

# Overview of Onshore Custody Business for Asset Management in the People's Republic of China

As the investment management industry in the People's Republic of China<sup>1</sup> has grown, custody business in China has also become increasingly attractive for stakeholders looking at this market.

## Recent regulatory trends

According to the China Securities Regulatory Commission (**CSRC**), the assets under custody for securities investment funds have amounted to RMB2.37 trillion (approximately US\$377 billion) as of September 2012. Pursuant to the newly-amended *PRC Securities Investment Funds Law* which will take effect on 1 June 2013, asset managers (in addition to the current securities investment fund management companies) may, subject to obtaining CSRC's approval, manage publicly-offered securities investment funds. According to a consultation paper issued by CSRC, these asset managers include securities companies, insurance asset management companies and managers of privately-offered securities investment funds. This initiative is very likely to enlarge the current market size for securities investment funds.

Another potential de-regulation may also allow more participants into a broader custody market. On 26 October 2012, CSRC released the consultation draft for the *Administrative Measures on the Custody Business of Securities Investment Funds (Consultation Draft)*, which permit foreign subsidiary banks in China to apply for custodian licence for onshore securities investment funds. This business is currently only open to Chinese-funded banks. As most other types of investment management schemes also require the custodian to possess the qualifications of a custodian for securities investment funds, the proposed change will imply that a foreign subsidiary bank may potentially deal with a much larger group of custody clients.

This briefing aims to provide a panorama of the vast variety of onshore custody business, the eligibility requirements of an onshore custodian and the special roles they undertake under PRC regulations.

### Key issues

- Recent regulatory trends
- Eligibility requirements for onshore custodians
- Special role undertaken by onshore custodians
- Implications for market players
- Conclusion

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<sup>1</sup> PRC or China, which, for purposes of this briefing, does not include Hong Kong, Macau or Taiwan  
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## Eligibility requirements for onshore custodians

Although it is mainly banking entities that carry out custody business in China, there is no single regulator to monitor the conduct of custody business. Instead, regulators differ according to different investment management schemes (see below), which results in a complicated regulatory regime in China for custody business. Most regulators generally require the custodian to be a domestically-incorporated commercial bank, and in certain situations, a bank branch in China established by a foreign bank may also be acceptable. Since commission-based banking services are not listed in the general business scope of banks under the *PRC Commercial Banking Law*, their conduct of custody business must be filed with the China Banking Regulatory Commission (**CBRC**) and/or be subject to CBRC's approval if so required.

The investment management schemes discussed in this briefing include:

1. securities investment funds (regulated by CSRC);
2. the qualified foreign institutional investors (**QFIIs**) scheme (regulated by CSRC and the State Administration of Foreign Exchange (**SAFE**));
3. separate account assets management services (**FMC Separate Account Services**) provided by fund management companies (**FMC**) (regulated by CSRC);
4. collective investment schemes of securities companies (**Collective Investment Schemes**) (regulated by CSRC);
5. separate account assets management services provided by securities companies (**Securities Companies Separate Account Services**) (regulated by CSRC);<sup>2</sup>
6. wealth management products of commercial banks (**Wealth Management Products**) (regulated by CBRC);
7. collective funds trust schemes of trust companies (**Collective Funds Trust Schemes**) (regulated by CBRC);
8. National Social Security Fund (**NSSF**) (regulated by the Ministry of Finance (**MOF**), the Ministry of Human Resources and Social Security (**MOHRSS**), CSRC and CBRC<sup>3</sup>);
9. enterprise annuities funds (regulated by MOHRSS, CSRC and the China Insurance Regulatory Commission (**CIRC**));
10. insurance funds (regulated by CIRC);
11. private equity investment funds (regulated by the National Development and Reform Commission (**NDRC**));<sup>4</sup>

<sup>2</sup> These services include single-client asset management services and special-purpose asset management services. Since special-purpose asset management scheme requires CSRC approval on a case-by-case basis, this briefing only covers single-client asset management services.

<sup>3</sup> CBRC has replaced the People's Bank of China (**PBOC**) as the regulator of the banking aspect of this regime since 2003.

<sup>4</sup> This category of funds generally includes venture capital funds and industrial investment funds. Custody mechanism is generally optional for private equity funds. However, if the manager is a foreign-invested entity (either a wholly foreign-owned enterprise or a Sino-foreign joint venture), an onshore custodian bank (with legal person status) must be appointed. Therefore, only the detailed requirements for the custodian under the qualified foreign limited partner (**QFLP**) regime in pilot cities (Beijing, Tianjin and Shanghai) are set out in this briefing.

12. the qualified domestic institutional investors (**QDIIs**) scheme for FMCs and securities companies (**CSRC QDIIs**) (regulated by CSRC);
13. QDII for commercial banks (**Bank QDIIs**) (regulated by CBRC);
14. QDII for trust companies (**Trust QDIIs**) (regulated by CBRC); and
15. QDII for insurance companies (**Insurance QDIIs**) (regulated by CIRC).

The above list does not intend to cover all investment management schemes allowed under PRC law. For example, asset management services of futures companies (regulated by CSRC) also require the custody of assets. However, the detailed rule for this scheme is not clear and the governing regulation makes reference to the rules applicable to custodian of margin for futures transactions. Although the custodian of margin for futures transactions no longer requires regulatory approval after 23 September 2012<sup>5</sup>, only the "big five" commercial banks are carrying out this business in reality as a result of current restrictions associated with futures exchange and futures transactions<sup>6</sup>.

Apart from the general requirements of having to establish an independent custody department, putting in place a safe and efficient settlement and clearing system, and having a fixed place of business and proper security measures, different regulators may also impose specific additional requirements. Custodians for certain investment vehicles may trigger further regulatory approval. Please refer to the matrix in Annex I on the additional eligibility requirements for some key investment management schemes.

A custodian must satisfy the qualifications required of a securities investment funds custodian if it wishes to act for a number of different investment schemes (e.g. Wealth Management Products and CSRC QDIIs). Although certain investment schemes do not prescribe the eligibility requirements of custodians in detail, a custodian that satisfies the qualifications of a securities investment fund custodian is likely to qualify as the custodian in most investment schemes. In fact, the custodian qualification for securities investment funds may become a generally recognized standard, hence one with such qualification may be able to conduct custody business for a substantially larger scope of assets. For custodians that are unlikely to satisfy the approval requirements for specific investment schemes in the short run, they may initially specialize only in certain niche markets that do not require administrative approval.

## Special role undertaken by onshore custodians

In certain offshore jurisdictions, custodians tend to play a more passive role and are only responsible for safe-keeping the assets under mandate, executing the instruction of the manager and reconciliation. Since China does not have a parallel set of duty of care standards as in common law, the role of custodian is less clear as it is ambiguous as to whether they actually act as *de facto* trustees for the assets under custody. For example, the rules relating to the CSRC QDIIs explicitly provide that the onshore custodian should perform certain "trustee duties". Yet, the regulators do not define what "trustee duties" encompass when setting out in detail the duties such custodians have to perform.

According to the regulatory rationale of PRC financial regulators, onshore custodians are generally required to undertake certain duties and obligations that imply a proactive role in implementing the investment plan of the asset managers and in

<sup>5</sup> According to the *Decree of the State Council on Removing and Adjusting the Sixth Batch of Administrative Approval Items* issued on 23 September 2012, the approval requirement on custodians of margin for futures transactions has been removed.

<sup>6</sup> For example, the Shanghai Futures Exchange requires a margin custodian to be a nationwide commercial bank with branches and/or outlets in all major cities. This network requirement is impossible to be satisfied by a commercial bank other than by one of the "big five".

complying with the relevant regulations. Please refer to the matrix in Annex II which sets out the additional duties and obligations that custodians are required to undertake in respect of some investment management schemes.

## Implications for market players

While existing market players may wish to leverage their current infrastructure facilities to tap new business areas, potential market entrants may wish to grasp the right niche market as a starting point.

To better identify this starting point, banks considering an entrance into the relevant onshore custody market are suggested to:

- conduct a feasibility study on the required resources and procedures of the targeted market, and set up communication channels with the relevant regulators;
- develop template custody documentation adapted to the specific regulatory requirements and internal operations, which may reduce the ongoing negotiation costs and help control the documentation quality; and/or
- leverage the global network and other financial services within the existing range of products (fund administration, online services, information services, etc.).

Foreign banks may wish to additionally consider whether to incorporate their bank branches in China as a subsidiary bank to qualify as a custodian for certain investment schemes.

## Conclusion

While sharing most features of the generally recognised custody business, potential market participants ought to watch out for the specific characteristics and issues relating to the PRC onshore custody business. With rapid growth of China's asset management industry, the development of a more transparent regulatory framework for conducting custody business is anticipated.

## Annex I Eligibility Requirements for Custodians of Different Investment Schemes

	Capital & assets	Risk management indicators	Staffing	Technology system	Internal audit and risk management system	Track record	Note
Securities Investment Funds (based on the Consultation Draft)	At least RMB2 billion of net assets at year-end of the last three fiscal years	Satisfy all relevant regulatory requirements <sup>7</sup>	Satisfy all detailed requirements <sup>8</sup>	Independent (consist of network system, application system, safety protection system and data backup system)	Required	Three years without material non-compliance	<ul style="list-style-type: none"> <li>Joint approval of CSRC and CBRC is required;</li> <li>The custodian and the manager must not be affiliated; and</li> <li>Only banks with legal person status may be qualified.<sup>9</sup></li> </ul>
QFIs	At least RMB8 billion <sup>10</sup> of paid-in capital	Not specified	With sufficient full-time employees who are familiar with custody business	Not specified	Not specified	<p>No material violation of foreign exchange rules in the last three years.</p> <p>As for the branch of a foreign bank, it must have operated in China for more than three years.</p>	<ul style="list-style-type: none"> <li>Joint approval of CSRC and SAFE is required;</li> <li>Licence for engaging in foreign exchange remittance, settlement and conversion business as well as RMB business is required; and</li> <li>Although branches of foreign banks are technically qualified to apply, such applications have not yet been made in reality.</li> </ul>

<sup>7</sup> This is mainly measured by the capital adequacy ratio.

<sup>8</sup> Eligibility requirements for the senior management of the fund custody department are specified; at least half of the employees of the fund custody department must obtain the qualification to engage in fund business; at least 8 professionals must be qualified to engage in fund business for fund clearing, accounting, investment supervision, information disclosure and internal audit monitoring, among which the professionals for accounting, supervision and other core business positions must have at least two years' experiences in custody business.

<sup>9</sup> Under the current rules, foreign-invested banks are still not allowed to apply for this qualification.

<sup>10</sup> A PRC branch of a foreign bank may rely on the paid-in capital of its parent bank.

	Capital & assets	Risk management indicators	Staffing	Technology system	Internal audit and risk management system	Track record	Note
FMC Separate Account Services	Not specified						N/A
Collective Investment Scheme	Not specified						Technically, securities company may also be qualified.
Securities Companies Separate Account Services	Not specified						Technically, securities company may also be qualified.
Wealth Management Products	Same qualifications as custodians for securities investment funds must be met.						N/A
Collective Trust Funds Schemes	Commercial banks with stable operations						N/A
NSSF <sup>11</sup>	Paid-in capital of at least RMB8 billion	Not specified	With sufficient full-time employees who are familiar with custody business	Not specified	Must be satisfactory for the custody of NSSF assets	Not specified	CBRC approval is required.
Insurance funds	With paid-in capital of at least RMB8 billion <sup>12</sup>	Not specified	With sufficient full-time employees who are familiar with custody business	Generally required	Required	Three years of custody business experience without material non-compliance	Should have the ability to assess the investment performance of insurance funds

<sup>11</sup> Currently, custodians for NSSF are all large state-owned banks.

<sup>12</sup> A PRC branch of a foreign bank may rely on the paid-in capital of its parent bank.  
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	Capital & assets	Risk management indicators	Staffing	Technology system	Internal audit and risk management system	Track record	Note
QFLP (Beijing & Tianjin) <sup>13</sup>	Not specified	Not specified	With sufficient full-time employees who are familiar with custody business	Independent (the relevant Beijing rules specifically require the presence of a network system, application system, safety protection system and data backup system)	Required	No material violation of laws, regulations and foreign exchange rules in the last 3 years.	<ul style="list-style-type: none"> <li>The bank must be qualified to engage in both foreign exchange and RMB business;</li> <li>Qualification of custodian for securities investment funds is required; and</li> <li>Strategic cooperation agreement with the regulator is required.</li> </ul>
CSRC QDIIs	Same qualifications as custodians for securities investment funds must be met.						N/A
Bank QDIIs	Not specified	Not specified	With sufficient full-time employees who are familiar with custody business	Not specified	Specifically required for foreign-invested banks	No material violation of foreign exchange rules in the last three years.	Custodians who qualify as custodian for securities investment funds, NSSF, Insurance QDII and insurance company stocks custody automatically satisfy this requirement. Otherwise, CBRC approval is required.
Trust QDIIs	Same qualifications as custodians for Wealth Management Products must be met						N/A

<sup>13</sup> The Shanghai QFLP rules do not specify the eligibility requirements of custodians.  
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	Capital & assets	Risk management indicators	Staffing	Technology system	Internal audit and risk management system	Track record	Note
Insurance QDIIs	Paid-in capital or net assets at the end of the last fiscal year is no less than RMB30 billion. <sup>14</sup>	At the end of the last fiscal year, the capital adequacy ratio is above 10% and the core capital adequacy ratio is above 8%. <sup>15</sup>	Having at least six professionals to take charge of the custody of insurance assets	Not specified	Required	No material violation of laws or regulations in the last three years.	<ul style="list-style-type: none"> <li>Assets under custody are no less than RMB200 billion;<sup>16</sup></li> <li>Long-term credit rating is "A" or above;<sup>17</sup> and</li> <li>A bank may be prohibited from acting as the custodian if it is affiliated with the insurer that jeopardises independence.</li> </ul>

<sup>14</sup> If the parent bank undertakes to be liable under the custody agreement joint and severally with the onshore custodian (its subsidiary bank or branch in China), the onshore custodian can rely on the paid-in capital or net assets and assets under custody of its parent bank to apply for the Insurance QDII custodian qualification.

<sup>15</sup> A PRC branch of a foreign bank may rely on the capital adequacy of its parent bank.

<sup>16</sup> A PRC branch of a foreign bank may rely on the assets under custody of its parent bank.

<sup>17</sup> A PRC branch of a foreign bank may rely on the credit rating of its parent bank.

**Annex II Additional Duties and Obligations of Custodians of Different Investment Schemes**

	Omnibus account	Accounting and Evaluation	Examining manager's NAV calculation	Supervision of Investment	Custodian and financial accounting report	Report of non-compliance to regulatory authorities	Documents and information retention	Special issues
Securities Investment Funds (based on the Consultation Draft)	Not allowed	Optional (as a matter of fact, most fund managers tend to do this in-house)	Required (obligated to report and make public disclosure of serious errors and deviation)	Required (alert the manager of non-compliance risk)	Required (provide a review opinion on the fund's periodical financial information, a custodian report in the interim and annual report of the fund, and ad hoc announcement of material events)	Required (report on non-compliance by the fund manager)	At least 15 years	<ul style="list-style-type: none"> <li>The custodian is obligated to convene fund unit holders' general meeting in certain situations;</li> <li>CSRC reviews the draft custody agreement;</li> <li>The custody agreement is subject to public disclosure.</li> </ul>
QFIs	Not allowed	Required	Not specified	Required	<ul style="list-style-type: none"> <li>Annual financial report to regulators;</li> <li>Report relevant foreign exchange information to SAFE; and</li> <li>Monthly report of QFII portfolio, funds flow and transactions to CSRC/SAFE</li> </ul>	Required (report on non-compliance by the QFII)	At least 20 years	<ul style="list-style-type: none"> <li>The custodian is responsible for foreign exchange conversion and remittance; and</li> <li>The custody agreement should be filed with SAFE.</li> </ul>

	Omnibus account	Accounting and Evaluation	Examining manager's NAV calculation	Supervision of Investment	Custodian and financial accounting report	Report of non-compliance to regulatory authorities	Documents and information retention	Special issues
FMC Separate Account Services	Not allowed	Not specified	Not specified	Required (notification to the manager and refusal to execute non-compliant instruction)	Annual custody report should be filed with CSRC	Required (report on non-compliance as well as violation of the asset management contract by the manager)	Only a general requirement	<ul style="list-style-type: none"> <li>The custodian needs to review the asset management report of the manager for the investors and issue a review opinion.</li> <li>The custodian needs to execute the asset management contract as a party, which should be filed with CSRC.</li> </ul>
Collective Investment Schemes	Not allowed	Not required (should be carried out by the manager)	Required	Required (require the manager to rectify any non-compliance)	Quarterly and annual custody report is required to be sent to clients and filed with the industry association; copying the same to CSRC by the manager and/or the custodian.	Required (report on certain non-compliance by the manager)	Not specified	The custody agreement should be filed with CSRC
Securities Companies Separate Account Services	Not allowed	Not required (should be carried out by the manager)	Not specified (as long as the client can check the NAV as agreed)	Required (require the manager to rectify any non-compliance)	Not specified	Required (report on certain non-compliance by the manager)	Not specified	N/A
Wealth Management Products	Not specified							

	Omnibus account	Accounting and Evaluation	Examining manager's NAV calculation	Supervision of Investment	Custodian and financial accounting report	Report of non-compliance to regulatory authorities	Documents and information retention	Special issues
Collective Funds Trust Schemes	Not allowed	Not specified	Not specified	Required	Periodical custodian report to be made to the trust company	Required (report on material non-compliance by the trust company)	Record of transfer of trust funds, and trust company's statement on usage of funds	Only cash is required to be kept under custody
NSSF	Not allowed	Not specified	Not specified	Required	Not specified	Required (report on non-compliance of the manager's investment instruction)	At least 15 years	Filing of the custody agreement with the Ministry of Finance, MOHRSS, CSRC and CBRC
Insurance funds	Not allowed	Responsible for the evaluation	Not specified	Required	Custody report to the insurer / manager, and investment performance & risk assessment report to CIRC	Required	At least 15 years	N/A

	Omnibus account	Accounting and Evaluation	Examining manager's NAV calculation	Supervision of Investment	Custodian and financial accounting report	Report of non-compliance to regulatory authorities	Documents and information retention	Special issues
QFLP	Not allowed	Not specified (in practice, this service can be outsourced)	Not specified	Required	Monthly / quarterly reporting by the manager/fund on the flow of foreign currency funds, foreign exchange settlement and investment and annual custody report should be filed with the regulator <sup>18</sup>	Required	At least 20 years  (Shanghai Rules do not specify)	<ul style="list-style-type: none"> <li>The custodian is obligated to implement the foreign exchange control rules on conversion into RMB for equity investment; and</li> <li>Custody agreement should be filed with the local SAFE office</li> </ul>
CSRC QDIIs	Not allowed	Not specified	The custodian has the obligation to ensure that the NAV is duly calculated	Required	Monthly report on QDII investment to CSRC and SAFE, and report on relevant foreign exchange information to SAFE	Required	At least 20 years	<ul style="list-style-type: none"> <li>The custodian should notify the manager of information on corporate action; and</li> <li>The custodian is responsible for foreign exchange conversion and remittance.</li> </ul>
Bank QDIIs	Not allowed	Not specified	Not specified	Required	Report on relevant foreign exchange information to SAFE (monthly, annual and ad hoc)	Required	Not specified	<ul style="list-style-type: none"> <li>The custodian is responsible for foreign exchange conversion and remittance; and</li> <li>The custody agreement should be filed with SAFE.</li> </ul>

<sup>18</sup> The Shanghai QFLP rules require periodical report on funds under custody and investment projects and annual report on onshore equity investment information.  
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	Omnibus account	Accounting and Evaluation	Examining manager's NAV calculation	Supervision of Investment	Custodian and financial accounting report	Report of non-compliance to regulatory authorities	Documents and information retention	Special issues
Trust QDIIs	Not allowed	It is implied that this should be carried out by the trust company	Not specified	Required	<ul style="list-style-type: none"> <li>Report relevant foreign exchange information to SAFE (monthly, annual and ad hoc)</li> </ul>	Required	At least 15 years	<ul style="list-style-type: none"> <li>The custody agreement is required to be filed with SAFE; and</li> <li>If the proposed offshore sub-custodian is an affiliate of the onshore custodian, prior report to CBRC is required.</li> </ul>
Insurance QDIIs	Not allowed (except for the insurance funds of the same sponsoring insurer, provided that funds managed by different managers and different funds are clearly separated in the books <sup>19</sup> )	Not specified (CIRC rules require the engagement of an eligible accounting firm)	Not specified	Required (alert the sponsoring insurer and the manager of non-compliance risk)	<ul style="list-style-type: none"> <li>File with CIRC (i) an <i>ad hoc</i> report on material events, (ii) quarterly statements on the offshore investment of insurance funds; and (iii) annual financial accounting report and internal audit report; and</li> <li>Report relevant foreign exchange information and onshore account balance to SAFE/CIRC</li> </ul>	Required	Not specified	The custodian is responsible for foreign exchange conversion and remittance.

<sup>19</sup> The underlying reason is that each insurer can only appoint one custodian for the offshore securities investment of its insurance funds.

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