

# Oversight

## ETF Connect

June 2022

### Introduction

On 27 May 2022, the China Securities Regulatory Commission (CSRC) and the Securities and Futures Commission of Hong Kong (SFC) issued a joint announcement (Announcement) in respect of an in-principle agreement between the CSRC and the SFC regarding the inclusion of eligible exchange-traded funds (ETFs) by Mainland Chinese and Hong Kong exchanges in the Mainland-Hong Kong Stock Connect arrangement (ETF Connect). On the same day Hong Kong Exchanges and Clearing Limited (HKEX) issued frequently asked questions (FAQs) on the inclusion of ETFs for northbound trading via the Mainland-Hong Kong Stock Connect (Stock Connect) and a regular review document regarding inclusion of ETFs in Stock Connect. On 28 June 2022, the CSRC and the SFC issued a further joint announcement (Further Announcement) to state that the trading of ETFs under ETF Connect will commence on 4 July 2022. The HKEX also issued on 28 June 2022 a circular regarding the launch of ETF Connect.

This **Oversight** first provides a brief overview of the background regarding ETF Connect. It then discusses the eligibility requirements and key features of ETF Connect as outlined in the Announcement and the FAQs. Finally it analyses the practical implications arising from the implementation of ETF Connect.

### Background

ETF Connect is an extension of Stock Connect. Stock Connect comprises two schemes: Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, which launched on 17 November 2014 and 5 December 2016 respectively and enabled mutual market access between the Shanghai Stock Exchange (SSE) or the Shenzhen Stock Exchange (SZSE) and The Stock Exchange of Hong Kong Limited (SEHK). Prior to the launch of Stock Connect, Hong Kong investors were unable to trade directly in individual Mainland Chinese stocks but instead had to rely on alternative measures such as the Qualified Foreign Institutional Investors and Renminbi Qualified Foreign Institutional Investors regimes (QFI regime). Stock Connect was developed jointly by the CSRC and the SFC with the objective of establishing mutual stock market access between Mainland China and Hong Kong and promoting the internationalisation of the Renminbi (RMB) and development of Hong Kong as an offshore RMB business centre. According to the Hong Kong government, since launch Stock Connect has sent a net inflow of over RMB1,600 billion to the Mainland Chinese stock markets through “Northbound trading” and brought a net inflow of over RMB2,300 billion to the SEHK through “Southbound trading”.

The idea of ETF Connect was first referenced in a joint announcement of 16 August 2016, which stated that the CSRC and the SFC had reached a consensus to include ETFs as eligible securities under the mutual market access programme, with the aim of expanding the variety of traded products and so providing more investment opportunities for domestic and overseas investors. On 1 June 2021, the market welcomed the first listings of ETFs in Hong Kong and Shenzhen under the Hong Kong-mainland ETF cross-listing scheme (Cross-Listing Scheme). Prior to the issuance of the Announcement, on 24 December 2021 the SSE, the SZSE, the HKEX, the China Securities Depository and Clearing Corporation (CSDC) and Hong Kong Securities Clearing Company Limited (HKSCC) reached an agreement on overall inclusion arrangements for eligible ETFs under Stock Connect. Accordingly whilst the Announcement and the introduction of ETF Connect is not a surprise it has had a long gestation period.

## Eligible ETFs

To be eligible for inclusion under ETF Connect, ETFs listed on the SSE or the SZSE and the SEHK will have to satisfy various criteria including as regards fund size and constituents of the index tracked by a fund. The requirements differ according to whether the ETF concerned are to be southbound or northbound traded.

### Southbound ETFs

Hong Kong ETFs that are listed on the SEHK and primarily regulated by the SFC will have to satisfy the inclusion criteria below in order to be accepted as eligible ETFs for “Southbound trading” i.e. traded out of Mainland China via ETF Connect. In particular, it should be noted that such eligible ETF must be primarily listed on the SEHK, which means it must be domiciled in Hong Kong and be managed by a Hong Kong-based and SFC licensed fund manager. In this regard cross-listed ETFs on the SEHK will not be eligible for southbound trading. Furthermore, as detailed below, there are relatively strict eligibility requirements in particular as to the weighting of constituents in the relevant benchmark indices.

- The ETF must not be a synthetic ETF or Leveraged and Inverse Product.
- The ETF must be traded in Hong Kong dollars.
- The ETF must have a daily average AUM of at least HK\$1.7 billion in the last six months.
- The ETF must have been listed for at least six months.
- The benchmark index of the ETF must have been launched for at least one year.
- The total weighting of SEHK-listed stocks in the benchmark index must account for at least 90%.
- The total weighting of Stock Connect eligible constituents in 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 be at least 70%. For other benchmark indices, the total weighting of Stock Connect eligible constituents must be at least 80%.
- Various criteria regarding constituent stocks apply. For instance, regarding broad-based indices, a constituent stock must not be more than 30% of the relevant index’s weighting. This is similar to the relevant requirements under the SFC’s Code on Unit Trusts and Mutual Funds (UT Code), where an index with a single constituent security weighing more than 20% or having few constituent securities would generally not be accepted by the SFC.

For those ETFs that satisfy the inclusion criteria, if such ETFs subsequently fall within any of the exclusion criteria below, they will then become “sell-only” securities and will therefore be subject to purchase restrictions. The exclusion criteria are:

- The ETF becomes a synthetic ETF or Leveraged and Inverse Product.
- The ETF has a daily average AUM of less than HK\$1.2 billion in the last six months.
- The total weighting of SEHK-listed stocks in the benchmark index accounts for less than 85%.
- The total weighting of Stock Connect eligible constituents in HSI, HSCEI, HSTECH and HSHKBIO falls under 65%. For other benchmark indices, the total weighting of Stock Connect eligible constituents falls under 70%.
- Various criteria regarding constituent stocks apply. For instance, regarding broad-based indices, the exclusion criteria is met when a constituent stock exceeds 30% of the relevant index’s weighting.

### Northbound ETFs

Mainland Chinese ETFs that are listed on either the SSE or the SZSE will similarly have to satisfy the inclusion criteria below to be accepted as eligible ETFs for “Northbound trading” i.e. traded out of Hong Kong via ETF Connect.

- The ETF must be traded in RMB.
- The ETF must have a daily average AUM of at least RMB1.5 billion in the last six months.

- The ETF must be listed for at least six months.
- The benchmark index of the ETF must have launched for at least one year.
- The total weighting of SSE-listed and SZSE-listed A shares in the benchmark index must account for at least 90%.
- The total weighting of Stock Connect “Northbound trading” eligible constituents in the benchmark index must be at least 80%.
- Various criteria regarding constituent stocks apply. For instance, regarding broad-based indices, a constituent stock must not be more than 30% of the index’s weighting.

For those ETFs that satisfy the above inclusion criteria, if such ETFs subsequently fell within any of the exclusion criteria below upon regular review by the SEHK, they will then become “sell-only” securities and will therefore be subject to purchase restrictions.

- The ETF has a daily average AUM of less than RMB1 billion in the last six months.
- The total weighting of SSE-listed and SZSE-listed A shares in the benchmark index accounts for less than 85%.
- The total weighting of Stock Connect “Northbound trading” eligible constituents in the benchmark index falls under 70%.
- Various criteria regarding constituent stocks apply. For instance, regarding broad-based indices, the exclusion criteria is met when a constituent stock exceeds 30% of the relevant index’s weighting.

The initial list of ETFs eligible for “Northbound trading” included in ETF Connect has now been published on the SEHK website. The SEHK website will also contain updated lists to assist market participants to differentiate whether a security is an eligible stock or a sell-only security for the purposes of ETF Connect.

## Regular review

Regular reviews will be performed by the SEHK to determine the list of eligible ETFs for inclusion in ETF Connect based on the inclusion and exclusion criteria set out above.

Regarding “Northbound trading”, the eligibility of SSE-listed and SZSE-listed ETFs will be determined based on relevant data as of the relevant regular cut-off dates and on the first predetermined data cut-off date at the launch of ETF Connect. The list of ETFs eligible for “Northbound trading” will be published after the relevant cut-off dates on a regular basis. Regarding “Southbound trading” of eligible SEHK-listed ETFs, regular review data cut-off dates will also apply and the relevant list will be updated on a regular basis.

## No creations and redemptions

According to the Announcement, eligible ETFs under ETF Connect may only be traded on exchange, i.e. via the secondary market. As such there will be no creations or redemptions via ETF Connect.

The fund sizes of eligible ETFs for “Northbound trading” will be able to be accessed on the SSE website ([here](#)) and the SZSE website ([here](#)).

## Quota

Similar to Stock Connect, the trading volume of ETFs under ETF Connect will be subject to a daily quota. Under the existing Stock Connect arrangements, “Northbound trading” and “Southbound trading” are subject respectively to a separate set of daily quota, which are monitored by the SEHK and the SSE or the SZSE respectively. The “Northbound trading” daily quota is set at RMB52 billion for each of SSE Stock Connect and SZSE Stock Connect, and the “Southbound trading” daily quota is set at RMB42 billion for each of SSE Stock Connect and SZSE Stock Connect. It should be noted that the same “Northbound trading” daily quota will be shared among A shares and eligible ETFs for “Northbound trading” under Stock Connect and ETF Connect respectively.

## Trading eligibility

According to the FAQs, although most trading arrangements such as the lot size, trading quota, short selling and arrangements on order cancellation will follow the existing practice for “Northbound trading” of A shares under Stock Connect, the trading of eligible ETFs will differ from trading A shares under Stock Connect regarding trading hours, eligibility criteria in relation to price limit and spread, fees and levies, and stock code.

## Marketing

ETFs are collective investment schemes and therefore marketing of ETFs in Hong Kong is regulated primarily by the provisions of the Securities and Futures Ordinance (SFO). Section 103 of the SFO prohibits the issuance of any advertisement, invitation or document which is or contains an invitation to the Hong Kong public to invest in an collective investment scheme unless the issue is authorised by the SFC or an exemption applies. Whilst it should be noted that the UT Code states that ETFs may be considered and treated as either listed securities or collective investment schemes subject to the relevant respective requirements accordingly, this is only in relation to diversification requirements.

Regarding listed securities, although section 103(2)(a) of the SFO provides that the prohibition regarding advertisement mentioned above does not apply to the issuance of an advertisement, invitation or document made by or on behalf of an intermediary licensed or registered for Type 1, Type 4 or Type 6 regulated activity, this is qualified by section 103(11) of the SFO which provides that section 103(2)(a) of the SFO does not apply to anything done by any person in respect of any interest in a collective investment scheme that is not authorised by the SFC. Therefore, although a collective investment scheme, such as an ETF, may be marketed to professional investors without requiring SFC authorisation, in practice the SFC will only permit the public advertising of collective investment schemes such as ETFs which it has authorised.

Accordingly with regard to any marketing of eligible Mainland Chinese ETFs under ETF Connect in Hong Kong, the same considerations will apply as those applicable to collective investment schemes in general. Whilst the requirements in this regard have yet to be addressed by the SFC, it is possible that such Mainland Chinese ETFs will need to be required to be authorised by the SFC before they can be publicly marketed in Hong Kong. Since Mainland Chinese ETFs eligible for inclusion under ETF Connect are passive index-tracking ETFs, it should be noted that under the UT Code, a relevant ETF may be authorised by the SFC as an “index fund” (i.e. a collective investment scheme, the principal objective of which is to track, replicate or correspond to a financial index or benchmark, with an aim of providing or achieving investment results or returns that closely match or correspond to the performance of the index). In addition under the mutual recognition of funds (MRF) between Mainland China and Hong Kong in place since May 2015, physical index-tracking ETFs are within the scope of MRF eligibility requirements. As such where such Mainland Chinese ETFs seek authorisation by the SFC these may be processed as standard applications provided that the relevant requirements are met. In brief, despite ETF Connect, only eligible Mainland Chinese ETFs which are authorised by the SFC, whether or not they are listed on the SEHK or not, will be allowed to be publicly marketed in Hong Kong as opposed to merely being available to be traded via ETF Connect.

## Delisting arrangements

For existing Stock Connect securities, there are no delisting arrangement periods which are imposed on SSE or SZSE securities if they are delisted as a result of the relevant compulsory delisting criteria. However, for stocks which are compulsorily delisted due to other circumstances, these are subject to a delisting arrangement period of 15 trading days.

For ETFs eligible for “Northbound trading” under ETF Connect, there will be no delisting arrangement period, which means that if an eligible Mainland Chinese ETF is delisted from the SSE or the SZSE, such ETF will be removed from the eligible ETF list starting from the date when further buy or sell orders of the delisted ETFs will not be accepted.

For delisting arrangements in respect of ETFs listed on the SEHK, further to an update by the SEHK in August 2018, the SEHK may either publish a delisting notice stating the SEHK’s right to delist an issuer if the issuer fails to resume trading within the period specified in the notice, or delist the issuer immediately in appropriate circumstances.

## Implementation timeline

As stated in the Further Announcement, the trading of ETFs under ETF Connect will commence on 4 July 2022, which is slightly earlier than the original timeline suggested in the Announcement. According to the Announcement, eligible ETFs will only be officially included in Stock Connect after (i) the trading and clearing rules and systems have been finalised; (ii) all regulatory approvals have been granted; (iii) market participants have sufficiently adapted their operational and technical systems; (iv) all necessary arrangements for cross-boundary regulatory and enforcement cooperation have been put in place; and (v) investor education measures have been determined. In this regard, it has been announced in the Further Announcement that such arrangements have been agreed between the CSRC and the SFC. The Further Announcement also states that the CSRC and the SFC will continue their efforts to educate investors and improve their investment knowledge related to ETF Connect, enhance enforcement cooperation against cross-boundary illegal activities and market misconduct, and make timely and appropriate responses to any contingencies or major events in order to maintain the orderly operations of ETF Connect and protect the interests of investors.

## Practical implications

The launch of ETF Connect shortly after the 25th anniversary of 1997 is a significant step in the eight-year journey regarding the establishment of mutual stock market access. Since the launch of Stock Connect, further connect schemes have been launched, including the launch of Bond Connect in July 2017 and Wealth Management Connect in Guangdong-Hong Kong-Macao Greater Bay Area (GBA) in June 2020. It is hoped that ETF Connect will consolidate Hong Kong's role as a bridge for flows of international and Mainland Chinese capital. Compared to past attempts at financial integration between the GBA and Hong Kong such as the Cross-Listing Scheme, ETF Connect may provide a more cost-effective way for issuers to make their ETFs available on a cross-border basis. Due to the low trading costs of ETFs, ETF Connect may attract more investors in making cross-border investments and improve the liquidity of relevant ETF markets.

The implementation of ETF Connect may allow further trading of technology securities by way of investment in related ETFs given that various technology stocks are not eligible to be traded under the current Stock Connect programme. However, after years of growth, it is noted that the technology industry in Mainland China has recently been impacted by tightened legislation and scrutiny from Mainland Chinese authorities. It is therefore questionable whether ETF Connect will boost investment in Mainland China's technology sector.

The list of limitations regarding operational procedures and thresholds in respect of eligible ETFs stated in the FAQs may deter potential market participants. Similar to other market mutual access programmes, whether the launch of ETF Connect will be able to garner strong interest and bring in substantial investment may depend on the variety of investment products available via ETF Connect. Whilst the SFC admits that the scope of ETF Connect is narrow, the programme may gain traction if the relevant eligibility requirements are relaxed. It has tended to be the case that similar arrangements are initially tested in a limited way before being broadened.

## Conclusion

Six years subsequent to the kite first being flown, the key features of ETF Connect have finally been worked out. Not only is ETF Connect expected to be a key enhancement to Stock Connect in terms of variety of investment products, it will also likely be able to improve the connectivity between the markets in Hong Kong and Mainland China. However, despite ETF Connect having similar key features as trading of A-shares under Stock Connect, the strict eligibility threshold in respect of ETFs may hinder the attractiveness of ETF Connect to many investors. In addition, the promotion in Hong Kong of Mainland Chinese ETFs which are eligible under ETF Connect will be limited by the legal framework under the SFO for marketing collective investment schemes unless the Mainland Chinese ETFs are separately authorised by the SFC under MRF. It is hoped that the relevant requirements will be reviewed and adjusted as appropriate following implementation of ETF Connect.

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