Positioning of Hong Kong amid Reforms in the Mainland Financial Markets

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Summary

1. *In recent years, the Mainland government has embarked on a number of reforms. The ultimate goal of these is to develop the Mainland capital markets through market forces and proper regulation. Hong Kong can serve as a platform to speed up the reform process, thereby creating a win-win situation for both the Mainland and Hong Kong.*

2. *The Mainland's share reform, and the accompanying pause in its fund-raising activities on domestic exchanges, fortified Hong Kong's position as a prime fund-raising centre for Mainland companies in 2005. As the share reform is almost complete, fund-raising activities have just been resumed on the Mainland exchanges. Some are concerned that fund-raising activities by Mainland companies in Hong Kong may be affected. But such concerns underestimate the full extent of Hong Kong's contribution. Hong Kong does not simply provide a platform for Mainland companies seeking to raise funds. It also serves as a platform for raising their corporate governance standards and international visibility. Moreover, Hong Kong has other advantages such as its proximity and affinity to the Mainland. As long as it can strengthen its competitive advantages, Hong Kong should be able to maintain its position as the prime fund-raising centre for Mainland companies. This view is evidenced by the latest IPOs of Mainland companies which continue to adopt the A+H model.*

3. *The implementation of the QDII scheme will provide qualified institutional investors and financial institutions the benefits of adopting international standards and practices, and encourage them to demand these same standards and practices back home. Over time, this will improve the further development of the Mainland markets in terms of the level of market sophistication and international best practices. The QDII scheme opens up opportunities for Hong Kong as well, but innovation is key. If we are to attract funds to Hong Kong, we need to continue offering more and better financial products and services to meet the varying needs of different investors.*

1 This paper is for pure fact-finding and research purposes, and is not an attempt to comment on the developments of any markets/companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

Background and Objective

4. In recent years, the Mainland government has embarked on a number of market reforms. The ultimate goal of these has been to develop the capital markets on the Mainland through market forces and proper regulation. A main focus has therefore been on enhancing the quality of issuers (i.e. listed companies in this paper) and intermediaries, and improving the knowledge of investors about the financial markets. The recent share reform and QDII scheme are important steps in this direction. But they have implications for the Hong Kong stock market also. This paper discusses the current status of these two reforms, and how Hong Kong should be positioning its own market amid these developments.

The Share Reform

Background

5. Prior to the share reform, about two-thirds of the shares in the Mainland stock markets were "state shares" or "legal person shares". These shares were not listed and hence not tradable. The existence of non-tradable shares meant the interests of major shareholders, minority shareholders and management do not always coincide. The objective of the share reform is to list the non-tradable shares. By doing so, the shares become tradable and the various interests better aligned. This in turn can help improve corporate governance and ultimately enhance investor confidence.

6. The share reform started in late April 2005. As the listing of non-tradable shares would inevitably increase the supply of shares, the Mainland authorities paused all fund-raising activities in the domestic market. As a result, Hong Kong became the prime fund-raising centre for Mainland companies over the period. During 2005, the total amount of funds raised in Hong Kong was HK$302 bn, making Hong Kong the fifth largest fund-raising market in the world and the largest in Asia. Of this HK$302 bn, HK$159 bn (or 53%) was attributable to H-share companies.

Latest Developments

7. At present, out of the 1,372 listed companies in the Mainland, 991 companies have completed the share reform or are in the reform process. Their total market cap accounted for over 70% of the market total. Given the significant progress of the share reform, the China Securities Regulatory Commission (CSRC) decided to resume fund-raising activities in the Mainland markets after a one-year suspension.

8. On 16 April 2006, the CSRC issued a statement saying that it would soon allow companies to float shares on the Shanghai and Shenzhen stock exchanges. According to the statement, the resumption would proceed in three stages:
   - first, allowing listed companies to issue new shares through private placements;
   - secondly, allowing listed companies to issue new shares publicly; and
   - lastly, allowing IPOs.

9. On 7 May 2006, the CSRC revised the rules governing the fund-raising activities of listed companies. On 17 May, the CSRC set out the new guidelines for IPO applicants. On 25 May, China CAMC Engineering Co. Limited announced its IPO plans and became the first company to launch an IPO after the one-year suspension.

Implications for Hong Kong

10. In view of the substantial progress of the share reform and the resumption of fund-raising activities on the Mainland markets, some are concerned that Hong Kong's role as a platform for Mainland companies to raise funds may be affected. However, such concerns are misplaced as they underestimate the full extent of Hong Kong's contribution. Hong Kong serves not only as a platform for Mainland companies to raise funds, but also as a platform for them to raise their corporate governance standards and international visibility. Hong Kong thrives on a market mechanism and embraces international standards and practices such as high regulatory and corporate governance standards. Moreover, Hong Kong has some unique advantages such as its geographical proximity and cultural affinity to the Mainland.

11. The combination of these qualities makes Hong Kong uniquely suited to serve as a platform between the Mainland and the rest of the world, thus creating a win-win situation for both the Mainland and Hong Kong. More importantly, it gives Hong Kong an edge in maintaining its position as a prime fund-raising centre for Mainland companies – notwithstanding the resumption of IPO activities on the Mainland. It is expected that, going

forward, the A+H model will continue to be adopted by Mainland companies as the dominant mode in fund-raising.

Qualified Domestic Institutional Investors (QDII) Scheme

Background

12. Developing a critical mass of high quality intermediaries and a pool of professionals and informed institutional investors is essential to the development of the Mainland capital markets. The QDII scheme will contribute to achieving this.

13. The scheme will bring many benefits for the Mainland. It will enable QDIIs to invest in a wider range of financial products. This will potentially allow them to enhance their returns (which may otherwise be limited due to the limited investment opportunities on the Mainland), and may reduce risks through diversification. The scheme will also expose QDIIs to markets that adopt a sound regulatory framework, and intermediaries that abide by global best practices and standards. Over time, as QDIIs become more familiar with the practices and operations of the more advanced markets, they will see the benefits of adopting international standards and practices and be encouraged to demand these same standards and practices back home. This will eventually improve the further development of the Mainland markets, particularly in terms of the level of market sophistication and international best practices. Hong Kong can play a key role in this process by serving as a platform for Mainland investors seeking to invest overseas, thus creating a win-win situation for both parties.

Latest Developments

14. In 2004 and 2005, the Mainland authorities allowed insurers to use their own foreign exchange (forex) proceeds to invest in overseas markets so long as the investments are within a certain quota. Commercial banks were also allowed to take forex fund-in-trust from individual clients to invest in overseas fixed income products.

15. In April 2006, the People's Bank of China announced that three kinds of financial institutions will be allowed to convert RMB into forex and invest overseas. Specifically:
    - Mainland commercial banks will be able to take RMB fund-in-trust from institutional and individual investors, and convert these into forex for investment in overseas fixed income products;

- Mainland fund management companies and brokers will be able to take forex fund-in-trust and invest these in overseas products including stocks; and
- insurance companies will be able to expand their overseas investment business by converting their RMB funds into forex for investment in overseas fixed income and money market products.

16. In late April 2006, the National Council for Social Security Fund (NSSF) released the *Provisional Rules for National Social Security Fund to Invest Overseas*, followed by the announcement of requirements for selecting its global custodians and fund managers.

17. All of these were perceived by the markets as part of the Mainland's long-awaited QDII programme.

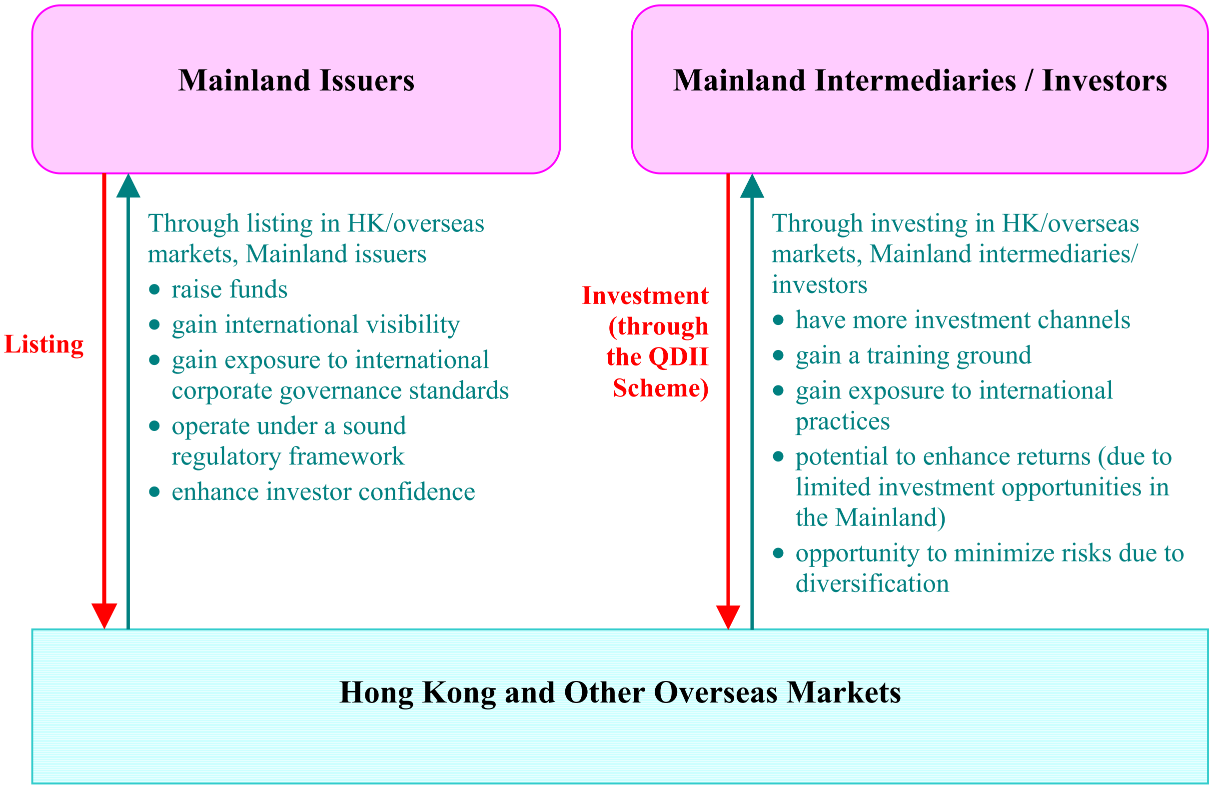
Implications for Hong Kong

18. The relaxation of restrictions on overseas investment and implementation of the QDII scheme is likely to bring new capital to Hong Kong.

19. Some of the funds will be invested in other overseas markets under the QDII scheme, despite a wide range of products being available in Hong Kong. To sustain its competitiveness, Hong Kong needs to continue offering more and better financial products and services to meet the varying needs of different types of investors.

Conclusion

20. As the Mainland economy continues to develop, the need for a well-developed capital market on the Mainland becomes increasingly pressing. Reforms are well under way to improve the Mainland markets by enhancing the quality of issuers and intermediaries and improving the knowledge of investors about the financial markets. Increased participation in international markets will hasten the Mainland's convergence with international standards. Hong Kong can serve as a platform to speed up the reform process on the Mainland and create a win-win situation in the process for both parties. Hong Kong can also serve as a platform for Mainland investors to gain exposure and accumulate experience through investing in overseas markets. To capitalize on the opportunities brought about by the developments in the Mainland, it is important for Hong Kong to continue to build on its existing competitive advantages and to serve as the Mainland's financial gateway to international markets.


Mainland Issuers
Mainland Intermediaries / Investors
Listing
Through listing in HK/overseas markets, Mainland issuers
• raise funds
• gain international visibility
• gain exposure to international corporate governance standards
• operate under a sound regulatory framework
• enhance investor confidence
Investment (through the QDII Scheme)
Through investing in HK/overseas markets, Mainland intermediaries/ investors
• have more investment channels
• gain a training ground
• gain exposure to international practices
• potential to enhance returns (due to limited investment opportunities in the Mainland)
• opportunity to minimize risks due to diversification
Hong Kong and Other Overseas Markets