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Homemade Foreign Trading

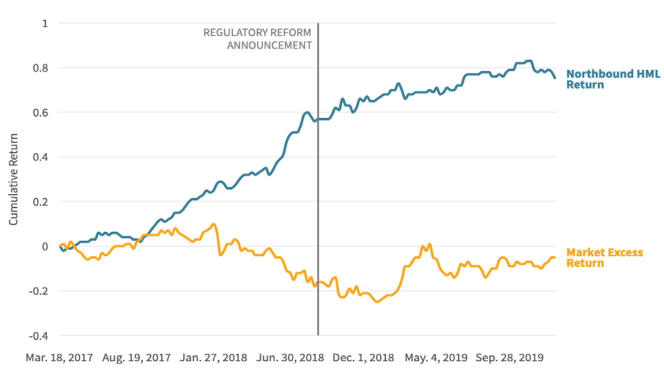
Based on BFI Working Paper 2022-170, "Homemade Foreign Trading," by Zhiguo He, Chicago Booth; Yuehan Wang, Central University of Finance and Economics; and Xiaoquan Zhu, University of International Business and Economics

This work offers new insights into foreign investment in China, offering evidence for the presence of homemade "foreign" investors who are likely mainland insiders who conceal themselves behind northbound flows.

Over the past two decades, China has taken steps to facilitate international participation in its capital markets, including Qualified Foreign Institutional Investors (QFII) and Renminbi QFII (RQFII), which allow licensed international institutional investors to directly invest in Chinese securities. Among all the accesses to Chinese capital markets, Stock Connect, which launched on November 17, 2014, and is the newest "opening-up" effort from Chinese policy makers, quickly became the dominant investment channel for foreign investors.

Stock Connect is distinctive in that it represents one of the greatest innovations in Chinese capital markets. The program achieves the goal of international financial integration (in certain stock/bond markets) with the rest of world, but without opening up China's capital account. It does so by enabling investors from Hong Kong and overseas areas—but also qualified investors from Mainland China—to directly trade eligible shares listed on the other market via their local exchanges, without the need to adapt to the operational practices of the other market. More importantly, investors on each side can only use their funds to trade securities in the specified market(s) on the other side, without further access to the rest of the economy in the other market.

Figure 1 • Return Predictability of Northbound Investor Flows



Note: This figure plots the cumulative returns of a weekly-rebalanced long-short strategy between the top- and bottom-decile portfolios sorted by northbound investor flows, starting from March 17, 2017 (the date on which regulators started releasing the daily stock-level northbound flows to the public) to December 31, 2019 (when Covid-19 hit China). Stock returns are weighted by their floating market capitalization winsorized at the 5% and 95% levels. During the post-reform period, which spans about 16 months after August 2018, the return from the same long-short strategy is a mere 8.8% annualized (for comparison, the contemporaneous market excess return over the one-month China Development Bank bond yield is 9.6%).

However, there is a dark side to this market. The authors show that Stock Connect creates regulatory loopholes for opportunistic mainland investors to arbitrage by "round-tripping." More specifically, the authors present evidence that a group of "homemade" mainland investors—likely Chinese corporate insiders for the purpose of identity concealment—engage in cross-border trading via the connect program as if they were "foreign investors."

Why would someone conceal their identity? Researchers have explored such motivations as tax evasion, tunneling, and market misleading, but this new work also examines round-tripping of insiders who choose to profit on their non-public information through the Stock Connect program. Round-tripping has gained prominence as the mainland and Hong Kong exchanges recently reached an agreement on the further expansion of eligible stocks under Stock Connect.

How does the Stock Connect program help conceal investors' identities? In contrast to the mainland exchanges, which adopt a see-through surveillance

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scheme for trading and clearing, under Hong Kong's jurisdiction there are financial intermediaries (brokers or custodians) who hold their clients' securities under the names of intermediaries. During the first three years after the launch of the Stock Connect program in 2014, northbound trading (or the trading of China Connect Securities by Hong Kong and overseas investors through Stock Connect) adopted the scheme that is consistent with Hong Kong's jurisdiction. Therefore, the Stock Connect program offers an opportunity for domestic traders in mainland markets to disguise themselves by trading eligible A-shares of connected firms indirectly.

Before describing the authors findings, it is important to note a key piece of legislation that the authors call a "game changer." In a joint announcement made by the two regulators on both sides on August 24, 2018, the Stock Connect program established a system whereby northbound custodians are required to assign a unique identifier to their northbound clients. This allows the mainland regulator to identify the actual beneficial owner of each northbound trade and to deal with irregular mainland investors.

Please see the full working paper for a more detailed description of how Stock Connect has reshaped trading and dealing within and through mainland China; in brief, the authors employ a comprehensive dataset on northbound custodian holdings operated in the Hong Kong exchange to explore irregular trading activities and to address the question: Who are more likely to exploit the advantage of disguising themselves through the connect program? They find the following:

- Beginning with a study of return predictability of northbound flows from different origins in the Chinese A-share market, the authors find that **although the trading activities of less prestigious foreign custodians and cross-operating mainland custodians were informative in the early days of the Stock Connect, their northbound flows have become uninformative about future stock since regulations were introduced to crack down on homemade foreign trading.**

- In China, state-owned enterprises (SOEs) and non-SOEs differ in government scrutiny in ways that might make non-SOEs better accommodating insiders as homemade foreign investors. Meanwhile, centrally administrated SOEs have more levels of administration and hence lack information transparency, which also creates space for homemade foreign trading. Consistent with these hypotheses, the authors find that **for both central-SOEs and non-SOEs, the return predictability of northbound flows from problematic custodians fell after the reform.**

- Finally, **concurrent trading activities of northbound investors from problematic custodians and mainland inside sellers become relatively infrequent after the regulatory reform.**

The effort to crack down on cross-border regulatory arbitrage continues. As of July 25, 2022, northbound brokers are no longer allowed to set up trading accounts for mainland investors. This presumably leads to an elevated transaction cost and litigation risk for engaging in homemade foreign trading in China, and, as the authors suggest, may encourage the flow of genuine foreign investment into the emerging capital market and improve market efficiency.

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