

# MARKET CONSULTATION ON PROCESS DEFINITION OF CHINA CONNECT STOCK LISTINGS

24 January 2020



## Content of the Market Consultation

Solactive AG has decided to conduct a Market Consultation regarding standardized treatments to address potential issues of inclusion of China A-shares in indices in the context of the **China Connect Stock Program**. These treatments include the introduction of a "Blocked List" for shares which have been removed from the Positive List (Eligible Securities) and an Extraordinary Rebalancing mechanism in the event the minimum members constraint of an index is breached due to removal of shares from the Positive List.

## Introduction to the China Connect Stock Program

To gain a better understanding of the topic of China Connect Stock Program, the following terms are discussed in detail in the section below.

### Differentiation between A-, B- and H-Shares

The Chinese stock market is categorised into different share classes depending on the availability to domestic investors and foreign investors. For the purpose of this market consultation, share classes A-, B-, and H- are discussed here in detail. These share classes differentiate themselves by different currency denominations and their degree of tradability for foreign investors.

#### A-Shares:

A-shares are listed on the Shanghai and Shenzhen Stock Exchange (SSE and SZSE respectively) and denominated in the local currency Renminbi (RMB). The A-shares were primarily available to domestic investors and to "Qualified Foreign Institutional Investors" (QFII) holding a special license for trading Chinese A-shares. Under the China Connect Stock Program, A-shares are now also available to international investors who do not hold a special license. Accordingly, this type of investors is now able to participate in the stock market of Mainland China with subject to restrictions as described in the section Rationale (see below).

#### B-Shares:

B-shares are listed on the Shanghai and Shenzhen Stock Exchange and denominated in foreign currency (on Shanghai Stock Exchange in United States dollar (USD) and on Shenzhen Stock Exchange in Hong Kong dollar (HKD)) while their face value is quoted in Renminbi. This type of shares was initially only available to foreign investors. Since February 2001 residents of the People's Republic of China are able to trade B-shares on the secondary market.

#### H-Shares:

H-shares are shares of companies incorporated in Mainland China listed on the Hongkong Stock Exchange and denominated in Hong Kong dollar (HKD). They can be listed instead of a B-share listing or in addition to a B-share listing to be tradable by foreign investors.



A-shares are included in the four indices from the Shanghai and Shenzhen Stock exchange (for more detailed information please follow the link: [https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Market-Participants/EP\\_CP\\_Book\\_En-\(3\).pdf](https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/Information-Book-for-Market-Participants/EP_CP_Book_En-(3).pdf)), which represent the universe for trading by foreign investors under Northbound Trading (see Rationale). This only accounts for companies which do not hold an additional H-shares listing on the Hong Kong Stock Exchange (SEHK). Companies which hold an A-shares and H-shares listing simultaneously can be freely traded under the **China Connect Stock Program** without being a constituent of the relevant indices in the first place (see Rationale below). The indices are rebalanced semi-annually at Close of Business on the **2<sup>nd</sup> Friday in June and December**.

## Rationale

With the **China Connect Stock Program** the People's Republic of China has allowed foreign and (residential) Hong Kong investors to participate within the Chinese stock market of Shanghai and Shenzhen (buy and sell A-shares). This was formerly restricted for international investors, not holding a QFII license described under term "A-Shares". That concept is formally referred to as "Northbound trading" while "Southbound trading" allows residents of Mainland China to invest in **foreign and Hong Kong stocks**.

However, this stock market participation is subject to a specified framework (as follows).

For Northbound trading the following securities under Shanghai-/Shenzhen Connect are eligible:

"SSE Securities"	"SZSE Securities"
1. All constituents of the two designated Indices.	1. All constituents of the two designated indices which have a market capitalization of not less than RMB 6B.
2. All the SSE-listed A shares that are not included as constituent stocks of the relevant indices, but which have corresponding H-shares listed on SEHK.	2. All the SZSE-listed A-shares which have corresponding H-shares listed on SEHK.

With the following exceptions:

- a) SSE-/SZSE-listed shares which are not traded in RMB
- b) SSE-/SZSE-listed shares which are under risk alert



The **China Connect Stock** Program also includes a risk management board which continuously monitors the underlying securities of the China Connect universe. The board is authorized to put a security under risk alert if they are in an actual delisting process or are in danger of a possible delisting due to non-fulfillment of the listing requirements for SSE or SZSE Securities. The securities of companies under risk alert are no longer eligible for buying but are eligible for selling ("Sell-only Securities").

Implications for Solactive as an index provider:

Under the **China Connect Stock Program**, the instruments which are no longer eligible for buying will be deleted from the current composition of Solactive Indices. Since, depending on the index type (e.g. divisor formula), a corporate action (e.g. dividend distribution) of another index member could lead to a des-/investment in the divisor and, therefore, the index shares would increase for all index members. This in turn would result in a tracking error, because the instrument which is no longer eligible would be excluded from buying ("Sell-only Securities").

To monitor eligible/ineligible securities or securities which are subject to possible changes (e.g. delisting, risk alert, cease as components of the reference indices of the SSE-/SZSE-universe, etc.), the Hong Kong Stock Exchange provides three types of lists concerning the eligibility of securities under Shanghai- and Shenzhen Connect.

**The lists are as follows:**

- "Positive List": Contains securities eligible for buying and selling unrestricted
- "Negative List": Contains securities only allowed for selling
- "Change List": Contains upcoming changes to securities mentioned in above mentioned list (e.g. share of company x is subject of put on Negative/Positive List)

These lists can be found under the following link:

[https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Eligible-Stocks/View-All-Eligible-Securities?sc\\_lang=en](https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Eligible-Stocks/View-All-Eligible-Securities?sc_lang=en)

For more detailed information about the China-Connect Stock Program, please follow the link:

[https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ?sc\\_lang=en](https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ?sc_lang=en)



## Proposed Changes for Treatment

Concerning our intention to implement china connect listings in our indices, Solactive is considering two main treatments to confront possible challenges which are uprising due to the special properties of these listings as described above. Main consequences would be increased turnover and possible violations of index selection criteria. Therefore, the following measures will be implemented:

- **“Blocked List”**
  - Past eligibility changes show that stocks which have been removed from the Positive List have a higher probability of being removed again. This means that if a stock has been removed and added again to the Positive List, it is more likely to be removed from the Positive List in the future (although the probability of repeated removals decreased significantly over the last years). Therefore, Solactive suggests for companies which have been removed from the Positive List will be blocked for 60 weekdays starting after the readmission on the Positive List (e.g. if company has been removed from the Positive List on 01.09.2019 and put back on the Positive List on 30.09.2019, the instrument would be blocked from getting into any Solactive index for 60 weekdays starting from the 30.09.2019). This measure helps to minimize unnecessary turnover.
  
- **“Extraordinary Rebalancing”**
  - For the case that removals of instruments from the Positive List result in a breach of the minimum constituents constraint (if there is a constraint) of an Solactive index, Solactive suggests to implement an Extraordinary Rebalancing to ensure that the minimum members criteria is met again and the index is reflecting its investment objective (and is also compatible with funds regulations). The mechanism would be as follows:



<u>EVENT</u>	<u>PROCEDURE</u>
Day the breach actually happens (e.g. 09.01.2020)	<b>Selection Day (cob)</b> of the extraordinary rebalance (09.01.2020)
Rebalance (e.g. 17.01.2020)	<b>Rebalance Day (cob)</b> according to the guideline (e.g. 5 BD in between Rebalance Day and Selection Day)

Exception:

- In case the next upcoming ordinary rebalance takes place as scheduled within the upcoming 15 Index Calculation Days, the index will calculate with less members than the minimum number of constituents initially defined by the guideline in order to avoid unnecessary costs.



Feedback on the proposed changes

If you would like to share your thoughts with Solactive, please use this consultation form and provide us with your personal details and those of your organization.

Name	
Function	
Organization	
Email	
Phone	
Confidentiality (Y/N)	

Solactive is inviting all stakeholders and interested third parties to evaluate the proposed measures and welcomes any feedback on how this may affect and/or improve their use of Solactive indices.



## Consultation Procedure

Stakeholders and third parties who are interested in participating in this Market Consultation, are invited to respond until **February 21<sup>st</sup>, 2020** (cob).

Please send your feedback via email to [compliance@solactive.com](mailto:compliance@solactive.com), specifying "**Market Consultation Process Definition concerning China Connect listings**" as the subject of the email, or

via postal mail to: Solactive AG  
Platz der Einheit 1  
60327 Frankfurt am Main  
Germany

Should you have any additional questions regarding the consultative question in particular, please do not hesitate to contact us via above email address.



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