STOCK MARKET INTEGRATION

IN

CHINA AND HONG KONG

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I. INTRODUCTION

The People's Republic of China (PRC) has undergone enormous economic change during the last 17 years from a centrally planned economy to the current socialist market economy, while Hong Kong has been a capitalist society for at least a hundred years under the British rule. Both have enjoyed high rates of growth and economic interdependency; both have seen the need for mutual cooperation and integration; and both have pledged to each other economic prosperity prior to and after 1997 when Britain returns Hong Kong to PRC. Nevertheless, striking differences exist in their economic and financial systems.

Hong Kong has had a relatively long history of a stock market. The first share was traded in the British colony in 1866. Four stock exchanges were in operation in such a tiny place, with its population of less than 6 million, before April 2, 1986 when the Stock Exchange of Hong Kong Ltd commenced trading with the unification of the four. Its sizeable neighbour, with a population of 1.2 billion, PRC had essentially nothing like a capital market --- not a single stock had ever been traded in the four decades since 1949. Not until fairly recently did three national stock exchanges mushroom within two weeks time --- Shanghai Stock Exchange on November 26, Shenzhen Stock Exchange on December 1, and Securities Trading Automated Quotation system on December 5, 1990.

As the handover in 1997 approached, Hong Kong's stock market index suffered from every rumour ranging from Deng Xiaoping's health to the nomination of Hong Kong's new Chief Executive. Despite the geographic and economic closeness, however, there lie tremendous differences. Hong Kong's GNP per capita is over US$ 22,000 while China's is only US$ 470. Hong Kong Stock Exchange is ranked number 6 in the world while PRC is number 32, putting Shanghai Stock Exchange and Shenzhen Stock Exchange together. The economic level of development in Hong Kong, its living standard and its status as the regional economic and financial centre have made it all the more superior to its big neighbour. That China has overwhelming political power over Hong Kong, on the one hand, and Hong Kong has economic superiority over the mainland, on the other, demonstrates the region's uniqueness in every aspect of life.

The Sino-Beritish Joint Declaration, signed by British Prime Minister Thatcher and Chinese Premier Zhao Zhiyang in 1984, provided for the handover of Hong Kong's sovereignty by 1997. As part of that agreement, the Basic Law outlines the framework of "One country, two systems" (Deng Xiaoping's exact words) for Hong Kong. It literally means, regardless of the event of the handover in 1997, that Hong Kong will continue practising under the Common Law system, at least for the next 50 years.

Under such a complicated conditionality, the word *integration* of stock markets between China and Hong Kong would have a different meaning from many other regions (European integration, for example). Political subtlety may make this word differ from its original sense. The term used in this paper carries no political implications of whether

PRC stock market is to be integrated into Hong Kong's or vice versa, but rather to provide a real picture of what is going on among the major stock markets in the region. Terms like linkage or interaction are alternatively used sometimes in place of integration.

The difficulty in analysing the stock markets activities and the financial environments lies in the exceptional inadequacy of legal infrastructure in the area of securities trading, foreign investment, currency controls and listing requirements, etc. To be more precise, even in the presence of laws or regulations, the undergoing practices may still be quite different from other regions. Chinese culture often allows people to conduct their business in a manner of moral judgement rather than obeying legal procedures. Relation-building instead of legal governance is the usual conduct in business in the region. In PRC especially, there is always a lack of laws and regulations. Therefore, it is a common practice for the average person to put morality before law. Hong Kong will be law-based as it was under the British Common Law system, but only within its physical boundaries. Once doing business across the border in mainland China, Hong Kong businessmen would immediately behave the same as native mainlanders. This helps explain the relation of stock markets in the region. This report deals with both the legal aspects as well as the underlying practices in the region.

Owing to the great disparity of the region's political and economic situation, this report avoids using econometric models. Either there would be a too much system noise in the model or the answers would be divergent or multifaceted. Instead, we create indicators as descriptive illustrations of the integration of the region's stock exchanges.

Despite the difficulties, there are also a lot of similarities and positive features. Within this region, all the exchanges are in the same time zone, people speak the same language---Chinese, and the deeply rooted Confucian culture prevails.

This paper is structured with Part I as an Introduction. Part II gives an overview of Hong Kong's and China's major stock exchanges, with an emphasis on cross-listing and trans-border trading. Part III deals with the general background of integration, and the institutional, legal, and political aspects. Part IV covers issues of the primary market regulation and co-operation, the secondary market regulation and co-operation and the policies that hamper or enhance integration. Part V looks into the future and tries to project directions to further stock market integration in this region. Part VI concludes.

II. OVERVIEW OF STOCK MARKETS IN THE REGION

Hong Kong is currently ruled by Britain under the Common Law system. Issues between Hong Kong and PRC in terms of the securities industry are generally considered as inter-country or Sino-British relations. After 1997 when Hong Kong becomes a part of China, the existing legal framework will still be maintained and carried on by Basic Law for at least 50 years. Therefore, Hong Kong and PRC will keep two separate political, economic and legal systems, making it hard for the two stock markets to physically merge in the future. Nevertheless, there will be an increasing linkage and cooperation between the two.

In Hong Kong, the Stock Exchange of Hong Kong Ltd (SEHK) is the only stock exchange which is being watched carefully by Securities & Futures Commission (SFC) and the Hong Kong government Monetary Authority on top; while in PRC, the securities industry is a relatively new business. Two national exchanges – the Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) - and the Securities Trading Automated Quotation System (STAQ), a computerised OTC system, were established only as experiments, fewer than five years ago. In order to carry out the experiment, PRC government has set up two institutions, the State Council Securities Commission, a policy-maker and China Securities Regulatory Committee (CSRC) as its executive body, to carefully watch and develop the securities market.[1]

The cooperative arrangement between Hong Kong and PRC is very important in H shares, Red Chip shares, and other cross-border issues. At the government level between Hong Kong and PRC, a Memorandum of Understanding (MOU) has been signed and joint meetings concerning H share issues and other cross-border issues have been held on a monthly basis. Working relations between the institutions on both sides are extremely cordial.[2] This is described in detail later in the paper.

A. STOCK MARKETS IN HONG KONG AND CHINA

1. Hong Kong

Formal trading did not begin in Hong Kong until 1891, but exchange records show that stockbrokers were operating as early as 1866, the year after Hong Kong's first Companies Ordinance passed. In 1891, the Association of Stockbrokers in Hong Kong was formed. It was renamed The Hong Kong Stock Exchange in 1914. A second exchange, the Hong Kong Stockbrokers' Association, was started in 1921. In 1947 these two merged to form the Hong Kong Stock Exchange Ltd. It existed as the only exchange until 1969 when, to counter its reluctance to admit new members, the Far East Stock Exchange was set up by a group of Chinese businessmen. This stimulated business and attracted new money to the colony. It also inspired the establishment of two other

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[1] Speaking at the 21st Annual Conference of the International Organisation of Securities Commissions in September, 1996 Mr Zhou Dodging, Chairman of the China Securities Regulatory Commission said: "The role of China's securities regulatory authorities can be summarised as follows: to nurture and regulate the market."

[2] Also in the above situation, Mr Anthony Neoh, Chairman of the Securities and Futures Commission Hong Kong, responding to an acknowledgement by Mr Zhou Daojiong, Chairman of CSRC, that "China and Hong Kong had a lot to learn from each other", said "The challenge for Hong Kong is to use our open [capital] markets and internationally oriented and respected systems, to continue to prosper and to help China to prosper."

exchanges --- the Kam Ngan Stock Exchange, which was set up in 1971 by members of the Chinese gold and silver exchange, and the Kowloon Stock Exchange, established by private entrepreneurs in 1972 but which never developed to any significant degree. The government then intervened to prevent the formation of further exchanges. On April 2, 1986, the four exchanges merged to form the Stock Exchanges of Hong Kong Ltd (SEHK).

By the end of 1995, there were 329 corporate members and 230 individual members. The highest decision-making body is the 31-member council. It is composed of individual brokers, corporate brokers and independent members from the business community, headed by its Chief Executive. All new policies and rules must be approved and endorsed by the council and the Hong Kong Securities and Futures Commission (SFC), the regulator of securities industry, before being put into practice.

On December 31, 1995, 1,033 securities were listed on the exchange, of which 542 were shares and the rest were 244 warrants, 184 debt securities, 52 unit trusts/mutual funds, etc. Of the 542 company stocks, 518 were domestic, 24 were foreign companies and 17 were PRC-incorporated enterprises known as H shares. So far, no Hong Kong company stock is listed in mainland China.

Market capitalisation by the end of 1994 was HK$ 2.1 trillion (US$ 270 billion[3]) and by December 31, 1995, HK$ 2.35 trillion (US$ 304 bn). The total volume of shares traded during 1995 was 306.7 billion and the turnover value was HK$ 806.4 bn (US$ 104.32 bn). In trading, it is ranked the 6th in the world.

The main index used in the exchange is Hang Seng Index, composed of 33 major stocks. Each stock is weighted so that it will influence the index in proportion to its respective market value. Sometimes they are referred to as “Blue Chips”. The Hang Seng MidCap 50 Index is made up of the 50 most-actively traded stocks, with an average market capitalisation of HK$ 4bn. The Hang Seng China Enterprises Index is composed solely of all H share companies, listed on the SEHK since 1993. An H share is listed in Hong Kong by PRC state-owned enterprises. By the end of 1995, 17 H shares had been issued and listed on SEHK.

Since February 1989, SEHK has indexed every ordinary share listed on the exchange except foreign stocks. This is known as All Ordinaries Index. Among all the stocks, about 39 are referred to as "Red Chips.”[4] These companies are Hong Kong registered but have powerful state-owned parent companies in mainland China. These are different companies from the “official” H share companies. Bloomberg currently runs the

[3] The exchange rate of HK dollar to US dollar used hereafter is 7.73:1.
[4] The (Bloomberg) Red Chip Index is trading with 23 times P/E as compared to Hang Seng Index at 15 times P/E. Source: Bloomberg.

Bloomberg Red Chip Index, which, for instance, was up 35 percent in the year prior to October 1, 1996, twice the rise of the benchmark Hang Seng Index. Just to give an idea of market performance, the Hang Seng Index had an overall rise of 22.9% to 10,073.39 from 8,191.04 last year and it stays above 13,000 to date. The market average P/E finished at 11.44 times at the end of 1995.

A survey shows that market turnover is shared almost equally between retail and institutional investors, with an increasing share from the institutional investors (60% by June 1996). Local investors contributed nearly half of market turnover; and international newcomers continue to take a bigger share. Most of the foreign participation (70%) came from the UK, Europe, and the U.S. Many regional mutual funds are quoted locally and invest mostly in Hong Kong, with smaller investments in other exchanges such as Singapore, Malaysia and, very occasionally, the Philippines and Thailand. There are 46 regional and international funds quoted in Hong Kong. Dutch and UK-based unit trusts and mutual funds have invested in the Hong Kong market for a long time, and, in recent years U.S. institutional investors have also begun to invest more heavily. It is believed that PRC has a large investment in Hong Kong as well.

2. People's Republic of China

Stock trading was not a complete blank in Chinese modern history. The first stock market was informally set up in Shanghai as early as in 1914, though it was not officially opened until 1920. The market's focus was on trading government bonds. Thereafter, stock markets were also opened in Beijing and Tianjin. In 1949 when the Chinese Communist Party came to power, the stock exchanges were forced to close and all securities were abolished. However, the PRC securities re-emerged in the 1980's following the introduction of China's economic reform programs. As nearly every reform measure has to be tested to see if it is successful before it is granted full official status, the securities market, according to the CSRC, is still in an experimental stage in PRC. Whether or when it will be fully recognised depends on economic performance and how quickly the ideological barrier can be removed. In late 1996, Zhou Zhenqing, chairman of the policy-making State Council Securities Commission, said "more than six years of experience prove that the securities market can undoubtedly serve the socialist market economy," and "the stock markets helped the economy in a variety of ways, including giving firms a means of raising funds."[5] This speech was a key indication of the central government support for the stock markets. Authorities have taken a variety of measures to boost markets in Shanghai and Shenzhen, particularly to make them more competitive before the Hong Kong handover.

PRC allowed its state-owned companies to issue Legal Person shares[6] as the first

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[5] Reuters 10/11/96, see Hong Kong Standard.

[6] Initially, PRC allowed institutions (primarily state-owned companies) to issue shares that did not have full corporate status. Such "Legal Person shares" were traded domestically only.

experiment in securities market. Then it allowed A shares for domestic investors and B shares[7] for foreign buyers. H shares were offered in 1993. Finally, N-shares referred to New York Stock Exchange listing, one Singapore listing and a few Australian listings. China announced that a major PRC company would list its shares on the London Stock Exchange before the end of 1996.[8] China intends to have an increasing number of foreign listings. Memoranda of Understanding have been signed with five major countries and additional MOUs are in the experimental stage. Since 1993, H share companies have listed on SEHK in three stages, and the fourth is coming soon with an even larger number of Chinese companies to list. There is a growing trend to have more PRC companies, mostly state-owned, list on SEHK. One strong feature of the PRC stock market is that it remains mainly as a primary market with too many IPOs pouring in. Therefore, price movement is much more volatile than HKSE and the secondary market is thin in general.

Shanghai Stock Exchange (SHSE), founded November 26, 1990, began trading securities December 19 of the same year. It is the first securities exchange in mainland China. The exchange is a non-profit legal entity with a membership in 1996 of 554 firms from all parts of China. In addition, 25 overseas brokers have obtained special seats on the floor. There are mainly two types of stocks traded: A shares, which are bought and sold only by Chinese investors, and B shares, which are restricted to foreign investors. By the end of 1995, 184 A shares and 36 B shares had listed on SHSE; the market capitalisation for A shares was RMB243.37 bn (US$29.32 bn) and for B shares, RMB9.2bn (US$1.11bn); the total turnover for A shares was RMB304.26 bn (US$36.66 bn) and for B shares, RMB6.09 bn (US$734.7 m).

SHSE has quickly developed into the principal national exchange with 3,700 seats in 8 trading floors,[9] all equipped with computer terminals electronically linked to 23 Exchange Centres in other provinces and major cities of China. The highest authority of SHSE is the general meeting of members and the board of directors, which consists of the chairman, vice-chairman, president and three managing directors. A supervisory committee oversees the day-to-day trading operation. The president is the legal representative who controls daily operation of the exchange.

As described above, PRC companies list shares of two kinds - domestic shares (A shares) which are quoted and traded only among domestic Chinese investors and foreign shares (B shares)[10], which are traded in RMB but quoted in foreign currencies. There is a complication in B shares trading since foreign exchange is under strict control by the State Administration of Exchange Controls. Subscriptions, dividends, and cash distributions to

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[7] In the recent CSRC Provisional Regulation on Domestic Foreign Invested Shares, the B share is changed to "Domestic Foreign Invested Shares".

[8] See 10/08/96 Hong Standard

[9] Currently the eight floors are scattered in different buildings but the SHSE is to move to a new office building next year and all locations will be merged.

[10] In recent modification of Detailed B share listing rule, the term "B share" is replaced by a new phrase as the "Domestic Listed Foreign Investment Shares".

foreign shareholders are paid in foreign currencies (in U.S. dollar at SHSE and in HK dollar at SZSE), based on the same-day official exchange rate.

Major indices are the Shanghai Securities Exchange Index (SSEI), a weighted-average index of all listed shares on SHSE, and the China Index of all listed shares on both SHSE and SZSE.

Shenzhen Stock Exchange (SZSE) is located about 30 miles north of Hong Kong. As Shenzhen is modelled on Hong Kong, SZSE is likewise modelled after SEHK, especially in technical terms. It has gone through several technology updating steps. It is equipped with a computerised network trading system, with paperless book-entry settlement for foreign investors. There are ten foreign brokers currently seated on the exchange, trading B shares. SZSE plans to link electronically with SEHK so that foreign brokers are able to trade B shares at Hong Kong end.

The 157 listed securities include 112 A shares, 23 B shares, 9 bonds, 4 treasury bonds, 8 domestic funds, and a convertible bond. Market capitalisation for all the above securities is RMB120.3 bn (US$14.5 bn). Trade volume in 1995 was RMB894.00m (US$107.7m). Trading is continuously conducted by an order-driven computerised matching system. Buy/sell orders are put into the central computer either through the terminals on the floor or the remote terminals at the broker's office. The bid and offer prices and other transaction information are shown on every terminal and transmitted through a satellite system to all the member brokers nationwide.

Because the city has a history of only 16 years, it has few sizeable industries. Over 90% of the companies listed on SZSE are from the hinterland of China, mostly from industrial and commercial cities other than the Shanghai area. Ironically, though SHSE prides itself on being PRC's No.1 national stock exchange, most of its listed companies are based locally, in the Shanghai area. SZSE is competing with SHSE to become the national stock exchange.

Securities Trading Automated Quotation system (STAQ) is China's prototype securities exchange, trading only among institutions. It started as an experiment. Now, as a computerised OTC securities market, it mainly targets domestic institutional investors as members. The system currently provides its 350 members with real-time price quotations, direct and indirect reading facilities, clearance and settlement, trading information, financial news and other related services. Trading is extremely thin. It also serves other functions, such as assisting CSRC in shaping policies, training professionals, and conducting surveys of the securities industry. Supervised by the State Commission for Restructuring Economic Systems and administered by the CSRC, the STAQ system has operated various trail schemes. For example, the system experimented with the Legal-

Person share,[11] the very first Chinese concept share.

There are 10 Legal-Person shares trading, 4 treasury bonds, 3 corporate bonds, 3 investment bonds and 2 financial instruments. The market capitalisation was RMB125.4bn (US$15.1bn) and trading volume from Jan-Jun 1994, RMB38.7bn (US$4.7bn). Trading hours are from 9:30 AM to 15:30 for bonds and from 9:30 to 11:30, 13:30 to 15:00 for shares. The holiday schedule is no different from that of SHSE and SZSE. Because the trading of Legal-Person shares was virtually zero, the on-going debate is whether to merge it with B shares, since both are traded by institutional investors.

B. CROSS-LISTING AND TRANSBORDER TRADING

The major event affecting both the Hong Kong and PRC securities markets was the creation of the H share, and the B share to a lesser degree. It was a big decision by the PRC government to move into overseas capital markets in 1992. However, the motivation behind such a policy in the minds of PRC decision-makers was not to integrate its national stock market with regional stock markets, but to find a direct financing vehicle for its state-owned enterprises to reach overseas capital markets.

1. Cross-Listing of H Shares and Other Chinese Shares

Because the original thought from Chinese leaders on cross-listing was to seek more foreign investment for Chinese state-owned enterprises, they did not expect to let any Hong Kong registered company or any other country's company list in return on Chinese domestic markets.[12] There exists an unwritten rule of "one-way traffic"---only to allow for Chinese companies to list on SEHK or other overseas stock exchanges but not the other way around. On the secondary market, the rule holds as domestic investors are restricted to A shares and Legal-Person shares and prohibited from holding B shares and H shares.

Hoping to attract more foreign investment to fund its economy, China started issuing B shares for foreign investors on SHSE and SZSE soon after issuing A shares for domestic investors. B shares were issued not by public offering but solely through international placement by going on road-shows to meet international fund managers at major financial centres. Because B shares were privately placed, most of the shares were in the hands of institutional buyers. This resulted in two problems: one is a lack of liquidity in the secondary market since most B share buyers are big equity investment funds who tend to hold for long-term gains and their one-time purchasing lots often exceed a million; the second problem is the inconvenience in the trading venues and

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[11] Shares issued only by institutions, often state-owned companies, and traded only among domestic PRC institutional buyers and sellers. This was the earliest form of shares that appeared in China before the establishment of SHSE and SZSE. Legal-Person shares are no longer issued.

[12] There was at one time a debate about whether to allow Mercedes Benz to list on SHSE but soon fell apart. SEHK also had brought up a similar issue and the answer was to postpone such a quest until the future.

inadequate disclosure of information about B share companies. As a result, trading becomes quite thin. The daily turnover averaged only US $ several millions in SHSE and in SZSE. The B share Index is below issuing price, 48.73 on October 21, 1996, against an average of 50.2 on the SHSE;[13] and 89.58 the same day in SZSE, with an average of 82.669 (close).[14] The PE ratio is about 5-7 times, much below that of A shares and H shares. By the end of July 1996, 78 Chinese enterprises had issued B shares.

Unlike B shares, A shares were traded by many individual players and fewer institutional investors. Individuals are quite speculative in the domestic market. Even with the limited numbers of domestic institutional investors, market behaviour is often highly speculative. Sometimes these PRC institutions are referred to as "institutional speculators." Market price movement is volatile and market turnover is generally small.

As a natural step, China started tapping Hong Kong market by issuing H shares. Painstaking efforts were made to prepare by various decision-making government institutions consulting with foreign investment bankers, law firms, accountants, and especially with SFC and SEHK counterparts. In early 1993, a list of the first batch of 9 Chinese companies was worked out and announced officially by the CSRC. After 6 months of due diligence and prospectus documentation, Tsingdao Beer became the first H share to list on SEHK, on July 12, 1993. In the meantime, it also had offered ADR in NYSE. This action immediately brought China into the limelight of the investment banking world. As a result, the initial public offerings of the first 9 PRC companies were all over-subscribed by hundreds of times. Kunming Machine, a relatively small H share issue of HK$65 mn had over six hundred times over-subscription with over HK$40 bn[15] pouring in. The issuer thus had unexpected interest income equalling the company's one-year profit. The HK$40 bn subscription must be kept in banks for about a week from the day of subscription to the day of listing. The interest would be roughly HK$23 mn.

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[13] Source: Bloomberg, Oct, 21,1996.

[14] See Appendix 1 and 2.

[15] In Hong Kong, a new issue usually had a technical price discount to attract investors. Investors in Hong Kong used to calculate this discount to decide how much they would borrow from banks. That is, investors equalise the cost of capital with their expected price rise after the listing. This practice artificially means a new issue receives a big over-subscription.

Table 1: H share companies list that have been announced by PRC[16]

Corp. Name	List-date	Sponsor	Vol.(HK$mn)
Tsingdao beer	7/15/93	CDFC	347.0
Shanghai Petrochem	7/26/93	Merrill Lynch	1,680.0
Beiren printing	8/6/93	Standard Chartered Asia	100.0
Guangzhou Shipyard	8/6/93	Peregrine	175.0
Maanshan Iron	11/3/93	Wardley	1,733.0
Kunming Machine	12/7/93	Baring Brothers	65.0
Yizheng Chem	3/29/94	Warburg	1,400.0
Tianjin Bohai	5/17/94	Jardine Fleming	340.0
Dongfang Elect	6/6/94	Nomura	170.0
Luoyang glass	7/8/94	CDFC	250.0
Corp. Name	**List-date**	**Sponsor**	**Vol.(HK$mn)**
Qingling Motors	8/17/94	Smith Barney/HG Asia	500.0
SH Haixing Shipping	11/11/94	Morgan Grenfell	1,080.0
Zhenhai Chemical	12/2/94	Baring Brothers	238.0
Chengdu Cable	12/13/94	Credit Lyonnaise	160.0
Harbin power	12/16/94	Warburg	435.0
Jilin chemical	5/23/95	Merrill Lynch	965.0
Dongbei Power	7/6/95	Daiwa	258.0
Jingwei textile	2/2/96	Peregrine	160.0
Fushan Ceramics	96	CDFC	
Beida Electronics	96	Peregrine	
Guangshen Rails	96	Bear Stein	
To be listed:			
East Air		Morgan Stanley	
South Air		Goldman Sachs	
Datang		Salomon Brothers	
Zhouxian		Goldman Sachs	
No2. Auto		JP Morgan	
Wugang Steel		Merrill Lynch	
Xifei Aircraft		JP Morgan	
TPCO			
De Zhou power			
Tienjin Medicine		DBS	
Xinhua Medicine		Nomura	
Wan Highway		Crosby	
SZ Highway			
No1. Auto			

Source: China Research, Baring Brothers Ltd., 1996

[16] The first and the second batches have been publicly announced but not the third. In practice, rumours went around before the official announcement and investment bankers started chasing after deals much earlier. Because of their efforts, rumours would likely turn out to be true. The table here is not complete as some of H shares were dropped and some others added in over time.

Insofar as the primary market for H share listing is concerned, a large number of international investment banks actively underwrite H share deals. Some of their company names appear in the above table.

Besides the H share, there are two other types of cross-border listed companies from PRC to SEHK. They existed before the H share came into being. One was known as backdoor listing, which is usually conducted as a take-over by a mainland Chinese company of a Hong Kong listed company in financial distress. After the acquisition, the mainland company would inject its capital into this Hong Kong "shell" company. In this way, the Hong Kong "shell" is used as a listing vehicle by the PRC acquirer. It had been a major way for powerful Chinese companies to seek Hong Kong listings before PRC formulated securities regulations. Since 1992, such practice has been stopped by CSRC. Any form of Hong Kong listing from mainland China must go through various official procedures to get an approval.

The second type of "cross-border"[17] listing takes place with mainland Chinese companies registered in Hong Kong. Most of these companies have been operating in Hong Kong for many years and Hong Kong investors are familiar with their business scope and sales. Because of their strong "red" China background Hong Kong people called these companies the "Red Chips". A subset of the "Red Chips" is the military-backed mainland civilian shell companies. Only the top-level People's Liberation Army organisations have the power to set up companies abroad. In Hong Kong, they are referred to as "PLA Red Chips".

2. Trans-border Trading

H share trading became a hot issue when they first came to list. However, owing to such problems as poor company disclosure and lack of transparent operations, some H shares began to fall sharply, especially during 1994-95. Compared to the Hang Seng Index, the Hang Seng China Enterprise Index fell far lower.[18] One extreme case is the Shanghai Haixing Shipping Co., a state-owned company in the second batch of H shares. When it started trading on November 11, 1994, its issue price was HK$1.46. This company dominated the inland river transportation in the lower reach of the Yangtse River near Shanghai. It was considered a good prospect. The state gave it many subsidised loans, with only 4-5% interest rate while the market rate was about 14-16%. Beginning April 1994, the state stopped its subsidy, immediately pushing the company into the red. However, this unfavourable news did not reach the public until October when PRC formally declared that the state had abolished the subsidy in the form of low interest loans. As soon as the news reached the investors in Hong Kong, Shanghai Haixing's H share price nose-dived more than half. The Hang Seng China Enterprise Index currently

[17] By the definition of cross-border, they are state-owned companies in mainland China but having their branches or subsidiaries listed cross the border on SEHK.

[18] See Exhibit 3.

underperforms The Hang Seng Index.

Table 2. **17 H SHARE COMPANIES & RANKS IN MARKET VALUE (End-1995)**

Ranking	Company	Market value (HKD million)
1	Shanghai Petrochemical	3,738.00
2	Yizheng Chemical Fibre	2,436.00
3	Maanshan Iron and Steel	1,871.56
4	Jilin chemical Industrial	1,527.65
5	Qingling Motors	1,125.00
6	Zhenhai Refining and Chemical	870.00
7	Tsingtao Brewery	620.86
8	Shanghai Hai Xing Shipping	561.60
9	Harbin Power Equipment	534.83
10	Louyang Class	497.50
11	Dongfang Electrical Machinery	352.75
12	Northeast Electrical T&T	325.02
13	Guangzhou Shipyard	308.50
14	Beiren Printing Machinery	211.20
15	Tianjin Bohai Chemical	183.60
16	Kunming Machine Tools	---
17	Shanxi Jingwei Textile	---

Source: SBC Warburg (Hong Kong)

A few “Red Chip” companies performed so well that they were included in Hang Seng Index of 33 major companies. One of them is known as Citic Pacific, a subsidiary of China International Trust and Investment Corp. in Beijing. The good performance in its share price occurs because people in Hong Kong know this company was PRC government backed when it invested heavily in Hong Kong property, infrastructure such as the new airport project, container port, and Hong Kong airlines. They knew of its close ties with Deng Xiaoping and other PRC VIPs. The other company is China Resources Enterprises Ltd. Its parent is PRC Ministry of Foreign Trade and Economic Relations and its main business is to provide Hong Kong with daily supplies ranging from drinking water to fresh vegetables.

Unlike the H shares, the Red Chip index chart is always in better shape than the H share index and even outperformed the Blue Chip index, the Hang Seng Index. These Hong Kong-based companies controlled by Chinese government agencies sometimes are not transparent. From time to time, they have tricky operations that could have made them look profitable. Tricks include acquisitions and restructuring resulting in one-time gains. In Hong Kong, investors' and the fund mangers’ general reaction to these tricky operations is unique: they stop number-crunching and start networking. They say it is difficult to invest in those companies on the basis of fundamentals but once they set up relations they can be safe. "They appear overpriced, but they just keep going up," said Andy Mantel, who manages HK$24 million in China equities for Hong Kong-listed China Growth Investment Ltd.

Prices of the shares of some companies that issue both H shares and A shares[19] move quite separately from each other. The prices have shown no sign of convergence. No arbitrage takes place, because the A shares are issued and traded only within China. The border creates a barrier to brokers seeking to arbitrage the shares. Shanghai Petrochemical serves as a good example.[20] Its different share prices show no sign of convergence, in the short term or the long term.[21] Note that a stronger correlation does exist between two domestic market prices that may show that the cointegration movement exists between A shares at SHSE and SZSE.[22]

III. BACKGROUND OF INTEGRATION

A. CHINA MOVING TOWARD WORLD CAPITAL MARKETS

Although the Red Chips listing had paved the way for H share listing, a strong ideological barrier still hampered China from listing its socialist companies on a capitalist capital market. By the end of 1992, reform in the rural areas had pushed many state-owned enterprises to become loss-makers. They were badly in need of capital investment to revitalise. But they were already heavily indebted to domestic and foreign lenders. Mr. Zhu Rongji, the vice-premier and governor of People's Bank of China at that time, decided to use equity financing from overseas capital markets. Beginning December, 1992, a policy was announced to allow the first 9 state companies to list on SEHK as an experiment. This was a political decision and the principle of selection was very debatable: to choose the ones that are, in term of profitabilities, "neither bad nor good" and the ones "neither big nor small" in terms of size.[23] The rationale was that PRC companies with good profitability do not need foreign funds and companies with bad profitability would find it too difficult to raise funds through overseas flotations. The worry about size is that the big strategic companies are usually highly controlled by the state, which does not want to lose control over those industries. Because of such mentality, the selection procedures were internally arranged although some foreign financial intermediaries had been involved in the early stage. Since China completely

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[19] There is a small number of mainland companies that are allowed to issue both H shares and A shares, or H shares and B shares, because the government considers the issue as a form of reward to the state-owned companies. Owing to the large demand from companies that are ready to list, this reward is too rare to give twice to one company.

[20] Shanghai Petro is the only state-owned company that has H share, N share (ADR on NYSE) and A share on SHSE.

[21] See Exhibit 3. Source: Bloomberg and on-line China Daily.

[22] Wei Shangjin, 1996 "Multiple Personalities: Mood Swings in the Chinese Stock Market".

[23] Talk with Liu Hongru, Chairman of CSRC and Sun Xiaoliang, Commissioner of SCRESS.

lacked investment banks of its own, while Hong Kong was full of big international banks and financial institutions, many of these investment bankers were invited to play active roles in educating and bringing H share companies to list on SEHK.

PRC's domestic stock market is more volatile than that of Hong Kong.[24] This phenomenon is explained as the lack of institutional investors in the relatively young PRC stock market. This could also be explained as Chinese culture, which usually treats stock buying and selling as a form of gambling. Individual players behave in stock markets rather as in casinos.

In order to cultivate an atmosphere of long-term healthy investment, the People's Bank of China issued regulations encouraging foreign mutual funds to invest, either directly or through joint ventures with PRC partners, in domestic stock market.

A secondary reason for PRC state-owned enterprises to become publicly traded companies became apparent later. As they prepared to list, the formal state-owned enterprises had gone through a great many procedures to fulfill their internal restructuring requirements before they could turn into public companies. These procedures are vital not only for listing purposes but absolutely necessary for modernising the outdated state sector industries. In fact, the period of allowing PRC companies to list overseas was associated with the domestic enterprise reform carried out in large scale among 400,000 state-owned enterprises.

The first batch of H share listings on SEHK was extremely successful. Soon there came the second batch of 22 H share candidate companies at the end of 1993 and the third batch of 7 in 1995. The listing venues included not only Hong Kong but NYSE, Nasdaq, and exchanges in Canada, Australia, and Singapore. Other listings are expected on the Tokyo and London stock exchanges.

B. HONG KONG'S REACTION TO CHINA'S MOVE

From the Hong Kong side, there is a strong need to let Chinese companies list on SEHK. Looking into the composition of Hong Kong's own listed companies, one can identify a large number in the service sector and property sector but a relatively small number of industrial companies. Trading volumes of industrial sector companies are half the volumes of companies in the service and property sectors. In China, most state-owned enterprises are in the heavy industrial sector. Hong Kong intended to change the composition over time by introducing mainland Chinese industrial companies to list on SEHK.

There is also a business interest for welcoming Chinese companies to list on

[24] Wei Shangjin, 1996 "Multiple Personalities: Mood Swings in the Chinese Stock Market".

SEHK. When Mr. Charles Lee, as Chairman of SEHK Council from 1992 to 1994, started talking to the Chinese side about H share issues, he reasoned as follows: "The Hong Kong stock market is now quite mature; and if we were just dependent on our own companies for new listings, the growth of the market would be very slow." In fact, most of the big local companies in Hong Kong have already been listed. On the other hand, there are thousands upon thousands of State-owned enterprises in China which represent tremendous growth prospects for the Hong Kong market. Mr. Lee hopes that "Hong Kong will become as important to China as Manhattan is to the United States."[25] Many business people in Hong Kong share his view. They see the future of the Hong Kong stock market in catering to the needs and wants not only of 6 million people in Hong Kong but also to 1.2 billion people in China.

Apart from the local business world, the international business world also showed its interest in investing in China's fast-growth economy. For foreign investors who have little knowledge of how to invest directly in PRC, Hong Kong H shares would be a better choice to invest in China. On this foreign demand side, the main investors are mutual funds and other institutions.

All these reasons contributed to a growing trend to use Hong Kong as PRC's principle overseas listing venue. Consequently, the number of H shares to be announced is growing at an accelerating pace.

C. ISSUES THAT EMERGED

Various problems concerning cross listing and trans-border trading have been identified during this period. They are mainly with PRC state-owned enterprises:

1. Too much spin-off work or restructuring effort is needed to turn a state-owned enterprise into a publicly listed and traded company.

2. As state-owned enterprises are not yet listed domestically, it is harder for investors to accept them overseas. This further thins trading in H shares.

3. Though listed under Hong Kong rules, H share companies are still greatly influenced by PRC domestic policies, which leaves investors at risk. The process of issuing an IPO is not based on the company's financial need and cannot be decided at the company level. It is rather a rationing system with quotas allocated by the central government. Due to such political selection, the quality of company candidates for H shares can be quite mixed.

4. There is an internal debate still going on about whether overseas listing will benefit state sectors since the state assets tend to be devalued in the process of flotation.

5. Restructuring creates social problems as it turns out large percentages of workers from the original enterprises. For example, when Wuhan Iron & Steel Co., a second batch H share candidate, went through the painful internal restructuring process its

[25] Source: Journal of Hong Kong Securities, October Issue, 1996

workforce had to split --- 50,000 workers to form a new company to list on SEHK and the rest --- 70,000 workers --- to be left with decaying factories. This prospect forced the company to give up its listing effort.

Because of these problems, not every company that has been announced on the lists as an H share candidate could be successfully listed on SEHK. Some have been chosen to list for two or three years, and the due diligence processes are not yet finished in these companies.

Once H shares are listed, trading tends to be more volatile than that of other non-PRC shares on SEHK. There is no cross-border arbitrage regardless of price differences. This is due to the fact that no free cross-border movement of capital is allowed and most of the H share companies are single-listed in Hong Kong without a previous listing in a PRC domestic stock market. This problem of market segmentation is fundamental in the region.

Little academic literature can be found about the relation between PRC and Hong Kong stock markets. However, a study by Guobo Huang (1994) did suggest that there were no general linkages between A shares and B shares or between A shares and H shares, due to the market segmentation. But he found that linkages between the two domestic markets noticeably strengthened over time.[26] He also found that B share returns in the Shanghai market could be forecast by market returns in Hong Kong, when policy allowed foreign institutions to trade. What he found confirmed that the policy-induced market segmentation hindered arbitrage opportunities in the regional market.

IV. REGULATORY COOPERATION

From Hong Kong's point of view, overseas issuers (including those of H shares) incorporated in the common law jurisdictions may list on SEHK without difficulty, provided they fulfill certain additional requirements set out in Chapter 19 of the Hong Kong Listing Ordinance. However, the legal system in PRC is not based on a common law system. Furthermore, existing PRC law imposes various restrictions affecting the use of foreign currency exchange in the PRC and its remittance out of the PRC. Despite the fact that a PRC issuer's shares may be traded in different markets as well as the non-common law basis of the PRC legal system, the Hong Kong regulators worked with PRC authorities on broad issues concerning stock market integration. For example, tremendous work was done to modify the Hong Kong Exchange Listing Rules, allowing certain additional requirements or exceptions to the rules in order for a PRC issuer to obtain and maintain a listing of its securities on SEHK.

The technicalities of trading side integration are relatively easy, for several reasons.

[26] See Guobo Huang, 1994, "China's Emerging Stock Markets: An Investigation of the Market Linkages".

Technically, Hong Kong is in a dominant position, but both SHSE and SZSE are catching up fast. There is no strong need to carry out trans-border trading since the markets are quite segmented. Policy and regulation, which provide the foundation for the regional integration, are more important.

A. MECHANISMS OF INTEGRATION

1. Legal Aspects

Hong Kong traditionally has a hands-off approach to economic activity. Its basic economic policy assumes that, except where social considerations are over-riding, the allocation of resources in the economy is best left to market forces. Consistent with this policy, the activities of the stock markets and commodities markets were left virtually unregulated until the mid-seventies. The proliferation of stock exchanges in the early seventies followed by the 1973-74 stock market crash prompted a series of measures to regulate the markets and to protect investors. The measures included the enactment of the Securities Ordinance and the Protection of Investors in early 1974, the establishment of the Securities Commission and the Office for the Commissioner of Securities (OCS) in the same year, the promulgation of the Code on Take-overs and Mergers in 1975.[27]

This regulatory framework remained largely unchanged through the seventies and eighties, a period of rapid change and growing sophistication of securities and futures markets both world-wide and in Hong Kong. As a result, the regulatory structure gradually took shape. Hong Kong legislators formulated sophisticated laws governing stock market operations. Hong Kong's securities and futures legislation is spread over 13 Ordinances, 6 Codes (including the Hong Kong Code on Take-overs and Mergers, Code on Unit Trusts and Mutual Funds, etc.) and 11 Guidelines, creating inconsistencies and duplication. Founded in May 1989, under the Securities and Futures Commission Ordinance and on the basis of the OCS, the Securities and Futures Commission is the major institution to administer Hong Kong's securities and futures legislation.

PRC legislators started formulating securities regulations rather late. So far, no law of this kind has been officially passed. However, a draft securities law has been under discussion among PRC legislators for years. Whenever an internal discussion of the issue was brought to the table, there was always a debate about public ownership vs. private ownership. The orthodox thought was that the PRC government should be responsible for the state-owned enterprises. The issue of foreign dominance in the ownership of PRC state-owned enterprise's shares became a big concern. PRC policy-makers are still bound to the socialist ideology. Therefore, the PRC government has formulated regulations requiring that it own no less than 60% of the shares of each state-owned enterprise. This means the listed portion of a PRC state-owned company's equity must not be greater than 40% under any circumstance. In practice, all the H shares issued so far have kept their

[27] Source: Hong Kong Securities and Futures Commission Ordinance.

listing equity between 25%[28] and 35%.

The Company Law of PRC was adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993 and put in effect from 1 July 1994. The central government also passed a set of regulations and rules concerning the stock market, such as "Provisional Regulations on the Administration of Securities Issuance and Trading" (1994), "Regulations on Domestic Foreign Shares Issued by Chinese Shareholding Limited Companies" (1995), "Provisional Measures for Prohibiting Securities Frauds" and "Provisional Measures for the Administration of Stock Exchanges". Governments in Shanghai and Shenzhen have issued local regulations and rules regarding to their stock market specifications.

2. Institutions

On the Hong Kong side, under the Securities and Futures Commission Ordinance, the SFC is established as an independent statutory body outside the Civil Service but still forming part of the wider machinery of the Hong Kong government. It is accountable to the Governor, and the Chief Executive of Hong Kong after 1997, for the discharge of its responsibilities, and is also responsible for advising the Financial Secretary on all matters relating to the securities, futures, and leveraged foreign exchange market.

The SFC is charged with the continuing development of Hong Kong's markets, which is crucial to maintaining Hong Kong's position as the leading financial centre in the region. It must help SEHK in its on-going market development efforts. It has spent considerable time and effort building working ties with its PRC counterpart, the CSRC (founded October 1992 as a professional association but officially became a government agency in 1995). The SFC helped develop the H share market and jointly formulate PRC regulations on H share listing and trading.

On the PRC side, the establishment of the State Council Securities Policy Committee (SCSPC) and the CSRC in October 1992 put in place a stock market surveillance system. Since its founding, the CSRC has had 40 cases leading to punishments for market abuses and failure to comply with state regulation. In order to supervise the securities markets more efficiently, PRC formed a network of local securities regulatory bodies at various levels, working with stock exchanges at Shanghai and Shenzhen. The CSRC authorized them to strengthen their capabilities to supervise market activities. This centralised supervisory system has worked well so far, with the CSRC on top and local bodies responding directly to the central government rather than to the local governments.

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[28] There is an incentive for PRC company to seek over 25% of foreign shares. Companies with over 25% foreign investment are governed by the PRC Law on Foreign Investment, which gives a preferable corporate tax treatment of 15%, compared to 33% under the Company Law.

For overseas issues, the CSRC must turn to the SFC for more sophisticated co-operation. A Memorandum of Regulatory Co-operation was signed between the SFC, the SEHK, the CSRC, and the SHSE and SZSE in 1993, creating the regulatory framework which allows for the listing of H shares on the SEHK. In 1995, a similar agreement concerning futures exchange was also signed by the two sides. These MOUs are essential in that they have provided the basis for regular institutional cooperation between the SFC and the CSRC on matters affecting the PRC and Hong Kong markets. The signatories hold regular meetings to discuss matters of mutual interest.

B. LISTING REQUIREMENTS

1. H Shares

Cooperation between Hong Kong and PRC stock market regulators started in 1993 when the issuance of H shares on SEHK was first proposed. By 1994 Hong Kong was able to update its legislation on Listing Requirements of PRC issuers. In November 1994, it added to Chapter 19 of Hong Kong Securities Exchange Ordinance a sub-clause known as Chapter 19a, which is solely devoted to PRC issuers.

The procedure in PRC was described. Before making an H share IPO, Chinese companies wishing to list on SEHK must apply domestically to the CSRC for approval. Meanwhile, they should also get their detailed listing plans approved by the State Planning Commission, which controls the national capital budgeting of foreign investment; the State Economic and Trade Commission, which supervises daily production of the state-owned enterprises; the State Commission for Restructuring Economic Systems, responsible for restructuring company ownership; the Ministry of Finance; and the State Administration of State-owned Assets. The actual procedures could be even more complicated: companies at various levels must also go through their local government, which meant getting approvals from more or less the same offices at the local level.

After all of these state organisations have consented, the CSRC will prepare a report to the Premier and vice-Premiers and let them decide. Final approval could take six to twelve months or even several years if everything else goes smoothly. The reason is simple: These are the state assets.

Because of such complex application procedures, enterprises often found their own “short-cuts” to listing. For instance, they could invite an above-Premier-level state leader to visit the company site. It is quite a common practice for Chinese leaders to go on a round-the-country trip from time to time, as Mao Zedong and Deng Xiaoping often proposed to do in the past. During the visit, the accompanying company managers would take the opportunity to request the leader directly to authorize an experiment in overseas listing. The answer would depend on the mood of the visiting state leader. If he gives his authority, the company then would have a “green light” to go through all the rest procedures.

Although the routine is extremely complicated, it does not stop the demand. Companies keep sending their applications to list to the CSRC hoping that someday they will have a chance to list on SEHK. The CSRC has improved the procedure, no longer treating individual companies case by case, and now grouping company applications and investigating them before making recommendations. This explains why H share applications come in batches.

In the meantime, the CSRC's Hong Kong counterpart, the SFC, will be informed and both parties will meet regularly to discuss and resolve issues. Each side can say no, effectively vetoing the subject or a particular case.

After final approval from the State Council, the CSRC announces the new batch of H shares, publicly.

Once listed on the SEHK, a PRC issuer is subject to all relevant Hong Kong laws and requirements, including the Stock Exchange Listing Rules and the Hong Kong Code on Take-overs and Mergers. The objective of the H share regulatory framework is to provide a level of protection comparable to that afforded an investor in any other company listed on the SEHK. The SEHK is the front-line regulator for all Hong Kong-listed companies, including H share companies.

The substantive laws in PRC required a flexible approach. When H shares were listed across the border, no ready-made regulation was at hand. As an alternative, the CSRC issued "Provisional Regulations on the Administration of Securities Issuance and Trading" and "Special Rules on Chinese Companies Overseas Issuance". By the end of 1993, China was going to pass its first Company Law. But still there was no article or anything regarding cross-listing of state companies in the final draft of the Company Law. This draft was before the National People's Congress (NPC) general meeting and due to pass. Knowing it had no time to recommend an amendment to the draft Company Law, the CSRC persuaded Mr. Qiao Shi, the President of NPC to insert a "window clause" in the Company Law, which stated that "PRC companies seeking overseas listing should refer to the CSRC related regulations," an "empty cause" giving a flexibility for PRC companies to be Hong Kong or elsewhere listed.

Language was an important issue. As English is the working language in Hong Kong business circle but Chinese is the language used in PRC, there had to be an agreement on the use of languages in company documents such as company accounts, articles of association, etc. PRC regulators recognised that English is so prevalent in Hong Kong that it should be used in the H share companies listing requirement as well. The Chapter 19A.36 thus reads "All documents furnished by a PRC issuer, including accounts, which are in a language other than English must be accompanied by a certified

English Translation.”

2. B Shares

Listing requirements for B shares are quite similar to H shares except that for B shares a strict annual quota system is applied. Each year, the State Council decides the amount of foreign money in US$ terms for that year’s B share quota (the 1993 quota was US$1 billion, for example). The B share Listing Rule did not decide listing venue. In practice, SHSE attracted the bigger and better PRC companies to list. But as it considered itself superior to SZSE, it waited for companies to approach them. To compete with SHSE, SZSE successfully caught up recently, attracting more well-qualified companies to list on it. The numbers of listed B shares are now just about equal on both exchanges.

3. Red Chip and Backdoor Listing

Many Red Chip companies are strongly backed up by their mainland parents. Some have a military background. They had successfully bypassed the official listing channels and gotten listed either through a backdoor listing or by acquiring a Hong Kong “shell” company in the past. After CSRC was established, PRC and Hong Kong regulators started to cooperate and coordinated on this issue. Both sides agreed that before granting a PRC listing, each side would inform the other of the nature of the listing, company type and other related information. In November 1994, new language supplemented Chapter 19A.39 of the Hong Kong Listing Agreement to prevent this practice. It required additional information from PRC issuers of other than H shares: they must submit a statement of “whether or not such issue plan has been approved by the State Council Securities Policy Committee and the timetable for the share issues under such plan” and "if such plan has not been approved, when such approval is expected”. After the amendment, only two cases fell within this regulation and both were listed only after they successfully manoeuvred to get the SCSPC’s approval. This became known as “official backdoor listing”.

C. TRANSACTION REGULATIONS

1. Trading

***Trading time**:* The trading days and trading hours of the three exchanges would permit integration. All are in the same time zone and trading takes place in more or less the same hours, with only little differences in each other’s opening, mid-session and closing times. Hong Kong enjoys more holidays, as it follows most traditional Chinese festivals as well as British and western holidays. After 1997, no change should occur in Hong Kong’s holidays under the new administration except perhaps for one holiday, Queen Elisabeth’s Birthday, being replaced by PRC’s national day, October 1.

The official trading hours of SEHK are from 10:00 AM to 12:30PM and from

14:30 PM to 15:55 PM. There is no afternoon trading session on Christmas Eve, New Year's Eve, and Lunar New Year's Eve.

SHSE's official trading hours are from 9:30 AM to 11:30 AM and 13:00 PM to 15:00 PM for stock trading; 10:15 AM - 11:45 AM and 13:00 PM - 15:30 PM for treasury bond; and 13:00 PM - 15:30 PM for treasury bond futures. Trading holidays include January 1, the New Year's Day, February 16, 19-23, Chinese New Year's long holidays, May 1, the International Labour Day and October 1-2, the National Day holidays.

SZSE's official trading hours are from 9:30 AM to 11:30 AM and 13:00 PM to 15:00 PM. Compared with those of Hong Kong's, there is a little difference: half hour earlier opening, an hour earlier closing of the morning session, an hour and a half earlier opening in the afternoon and 55 minutes closing ahead of SEHK. SZSE and SHSE thus have the same trading hours and holiday schedule.

Trading cost*:* On SEHK, buyers and sellers are charged a brokerage fee of not less than 0.25% of the value of the transaction. The minimum charge for brokerage is HK$50. A stamp duty is payable by both the purchaser and the vendor, at a rate of 0.15%. In addition, instruments of transfer must bear a HK$5 embossed stamp before being signed. Overseas institutions would bear the cost of maintaining a securities account with a local bank for safe custody.

On SHSE, the total cost is approximately 1.05%of the trade value. This includes a brokerage fee of 0.7% of the gross consideration (minimum RMB5), a transfer fee of 0.1% of par value (minimum US$1), stamp duty of 0.3% of the gross consideration, and a clearing fee of US$4 per execution for individuals and corporations (US$8 for custodians). There is registration fee.

The total trading cost on SZSE is 1.00%, a bit less than SHSE.

Type of Trading*:* SEHK operates an order-driven trading system under which share trading originates from an order by a client, as either a market order or a limit order. Trading is conducted in the trading hall of the exchange, while office trading is used for backup trading purposes. Typically, clients first place orders with their account executive/dealer at the broker's office, who calls up their floor trader at the trading hall. The floor trader enters the order into the computer system through the terminal in his booth. Since November 1, 1993 a computerised trading system called Automatic Order Matching and Execution System (AMS) was introduced to replace the old computer-assisted semi-automatic quotation system. It can support both automatic order matching and the previous trading method, which was an information-dissemination system (through the Teletext system). Under this dual operation mode, all stocks are traded through AMS and are divided into two categories: automatch and non-automatch stocks. The orders and trade information for both automatch and non-automatch stocks are disseminated to the market and the investors through the enhanced Teletext system. As of November 10, 1995 there were 751 securities admitted for automatching. It is believed that all listed securities are soon to be admitted for automatic matching.[29]

In SHSE, B shares are traded in paperless form using an automatic transfer and computerised system. Buy/sell orders are matched automatically by computer, based on price priority followed by time priority, and confirmation is relayed to investors on the same day. Foreign brokers with special exchange seats are permitted to execute their orders directly, without passing through local brokers as they used to before 1993.

Insider trading in PRC is not a crime since PRC has no Securities Law yet, but it could be severely punished under the provisional CSRC regulations.[30] Hong Kong has a more advanced legal system to deal with the issue. In essence, the Securities (Insider Dealing) Ordinance provides that a person who is connected with a listed company and is in possession of price-sensitive information not available to the general public may not deal in the securities of that company or any affiliated company. Although offences can be committed under the Ordinance (for example where a person refuses to co-operate with an enquiry or to tell the truth at an enquiry), insider dealing in itself is still not a crime. However, the Insider Dealing Tribunal has extensive powers to impose penalties on insider dealers. The Tribunal must publish its findings and it may then also:

a) disqualify a director from being a director or liquidator, manager of, or otherwise involved in the management of a listed company or any other specified company for a specified period up to five years;
b) make an insider dealer pay the government an amount calculated as the value of the profits made or loss avoided;
c) fine an insider dealer an additional amount up to a maximum of three times the amount of the profit made or loss avoided; and
d) require an insider dealer to contribute to the expenses of conducting the investigation.[31]

2. Settlement, Clearing and Payment System

Seeking to comply with the Group of Thirty (G30) Standards[32], Hong Kong Securities Clearing Company Limited (HKSCC) now operates the Central Clearing and Settlement System (CCASS) as the central depository body for the settlement of trading. CCASS provides T+1 matching for brokers who trade and it requires T+2 affirmation of

[29] Compiled from various sources of Securities Year Book by SBC Warburg (Hong Kong), A Guide to Custody in World Market from State Street Bank and other financial publications.
[30] Since the founding of CSRC, 42 cases of market abuses have been identified and punished by CSRC by the end of 1996, see The Developing Chinese Securities Market by Zhou Daojiong, Chairman of the CSRC.
[31] Source: Securities Ordinance (Insider Trading), Hong Kong.
[32] See the Appendix 3.

settlements by custodian banks. SEHK adopted only the qualified DVP/RVP (delivery versus payment/receipt versus payment) model.[33] There is so far no payment in same-day funds but HKSCC does provide securities lending. As for ISIN,[34] it has been partially implemented. With Mr Anthony Neoh, Chairman of the SFC, as the Chairman of Technical Committee of International Stock Exchanges Association since 1996, SEHK is now updating its payment system to keep its technological superiority in the region. The new system, known as the central Real Time Gross Settlement payment system (RTGS), will promise more risk reduction possibilities for the clearing houses, such as payment clearing facilities through RTGS system. SEHK promises to be more technically capable in securities trading in the future.

In SHSE, settlement time for A shares is now three days (T+3) but for B shares remains T+1. Turnaround trading time on the SHSE is the same day. SHSE has no ISIN so far and no securities lending, but it has payment in same-day funds, a qualified DVP/RVP Model and a central depository system through a company called Shanghai Securities Central Clearing and Registration Corporation (SSCCRC), which also serves as a clearing house.

SZSE is more or less in line with its big brother exchange in Shanghai. The clearing and depository house is called Shenzhen Securities Central Clearing Company Ltd.(SSCC). The settlement period is T+3. Foreign investors may hold only B shares. The securities settlement and income, paid in HKD, can be freely repatriated. Short-selling and OTC trading are illegal. Market entry requires obtaining a unique foreign investor code prior to trading.

3. Accounting System

PRC adopted different accounting rules for different types of ownership (state-owned, collectively-owned and privately owned) since the 1950s. There was no law on accounting rules until 1985 when PRC passed its first Accounting Law, which unified the different practices. Since then, several major modifications have updated the rules but there are still some significant differences with the Hong Kong accounting system or standard international accounting practice. The most recent updates were undertaken after 1992. Two laws have been released, “The Unified Accounting Rules on Corporate Finance” and “The Modified Accounting Law of PRC,” which have applied most international accounting standards to PRC companies.

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[33] A settlement system not offering a simultaneous and irrevocable exchange of securities and cash value, but which offers conditions or safeguards providing clearing and settlement conditions to those found under a Complete DVP/RVP Model.

[34] International Securities Identification Numbering system, designed by the International Organisation for Standardisation (ISO) and advocated by the G-30; increasingly accepted by world wide securities markets as the international industry standard for cross-border transactions. The ISIN code is a 12 digit code that includes an ISO country code, the local code of the national numbering agency (such as CUSIP in the US and Canada) and a check digit.

Since these changes took place only recently, they left no time for many H share candidates to convert to Hong Kong accounting standards. Most of the companies solved this problem by converting three years of accounts to the Hong Kong standard during the due diligence process with the help of international accounting firms. Hong Kong regulators quickly adapted to this situation by modifying the 1994 updated Hong Kong Listing Rules. Chapter 19A.01(3) stipulates that PRC companies are expected to present their annual accounts in accordance with Hong Kong or international accounting standards. For the accountants' reports, Chapter 4 deals with general standards and Chapters 19A.08 to 19A.11 deal with H shares. The chapters require that reports for PRC issuers normally conform either to Hong Kong accounting standards or the international accounting standards as promulgated from time to time by the International Accounting Standards Committee. They also allow, in addition to the general accountant reports, a PRC issuer to present in a separate part of the report, financial information conforming with applicable PRC accounting rules and regulations at the time of the application for H shares.

4. Taxation

In Hong Kong, dividends are regarded as having been paid out of taxed profits and are thus not subject to further taxation. In particular, there are no Hong Kong taxes imposed on foreign shareholders receiving Hong Kong dividends, and there are no withholding taxes on dividends paid by Hong Kong companies. There is no tax on capital gains.

In PRC, two types of taxes are related to securities: the withholding tax on dividends and the capital gains tax on securities traded. Non-residents pay no withholding tax or capital gains tax. However, PRC does apply a 20% tax rate to capital gains but currently securities are exempted. In practice, the CSRC was found to use the capital gain exemption as a tool to give a spur to a weak market from time to time.[35]

D. INTEGRATION TOWARD 1997

Three distinct phases in PRC-Hong Kong relations affected stock market integration. The early methodology of trial-and-error on the development of PRC stock market was much against integration. Policy makers wanted to see the effect but worried that this "capitalist market force" could easily destroy the socialist economy. Deng Xiaoping's idea of having "One country with two systems" seemed to fit both their hopes and worries at the same time. In a special interview in 1993 by Zi Zin,[36] a Hong Kong-

[35] In 1994, in order to stimulate the thin domestic stock market, CSRC announced a set of policies of introducing foreign funds to A share market, exempting capital gains for an indefinite time, etc. and within days, the market rocketed.

[36] Zi Zin, literally a purple flower, Bauhinia, is known as a Hong Kong emblem. It is also the name of a Hong

published PRC Magazine, Jiang Zemin, the Party Chief and Chairman of PRC further extended Deng's idea: "Hong Kong and China are like the same water in different situations. And as the well water never offends river water, likewise, we will never irritate Hong Kong affairs and hopefully Hong Kong will not do it to us". Using this Chinese metaphor, he was sending a signal that "Separation comes before integration" in Hong Kong-PRC relations.

The second phase occurred with the H share listing that started in early 1993 and has continued until the present. As PRC started its own stock market development, more and more cooperation between Hong Kong and mainland China grew at all levels of governments, regulatory bodies and market operations.

The third phase starts just before 1997 and will continue afterwards. The trend is to increase on-going cooperation in the integration process. However, the idea of "well water and river water" still counts. The Chairman of CSRC, addressing the state policy toward 1997 and after, said: "Based on the principle of 'one country with two social systems', the Basic Law of Hong Kong stipulates that the financial relationship between Hong Kong and mainland China will be that of 'one country, two currencies and two financial supervisory authorities." Regarding the two securities markets, he said further: "Hong Kong and PRC will enjoy a relationship of 'mutual leaning, mutual supporting, mutual developing, and mutual prosperity' with a pattern of 'two regulatory authorities and three stock exchanges' (namely, the CSRC and the SFC as the two regulatory authorities and the SHSE, the SZSE and the SEHK as the three stock exchanges)."[37] One can expect more cooperation in the regional stock market but with no institutional changes or merger of any stock exchanges.

Regulatory cooperation will take a very different form in the region, as compared to other regions, given the existence of such a vast gap between Hong Kong and PRC in type of regulation.

Many questions arise. How to deal with a situation where there is not an adequate existence of law to govern? How to deal with such a situation where law exists but people just do not observe it or rather ignore it? Are there any unwritten rules that actually govern the market practice independent of formal law? Financial market regulators in this region often ask themselves such questions. Trying to answer them, the Chairman of the SFC has made an excellent remark by reciting what Confucius said over 2,500 years ago: "In the final analysis, good regulation requires a culture of compliance, just as every legal system requires the majority to abide by the law. The logic for this is compelling and

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Kong official Xinhua News Agency magazine representing PRC political views, although it is published in Hong Kong.

[37] Zhou DaoJiong, in speech at the 36th General Assembly of the International Federation of Stock Exchanges, Beijing, November 1996

could not have been better stated by Confucius: 'In the regulation of human affairs, punishment may prevent people from committing crimes though they may remain shameless. But people who are actuated by morality will not only follow the law but will feel ashamed to break it.'"[38]

What he said may sound too remote to be true, but it may be most likely the real situation facing the wind of change by 1997 and beyond in this region.

V. PROJECTIONS ON INTEGRATION

A. SZSE-SEHK LINKAGE AFTER 1997

Many people wonder if it is still necessary to have the SZSE operate after 1997, since it is only a stone's-throw away from Hong Kong. However, since the policy today is to keep it going even after 1997, the debate centres around the interaction and linkage of SZSE with SEHK rather than the physical integration of the two.

Shenzhen is an artificial "Special Economic Zone"[39] built primarily within the last 16 years from a little fishing village into a cosmopolitan city of 3 million people. The purpose of having a city just neighbouring Hong Kong was to create a window which allows Hong Kong to gradually merge into mainland after 1997. The same concept applies to the stock market but in reverse. As 1997 approaches, more and more publications and policy studies focus on the issue of Shenzhen-Hong Kong stock market linkages. The main ideas are the following:

First, after 1997 when Hong Kong becomes a part of China, Shenzhen and Hong Kong will be more economically integrated. In terms of economic scales, SEHK will play a major role as an international financial market. With SHSE as a national market, SZSE would loose its competitive edge in this Three Exchange pattern.

Second, in order to link with SEHK, SZSE may set up a Second Listing Board for smaller Hong Kong companies which cannot list on SEHK because they do not meet the listing requirements but which are expected to grow quickly so that they can go to the "First Board." SZSE could actively serve as an ideal "Second Board" for Hong Kong, after 1997.

B. THE B SHARE CONVERGENCE AFTER RMB CONVERTIBILITY

[38] Staying on Top - A Look at Hong Kong's Financial Markets, Anthony Neoh, Winter 1996-97 Asia Pacific Review, Harvard University.
[39] PRC nominated 14 coastal cities as Special Economic Zones in late 70s. This policy was an important part of Deng Xiaoping's economic reform program.

People's Bank of China announced its goal to achieve RMB full convertibility before the year 2000. By 1998, RMB will be partially convertible under the current account. In July 1996, China abolished its long-time practice of foreign exchange swap centres. China's central bank is confident that the RMB is able to stand on its own as a convertible currency, for it had accumulated over US$ 104 billion foreign currency reserves by the end of 1996, which can be used to back up the RMB in case of an emergency.

With this timetable, B shares will soon be practically extinct. Now that many mainland Chinese citizens have become foreign currency holders, it is more and more difficult to stop them from trading B shares with their foreign currencies. After the RMB is fully convertible, it will make no sense to split investors into domestic and foreign, and shares that are domestically invested or foreign invested. Since most of the B share companies are stronger than domestic A share companies and currently the average B share P/E is much lower than that of A shares, B shares are expected to rise significantly after RMB becomes convertible.

One alternative solution for B share is to merge into either A shares or to seek a secondary cross-border listing on SEHK.

C. REGIONAL AND INTERNATIONAL PROSPECTS

At the Asia-Pacific Economic Co-operation summit (APEC), the issue of financial integration was once more brought up. The 18-member regional cooperative organisation provides a good venue for big economic powers in the region, such as Japan, China, Korea, Hong Kong, Singapore, Australia, and the United States, to cooperate and integrate more profoundly in trade, industry and banking. PRC has signalled its intent to open its door wider to the outside world by further reducing its import tariffs from the current 23% to 15% and by letting international banks operate RMB business in China. On stock exchanges, China pledged to let foreign investors and brokers compete on a more equal footing with domestic counterparts in order to change the present segmented market to an integrated one. We see the trend in China to integrate its domestic stock markets. The Legal-Person shares, B shares, A shares, and H shares will sooner or later be merged as China's open-door policies take effect. Hong Kong will continue to play a major role in bringing the region's stock markets up to international standards.

Technically, the Group of Thirty's rules (G30) serve and will continue to serve as a standard in terms of stock market integration. Most stock exchanges in the world cannot meet the nine recommendations set forth by G-30[40] on the technical standards for stock market integration on time. Ironically, some of the larger and more sophisticated markets may have more difficulty than some of the newer or emerging markets in meeting the G30

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[40] See Appendix 3.

goals. More and more markets have participated and recognized them as a standard for integration in the international stock market.

VI. CONCLUSION

While global integration of stock markets seems still too dim to talk about, regional integration may be more meaningful. Given the different and difficult situations facing China and Hong Kong in the same region, there is a strong trend to regionalization.

Our findings may be seen as controversial: signs both of segmentation and convergence have been identified at the regional level. In this often policy-determined region, political differences made the first rules of segmentation. Other policies, however, working more toward integration became dominant as the PRC's economic reforms unfolded and the rate of regional economic interdependency grows.

Our findings also indicate that in the process of the regional integration of stock markets, the more advanced market can set a benchmark or model for the rest to follow. Hong Kong, at a much more advanced level in its stock market industry, serves this purpose well. The integration in this region takes place around SEHK. As long as Hong Kong’s position as the regional financial centre is maintained after 1997, there will be still such a pattern of integration in stock market for the years to come.

Finally, we must not ignore the important factor that culture plays in this regional integration. The Confucian idea of putting morality before law seems to be an undercurrent, driving to seal the gap between differences in the region. This, we note, may serve as a unique feature of stock market integration in PRC and Hong Kong.

APPENDIX 3

The nine G30* recommendations, published in 1989, are:

1) By 1990, all comparisons of trades between direct market participants should be accomplished by T+1.

2) Indirect market participants should, by 1992, be members of a trade comparison system which achieves positive affirmation of trade details.

3) Each country should have a fully developed central securities depository organized to encourage the broadest possible industry participation by 1992.

4) Each country should determine whether a trade netting system would help reduce risk and improve efficiency. If a netting system is appropriate, it should be in place by 1992.

5) Delivery vs. Payment (DVP) should be used for settling all securities transactions. A DVP system should be in place by 1992.

6) Payments associated with the settlement of securities transactions should be consistent across all instruments and markets by adopting the same-day funds convention.

7) A "rolling settlement" system should be adopted by all markets. Final settlement should occur on T+3 by 1992. As an interim target, final settlement should occur by T+5 by 1990, except where it hinders the achievement of T+3 by 1992.

8) Securities lending and borrowing should be encouraged as a way to expedite the settlement securities transactions. Regulatory barriers to securities lending should be removed by 1990.

9) Each country should adopt the ISO standard for securities messages and the ISIN numbering system by 1992.

* The Group of Thirty is a private, international group of top economists and bankers who meet for the purpose of exploring and discussing issues of international finance and global economics. Although it has no legislative power, it is highly respected, and its recommendations are taken into serious consideration by many countries. Various countries have groups set up to study G30 proposals, and give feedback or progress reports on the issues. (Source: State Street Bank "Financial Industry Topics")

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