporate financiers will need local experience. There is also the need to obtain a work permit; this tends to be easier for Hong Kong professionals going into the Mainland than for Mainlanders coming to Hong Kong. Hong Kong securities professionals can now enrol for the PRC Securities Regulations Examination offered by the Securities Association of China through the Hong Kong Securities Institute. The first batch of Hong Kong professionals took part in the exams under the new arrangements in Shenzhen on 20 March 2004.

Other Financial Sector Measures

Other measures included in CEPA have relevance to the Hong Kong securities industry. The agreement states that in the areas of banking, securities and insurance, specific measures will be adopted to strengthen cooperation on both sides. The measures[6] are as follows:

- Mainland state-owned commercial banks and some shareholding commercial banks are supported in relocating their international and foreign exchange trading centres to Hong Kong.
- Mainland banks are supported in developing their network and business activities in Hong Kong through acquisition.
- The Mainland supports the full utilization of financial intermediaries in Hong Kong during the process of the reform, restructuring and development of the Mainland financial sector.
- Financial regulators on both sides will strengthen cooperation and information sharing.
- The listing of eligible Mainland insurance companies and other companies (including private companies) in Hong Kong will be supported.

These measures are to some extent existing policy directions which were already in effect. However, they gain reinforcement from their specific inclusion in CEPA. The recent listing of large insurance companies has boosted the size of the Hong Kong market.

Other Liberalisation Measures

Other streams of negotiation have been in progress concurrently with the CEPA talks, although now these may be brought more under the CEPA umbrella. There has been a relaxation of restrictions on Mainland tourists coming to Hong Kong. Under CEPA, residents in Guangdong and some major cities along

[5] A thorough discussion on this is found in a paper entitled *CEPA Opens Up Northern Conduit For Market Professionals*, published in the SFC Quarterly Bulletin, Issue No. 54, Winter 2003. The paper is prepared by the SFC and is downloadable from the link: http://www.hksfc.org.hk/eng/press_releases/html/sfc_bulletin/winter_03.htm.

[6] *CEPA*, Article 13.

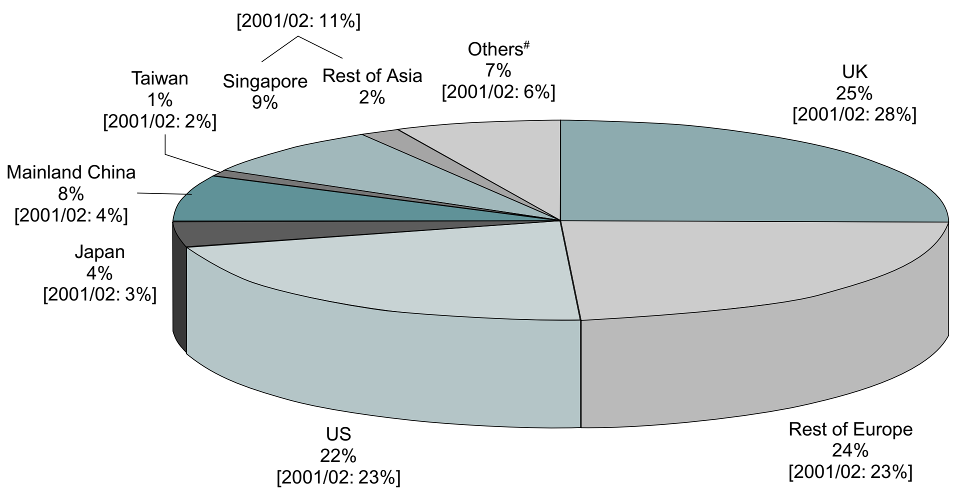
the coast are allowed to use individual visas to come to Hong Kong (rather than merely in tour groups) and are allowed to use RMB credit cards in Hong Kong. Banks in Hong Kong are allowed to open RMB personal deposit accounts and issue RMB credit cards. In the context of these measures, there has been a big influx of Mainland tourists into Hong Kong.

HKEx's *Cash Market Transaction Survey 2002/03*, which covers the year ended 30 September 2003, found increased Mainland participation in the Hong Kong stock market, even though the recent stock market boom did not begin until the final quarter of that period. Orders of Mainland origin contributed 8% of overseas investor trading (2.9 % of total trading) in the Hong Kong stock market, up from 4% (1.5%) the previous year, and 2% (1.2%) the year before that.

This rising trend would be further supported by CEPA and concurrent liberalization measures, which have in one way or another made it easier for Mainland issuers and investors to reach Hong Kong and list and trade there. Thus, although the direct benefits for the Hong Kong securities industry from these measures may have been small, the indirect benefit has probably been quite significant.

It should also not be overlooked that some of the eight Hong Kong banks which benefited from CEPA themselves channel securities transactions into the Hong Kong market, eg via Internet trading. Perhaps as these banks expand their Mainland business, when policy conditions permit they will be able to promote the Hong Kong securities market to their Mainland customers.

Chart 1 - Distribution of Hong Kong Stock Market Overseas Investor Trading by Origin (Oct 2002 - Sep 2003)



Includes Australia, British Virgin Islands, Canada, New Zealand, Cayman Islands and Africa.
Source: HKEx Cash Market Transaction Survey 2002/03

Strategic Outlook

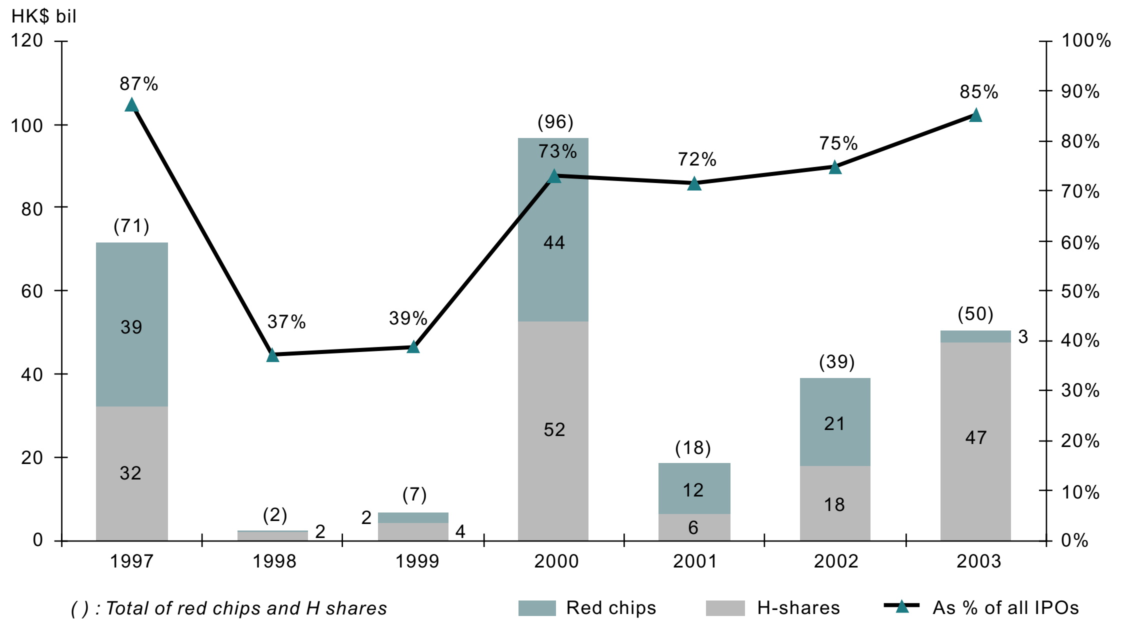
How important is CEPA to the Hong Kong securities industry from a longer term perspective?

CEPA is a significant stage in the progressive opening of the Mainland economy to the outside world. This opening is of fundamental importance to Hong Kong. It is a two-edged sword. On the one hand, opening enables the faster growth and development of the Mainland economy, providing substantial long term business opportunities on Hong Kong's doorstep. On the other hand, as China opens to the world directly, it has less need of Hong Kong's traditional gateway services. Thus China's market opening requires Hong Kong to adjust its service offering. Hong Kong has to provide more upmarket and sophisticated services to maintain its usefulness.

Financial services, including securities market services, are a good example of the kind of services that Hong Kong should be providing more of as it adapts. How well is the Hong Kong securities industry positioned to serve China in the future?

In terms of listing and trading China-related stocks, the Hong Kong securities market has been serving China on a large scale. In the first two months of 2004, China-related stocks contributed more than 30% of market capitalisation and 40% of trading volume in the Hong Kong stock market; in 2003, they absorbed 85% of IPO capital raised. Charts 2, 3a and 3b show the contribution from H-shares and red chips[7] alone (ie not including many private enterprises).

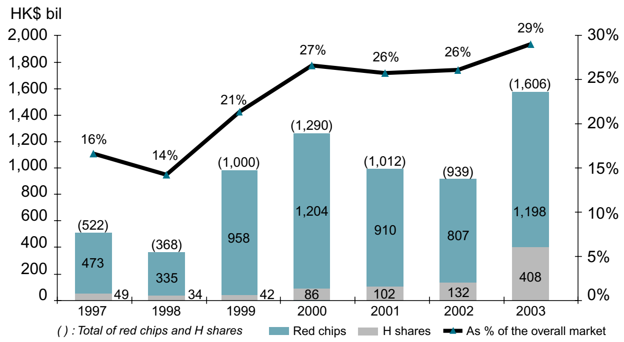
Chart 2 - Equity IPO Funds Raised by H-shares and Red chips in Hong Kong (Main Board & GEM)



Source: HKEx

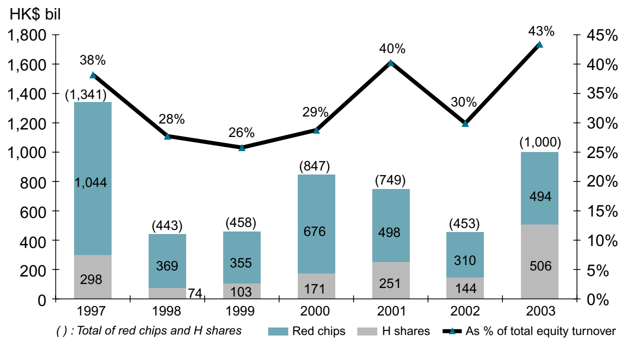
[7] For the definition of H-shares and red chips, please refer to Table B2 of the Statistics Section.

Chart 3a - Market Capitalisation of H-shares and Red chips in Hong Kong (Main Board & GEM)



Source: HKEx

Chart 3b - Turnover Value of H-shares and Red chips in Hong Kong (Main Board & GEM)



Source: HKEx

It can be seen from the above charts that the recent dominance of China-related stocks relates partly to the market's boom conditions. Similar China-related booms took place in 1997 and 2000. Nonetheless, the China-related listings on the Main Board and GEM constitute a critical mass that will serve to attract more issuers in the future.

Hong Kong faces competition in its listing role with other overseas exchanges such as New York and London. However, Hong Kong has by far the largest number of China-related listings. And in cases of cross-listing of China-related enterprises between Hong Kong and the New York Stock Exchange, Hong Kong gets the lion's share of the trading volume. In 2003, of the total trading volume in the 18 cross-listed China-related companies, 81% was in Hong Kong.

Table 1 - Turnover of Dually Listed China-related Stocks in Hong Kong and US

Stock Code	Company Name	US Exchange	Jan 2003 - Dec 2003			
			Turnover (HK$M)		Market Share (%)	
			Hong Kong	US	Hong Kong	US
02600	**Aluminum Corporation of China**	NYSE	19,391	6,942	73.6	26.4
01045	APT Satellite	NYSE	211	996	17.5	82.5
01114	Brilliance China Automotive	NYSE	21,385	3,301	86.6	13.4
00670	**China Eastern Airlines**	NYSE	6,352	189	97.1	2.9
02628	**China Life Insurance**	NYSE	26,890	23,641	53.2	46.8
00941	China Mobile (Hong Kong)	NYSE	119,671	11,637	91.1	8.9
00386	**China Petroleum & Chemical Corporation**	NYSE	32,698	9,494	77.5	22.5
01055	**China Southern Airlines**	NYSE	8,656	388	95.7	4.3
00728	**China Telecom**	NYSE	39,193	7,365	84.2	15.8
00762	China Unicom	NYSE	27,457	7,486	78.6	21.4
00883	CNOOC	NYSE	37,075	4,187	89.9	10.1
00525	**Guangshen Railway**	NYSE	4,026	843	82.7	17.3
00902	**Huaneng Power International**	NYSE	23,097	6,722	77.5	22.5
00368	**Jilin Chemical Industrial**	NYSE	8,189	307	96.4	3.6
00857	**PetroChina**	NYSE	63,776	20,117	76.0	24.0
00325	**Sinopec Beijing Yanhua Petrochemical**	NYSE	8,714	678	92.8	7.2
00338	**Sinopec Shanghai Petrochemical**	NYSE	10,473	1,447	87.9	12.1
01171	**Yanzhou Coal Mining**	NYSE	10,043	779	92.8	7.2
	Total (18 dually listed companies)		***467,297***	***106,519***	***81.4***	***18.6***

Notes:
(1) Different exchanges would have different trading data capturing method. The above comparison is for indicative purposes only.
(2) H-share companies are in **bold** font.

Sources: HKEx and Reuters

Some are concerned with the possibility of Mainland enterprises raising funds directly from and getting listed in the Mainland markets. Since 2001, the performance of Mainland markets has not been particularly outstanding, and it could be time-consuming for Mainland enterprises to list at home. For these reasons, the Hong Kong market represented an attractive opportunity to raise capital. And for the largest state-owned enterprises, the very large amounts of capital they required could only be raised on the international markets, usually by way of cross-listing in Hong Kong and New York.

The constraints on Mainland enterprises listing at home may lessen in future. There have also been discussions about the launch of a second board in Shenzhen. However, the overall capital formation needs of the Mainland remain very great. If high growth levels are maintained, part of the capital has to be sourced from overseas – which in practice means to a large extent through Hong Kong. From a purely quantitative point of view, then, Hong Kong has a continuing role.

There are qualitative reasons, too, for Mainland-related enterprises to continue to seek a listing in Hong Kong. After fund-raising capability, the leading factors for Mainland enterprises in choosing a listing are international status, market reputation for quality, availability of professional services, regulatory issues, and quality of investors[8]. On all of these, Hong Kong has much to offer.

The Hong Kong market must be attractive not only to issuers but also to investors. At present, there is strong investor interest in Mainland enterprises. In the longer run, when Mainland policy permits, investors from Mainland China itself would likely form a crucial part of the Hong Kong market's investor base.

As discussed above, Mainland investor participation in the Hong Kong market is small, albeit growing. Steps are being taken by the Mainland authorities to allow selected Mainland institutions to invest overseas, including in Hong Kong. To diversify their investment portfolios, Mainland investors would be interested in the China-related stocks listed in Hong Kong. For institutions, such as pension funds or the National Social Security Fund, it also makes sense to diversify into overseas markets such as Hong Kong to improve returns and lower risk. The trend of Mainland investment in the Hong Kong market is likely to grow over time.

At present, the Hong Kong stock market has some 19 Mainland-related Exchange Participants. In the longer term, when policy permits, Mainland investor orders might be channelled directly from the networks of the Mainland-related brokers down to Hong Kong. In the European markets, it is common for exchanges to receive a share of their trading from remote members, ie securities firms which are located in overseas countries and route their investors' orders electronically to the exchange. This may also be a model for the future of the Hong Kong market vis-à-vis the Mainland.

The foregoing discussion has concentrated on equity. Equities, equity-related structured products such as warrants, and equity-related derivatives are the strength of the Hong Kong securities market. However, China is a continental economy with the full range of securities-related needs. Such needs include fixed income, financial futures and commodity futures. In these latter areas, Hong Kong's offering is less strong. However, in principle, Hong Kong would seem to have a natural role as a centre of risk management for the Mainland. Any opportunity for Hong Kong to reinforce its offering in these areas should be taken.

[8] HKEx's *Primary Market Survey 2001/02*. On a scale of 1 (very insignificant) to 7 (very significant) the factors mentioned all attracted an average rating of more than 5.0 from Mainland enterprises listed in Hong Kong. SFC Research has also discussed the role of Hong Kong in the fund-raising activities of Mainland enterprises in an article entitled *IPO Activities In Hong Kong* and published in the SFC Quarterly Bulletin, Issue No. 53, Autumn 2003. The paper is downloadable from the link: http://www.hksfc.org.hk/eng/press_releases/html/sfc_bulletin/autumn_03.htm.

Conclusion

CEPA has so far provided the Hong Kong securities industry with few direct benefits. However, the indirect benefit to the stock market of other measures to open up the Mainland economy appears to have been quite significant. This already suggests that the Hong Kong securities market is well-placed to gain from the Mainland's further general opening under CEPA and WTO.

In the future, the Hong Kong securities industry – firms, market operator, and regulators – will need to further strengthen its value proposition to China. As Hong Kong's uniqueness as a gateway to international investors diminishes, it will have to rely more and more on its reputation for quality and service. This will mean further work on regulation, corporate governance, disclosure, as well as maintaining and improving operational integrity. When policy permits, the distribution network on the Mainland will need to be improved, perhaps via Hong Kong brokers' expansion onto the Mainland, and via the remote or direct participation of Mainland brokers in the Hong Kong market. And if there is a chance to broaden the Hong Kong market's service offering beyond the equity arena, it should be taken. Such steps would enable the Hong Kong market to play a more integral function within Mainland economic development, both as a centre for capital formation for Mainland issuers, and as a transaction space and store of value for Mainland investors.