Comments on China's Recent Capital Market Liberalization from Legal Perspective

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Abstract

In recent years China has implemented a range of initiatives to promote cross border investment and open up its capital markets. China has also set on market liberalization and bail-out measures taken by Chinese regulators in response to the stock market crash in mid-June 2015. Among these capital market liberalization measures, there are still some areas that could be further improved or clarified by the government. The article gives some comments on the recent open up measures on China's capital markets from legal perspective and the outlook for China's future development on capital market.

Keywords

Capital Market, Liberalization, Legal Perspective.

1. Introduction

China's capital markets have been closed to the rest of the world for a long time. However, since the beginning of the 21st century, China has implemented a series of initiatives to facilitate inbound foreign investment and to open up its capital markets, with a view to promoting economic development. In particular in November 2013 the Chinese government set out a blueprint for China's future reforms which outlined its plans to let market forces play a "decisive" role in determining pricing and allocating resources.

Some commentators have raised concerns that the recent stock market crash in the second half of 2015 and the subsequent bail-out measures may delay China's financial reforms on capital market to a certain degree.

2. A-share IPO rule reform:

Starting from late 2013, the China Securities Regulatory Commission has lifted a 13-month ban on A-share initial public offerings and released revised rules to establish a more market-driven approach. China is in the process of planning to change the IPO regime from approval-based regime to registration-based regime. In late 2015, the State Council passed a draft document in favor of registration-based stock listing reforms, which should help ease funding difficulties of companies. The stock listing will shift from an approval-based system to a registration-based one within two years.

Although the document still needs to be ratified by the National People's Congress Standing Committee, the top legislature, experts believe it will be adopted soon. The amendment process has already been delayed due to this summer's capital market rout. A more market-oriented system means simplified procedures as the bourses will take over IPO approval power. The change is expected to improve the effectiveness of markets as a source of business financing. If the new system is adopted, regulators will no longer judge or endorse businesses based on performance, value and prospects. However, according to widespread expert opinion, implementation of the registration-based system would be gradual, with the CSRC still managing the IPO supply in the early stages.

China has adopted the approval-based IPO system since 2000. The regulator also holds the power of setting IPO prices. The IPO reform is the most important task for the regulator and it will help clarify the role of government and market. In addition, it will also solve some of the key problems in the nation's capital market. The long-awaited reform has been viewed as a crucial step for the capital market to become more market-oriented. It also implies that the regulator desires to rein in the regulator's administrative controls and government intervention in the market.

According to the CSRC, the purpose of the reform is to build a market-driven IPO system with an emphasis on information disclosure and effective regulation. The current approval-based IPO system has led to government endorsement on the profitability of the companies and its investment value, which lowered the risk awareness of the market and investors, he said in the speech published on the regulator's website. It also created distortion of IPO supply and demand in the market and would hurt the market's long-term development, although it could stabilize prices and investors' expectations in the short term.

The registration-based system will help draw the boundary between the regulator and the market and prevent excess intervention as the government will no longer endorse the issuers and the investors will judge the value of the IPOs on their own.

In the meantime, the CSRC introduced significant changes to IPO procedures, allowing investors to subscribe without paying into escrow accounts in advance. The changes prioritized information disclosure rather than pre-IPO approvals and simplified procedures for smaller IPOs.

One important change is that under the newly approved rules for China IPOs which was effective from Jan 2016, stock investors can seek compensation immediately form sponsors if they suffer losses due to false or misleading information in the listing materials. This new sponsor liability regime will have fundamental challenges to sponsors and issuers in China. Such regime has some issues to be further discussed and clarified with the regulator:

1) The advanced compensation undertaking that the CSRC is forcing the A-share IPO sponsors to sign in its current form ignores the “due diligence defense” provided in the PRC Securities Law, thus causing a conflict between this CSRC requirement and the PRC Securities Law. The due diligence defense is a vital legal protection to sponsors and underwriters in their business and is available in most of the jurisdictions in the world.

2) Contingent liability brought by potential advance compensation would exhaust sponsors’ cash flow, which would bring liquidity and systematic risks to the entire finance industry.

3) Such advance compensation, although is a Sponsors’ liability, would increase issuers’ financing costs in IPOs; and

4) Investors on capital markets are not always vulnerable groups. Professional and institutional investors shall bear their own risks when making investment decisions based on their own professional analysis. It is unfair for sponsors to compensate investors for other professional parties’ intentional misrepresentation, fraud and gross negligence.

3. QFII & RQFII programs:

China introduced Qualified Foreign Institutional Investor (QFII) regime in 2002 and RMB Qualified Foreign Institutional Investor (RQFII) program in 2011. QFII and RQFII programs are common regimes for developing countries to establish an available channel for foreign investors to access domestic securities market. Under the programs, a qualified foreign institutional investor may apply for a QFII or RQFII license from the China Securities Regulatory Commission (CSRC) to invest in China’s securities market, subject to a quota approved by the State Administration of Foreign Exchange (SAFE). The QFII regime has evolved rapidly and has attracted a wide range of international institutions globally including asset management firms, investment banks, securities companies, sovereign wealth funds, central banks and other institutional investors.

The RQFII program was originally launched in December 2011 and initially only the Hong Kong subsidiaries of fund management companies and securities companies incorporated in Mainland China were eligible to apply for a RQFII license. Subsequently the RQFII program has been expanded to asset management firms in more jurisdictions, and not simply subsidiaries of Chinese companies.

Over the years the PRC regulators have revised the relevant rules to lower entry barriers, simplify license application procedures, clarify the Chinese tax position and expand investment scope, which now covers exchange traded stocks and bonds, bonds traded on the inter-bank bond market, stock index futures and securities investment funds.

In February 2016, Chinese regulators further opened up the China Interbank bond market to more overseas financial institutions and removed the quota restrictions for trading in the interbank bond market.

Although Chinese government further liberalized QFII and RQFII restrictions in the interbank bond market, there are still some areas to be further clarified. For example, it remains unclear whether the removal of quota restrictions for interbank bond market trading means if a QFII's investment in such market will no longer occupy any investment quota of such QFII. In addition, it needs to be clarified whether the quota will be relieved for the existing QFIIs which have already invested in the interbank bond market.

4. Mainland – Hong Kong Mutual Recognition of Funds

Another significant collaboration between CSRC and SFC is the Mutual Recognition of Funds (MRF) scheme. The CSRC and SFC jointly decided to embark on the long-awaited MRF scheme as from 1 July 2015. The initial quota is set at RMB300 billion for each of the Hong Kong and mainland funds. In contrast to the more commonly-seen "passport" regime elsewhere in the world, MRF allows a fund that has been authorized by or registered with the relevant authority in one jurisdiction (e.g. Hong Kong) to obtain authorisation or approval from the regulator in the other jurisdiction (e.g. China) so as to offer to the public in the Host Jurisdiction.

The program now enables Mainland Chinese and Hong Kong funds to be distributed in each other's markets through a streamlined vetting process (Mutual Fund Recognition Scheme). After the Mutual Fund Recognition Scheme as in effect, eligible Mainland Chinese and Hong Kong funds are now able, upon successful registration with the relevant regulator through a streamlined vetting process, to offer the fund to retail investors in each other's market. Of key interest to non-Mainland Chinese fund managers will be their ability to CSRC and SFC have set equivalent eligibility criteria for qualified funds, including qualification of fund manager, size of fund, source of capital, etc. Under the MRF scheme, a recognized fund should generally operate in accordance with the applicable laws of the Home Jurisdiction and, at the same time, comply with the disclosure and offering requirements of the Host Jurisdiction.

The Mutual Fund Recognition Scheme is the next, long overdue step in the development of the Mainland Chinese funds market, providing international asset managers with a means to access a huge and previously untapped retail investor market in Mainland China, boosted by a growing middle class and a huge pool of domestic savings. Both non-Mainland Chinese investors through Hong Kong and Mainland Chinese investors will have access to a wider selection of fund products. By providing an avenue to convert domestic savings in Mainland China into cross-border investments, it will expand the cross-border flows of Renminbi (RMB) and facilitate China's efforts to open up its capital markets and internationalise the RMB.

5. Outbound Investment

There are also some programs available in China under which domestic investors may make overseas investments. Under a Qualified Domestic Institutional Investor (QDII) regime initiated in 2006, domestic financial institutions including commercial banks, trust companies, securities houses, fund management firms and insurance companies may invest in the overseas financial market with funds

collected from domestic institutional or individual investors, subject to regulations of the competent PRC financial regulators. The regulatory framework for QDIIs of different types of financial institutions may vary slightly in terms of eligibility requirements, investment scope, etc., but generally the permissible investment scopes are limited to overseas secondary markets.

Some market participants view the QDII regime as being overly restrictive. In response to market demand, some local governments have launched pilot programs (the so-called QDLP or QDIE program) to provide alternative channels for onshore investors to invest in asset classes overseas which are not otherwise permissible under the QDII regime, such as offshore hedge funds and real estate properties.

QDLP, which was launched in 2013, allows global fund managers to bring together domestic investors in limited partnerships that buy offshore alternative assets. The program is an effective new initiative that allows asset management firms to help domestic professional investors to access more asset classes overseas. In the first round of the Shanghai-based QDLP scheme, only six hedge fund managers, which included U.S.-based Och-Ziff Capital Management Group LLC, Citadel LLC, and UK-based Man Group Plc, received a quota of US$50 million each.

The QDLP program is an important step forward for international asset managers to enter into the Chinese market. Although the foreign exchange quote granted to each approved asset manager is only at US$50 million at this stage, being symbolic rather than material, it does reflect China's long-term commitment to opening the capital account and internationalizing the RMB, as well as Shanghai's ambition of becoming an international financial centre.

Due to the regulatory restrictions (including foreign exchange restrictions), Chinese investors are usually not able to invest in offshore securities markets other than via the QDII program. However, the QDII investment funds are issued to the general public and are not tailored to the needs of specific investors. The QDLP program now provides a new channel for Chinese domestic capital to be invested in offshore securities markets and this should be greatly welcomed by Chinese institutional investors and high net-worth individuals.

While the QDLP program provides a new window of opportunity for both overseas hedge funds and Chinese domestic investors, there are a number of issues that need to be managed by asset managers. Asset managers need to consider the marketing strategy on how to promote the QDLP products to Chinese investors and in this regard they need to think of different ways of marketing activities such as looking at a Chinese partner, engaging some distribution channels such as trust institutions, wealth management institutions, etc. Moreover, asset managers need to be alert that Chinese investors are far from mature as compared with investors in more developed markets like the US and UK. Asset managers should also consider how to deploy manpower in this new market, taking account of employing local Chinese residents, sending people to oversee this new market, or even using the employees of existing regional offices like entities in Hong Kong through travelling to China on frequent basis, etc.

The QDLP program is designed such that the management fee and performance fee might be collected by the offshore fund manager of the master fund under the "master-feeder" structure. Nevertheless, asset managers need to design a structure for compensating the Onshore FMC from the Chinese tax and transfer pricing perspectives. The structure should ensure tax efficiency, that is, to mitigate the Chinese tax cost at the Onshore FMC level, and mitigate the possible PRC tax authority's challenges as well. While respective asset managers have particular management fee and performance fee arrangement with investors, a tailored tax structure for compensating the Onshore FMC should be designed in order to achieve the tax efficiency. In some situations, pre-discussions with the tax authorities could be arranged as a way to mitigate the risk of being challenged by the PRC tax authority on the structure in future.

It is foreseeable that that the QDLP program will expand further with more and more asset managers participating in the program. The total volume as well as the individual volume for each QDLP fund will be further increased in the coming time. The QDLP program definitely provides good business opportunities for international asset managers. That being said, to achieve maximised investment return, there are various issues to be addressed beforehand. It is suggested that asset managers seeking to participate in the program take a proactive approach and actively engage in dialogue with the Shanghai financial service authority in advance and seek assistance from advisors accordingly.

A similar scheme, called Qualified Domestic Investment Enterprise (QDIE), was launched last year in Shenzhen. On 8 December 2014, Shenzhen Municipal Government issued the *Provisional Measures on Shenzhen Pilot Scheme for Overseas Investment of Qualified Domestic Investors* formulated by Shenzhen Financial Development Services Office (the "Provisional Measures"). The Provisional Measures take effect from the date of issue, and are aimed towards further opening up of the financial market and to accelerate the development of a mechanism for free cross-border capital flow. Prior to QDLP and QDIE, Chinese investors were not allowed to invest in offshore securities markets unless via the Qualified Domestic Institutional Investors program, which is however tailored to the needs of retail investors.

According to the Provisional Measures, "overseas investment fund management enterprises" recognized by a committee of the pilot scheme ("Fund Management Enterprises") would be able to establish overseas investment enterprises under the scheme. Such QDIE may be formed with investment capital owned by qualified domestic investors, and may make overseas investment upon completion of formalities of foreign exchange capital remittance within its fund size as established and registered with the Shenzhen Financial Development Services Office.

As set out in the *Basic* Situation *of Shenzhen Financial Industry in the Third Quarter of Year 2014* published on 13 November 2014 on the website of the Shenzhen Financial Development Services Office, the State Administration of Foreign Exchange has granted the first batch of investment quota of US$1 billion to QDIE scheme.

A key difference of the QDIE scheme from the QDII scheme and the QDLP scheme is that the Provisional Measures of the QDIE scheme does not contain any expressed restriction on the permitted scope of overseas investment. In comparison, CSRC, CBRC and CIRC imposed detailed provisions on QDII investment scope, while the investment scope under QDLP scheme is also limited to "direct investment in overseas secondary market or investment in overseas secondary market through overseas funds".

A Fund Management Enterprise may be established as a company, partnership or other forms. Overseas or domestic Fund Management Enterprises shall have a registered capital (or subscribed capital) of not less than US$ 2 million (or equivalent currency) or RMB 10 million respectively, and shall also meet qualifying conditions such as the "controlling investor (or the general partner) or the associated entity of the controlling investor (or the general partner) having continually operated the management of overseas investment funds for at least three years, having at least one investment personnel with over 5 years overseas asset management experience and at least two investment personnel with over 3 years overseas asset management experience ".

The legal structure of a QDIE is quite flexible, which could be a corporation, a partnership, a contractual fund, a segregated account, etc., provided that such QDIE meets the conditions such as having size of not less than RMB 30 million (or its equivalent in foreign currency), and having not less than RMB 2 million (or its equivalent in foreign currency) invested by each qualified domestic investor.

If a QDIE adopts the legal form of a company, a limited partnership or a contractual form, its Fund Management Enterprise shall register with the Asset Management Association of China ("AMAC") as a private fund manager; whereas if a segregated account arrangement is adopted, it means that a Qianhai-registered subsidiary of a retail fund management company may directly apply for the pilot QDIE qualification. Currently, several subsidiaries of fund management companies have obtained the pilot QDIE qualification according to the media.

Each qualified domestic investors must meet requirements such as having net assets of not less than RMB 10 million (as applicable to institutional investors) or financial assets of not less than RMB 3 million (as applicable to natural persons).

These local pilot programs are now available in big cities in China including Shanghai, Shenzhen, Tianjin and Qingdao. For international asset managers, the local programs provide a new source of investor capital. For Chinese investors, these programs enable access to new asset classes which are not otherwise available under the QDII regime and help to diversify risk. For local governments, these pilot programs promote the development of the asset management industry and add some energy into the local economy.

It is also anticipated that a "QDII2 regime" allowing qualified PRC individuals to directly make overseas investments will be rolled out soon. Although no further detail or clear timeline has been officially announced, the QDII2 regime was expressly mentioned as one of the initiatives to further promote China's capital account liberalisation.

The Shenzhen government last year filed applications for Qianhai to be a pilot zone for the QDII2 program, along with several other cross-border businesses involving securities. The point of being a testing ground is that Qianhai should not be restricted by existing laws and regulations, especially foreign exchange restraints.

But another source from the municipal government, who is familiar how the central government reviews trial measures, said the discretion was probably necessary. Launching QDII2 would be a significant step towards liberalizing the country's capital account, an official close to the foreign exchange regulator said. Nevertheless, to control risk, the central government is probably going to restrict the targets of all QDII2 investments to only securities traded in Hong Kong at first. The type of QDII2 investments would be limited as well, and risky financial derivatives are unlikely to be in the approvable range, a QDII fund manager said.

However, it was reported in February 2016 that the QDLP and QDII2 programs have been suspended due to the recent trend of capital outflow.

6. Shanghai – Hong Kong Stock Connect

PRC regulators adopted a series of bail-out measures to rescue the stock market from falling further and some of the measures are unusual, such as asking PRC securities companies to purchase A shares with their proprietary funds and banning major shareholders and all shareholders holding more than 5% of a listed company from selling the company's shares on the secondary market within a period of 6 months from 8 July 2015. In addition the CSRC and the PRC Ministry of Public Security regulators have initiated investigations focused on the "malicious" shorting of A shares.

The Shanghai-Hong Kong Stock Connect program (Stock Connect) was launched on 17 November 2014 by CSRC and the Hong Kong Securities and Futures Commission (SFC). It marks a historic moment in the liberalization of China's Capital markets and provides unique opportunities for investors globally. The launch of the program relaxes restrictions that historically split the Chinese stock market between shares targeted at local investors and those available to international investors. The Shanghai-Hong Kong Stock Connect allows mainland Chinese investors to purchase select Hong Kong and Chinese companies listed in Hong Kong, and lets foreigners buy Chinese A shares listed in Shanghai in a less restrictive manner than has previously been the case. The program is also expected to reinforce Hong Kong's position as the most important offshore RMB centre and the main access point to the Chinese capital markets. Under Stock Connect, for the first time, Hong Kong and international investors are able to trade eligible shares listed on the Shanghai Stock Exchange (SSE) directly through local brokers on the Hong Kong Exchange (SEHK) without the need to obtain regulatory approval from any PRC authorities (Northbound Trading Link), as they are under the QFII or RQFII program. Similarly, eligible PRC investors are able to trade eligible shares listed on the SEHK directly through PRC brokers on SSE (Southbound Trading Link). A linkage between PRC and Hong Kong clearing systems has also been implemented. The new regime may unleash

significant fund flows in both directions as mainland investors get the chance to invest in major Hong Kong and Chinese companies that are listed only in Hong Kong, and as foreign investors gain access to the A-share market. Quotas will limit the size of the flows in either direction.

At the initial stage, the cross-border capital flow on a net basis is subject to a total quota (RMB300 billion for Northbound Trading Link and RMB250 billion for Southbound Trading Link) and a daily quota (RMB13 billion for Northbound Trading Link and RMB10.5 billion for Southbound Trading Link). So far, trading under Stock Connect has been stable and the quota usage is relatively balanced between the two trading links.

There are several crucial differences between Stock Connect and QFII/RQFII including eligible investors, investment scope, quota and repatriation which suggest that these programs can co-exist as multiple methods for foreign investors to access the PRC markets, satisfying diversified business objectives of various investors. Although eventually the PRC capital market will be completely opened up, this may not happen very soon and the market is expected to be liberalized gradually by introducing more programs to facilitate cross-border investments. Stock Connect is a pilot program that has been designed to ensure sustainability and scalability of the model for further expansion to other markets and/or asset classes. The program is expected to be expanded to the other stock exchange in China, the Shenzhen Stock Exchange.

The complexity and novelty of Stock Connect have resulted in some challenges for both regulators and market participants, especially due to the different legal systems and market practices in Mainland and Hong Kong. While the regulators have made great efforts to provide solutions and clarification around some of these issues, including pre-trade checking and beneficial ownership, there remain outstanding issues to be resolved which will occur over time.

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