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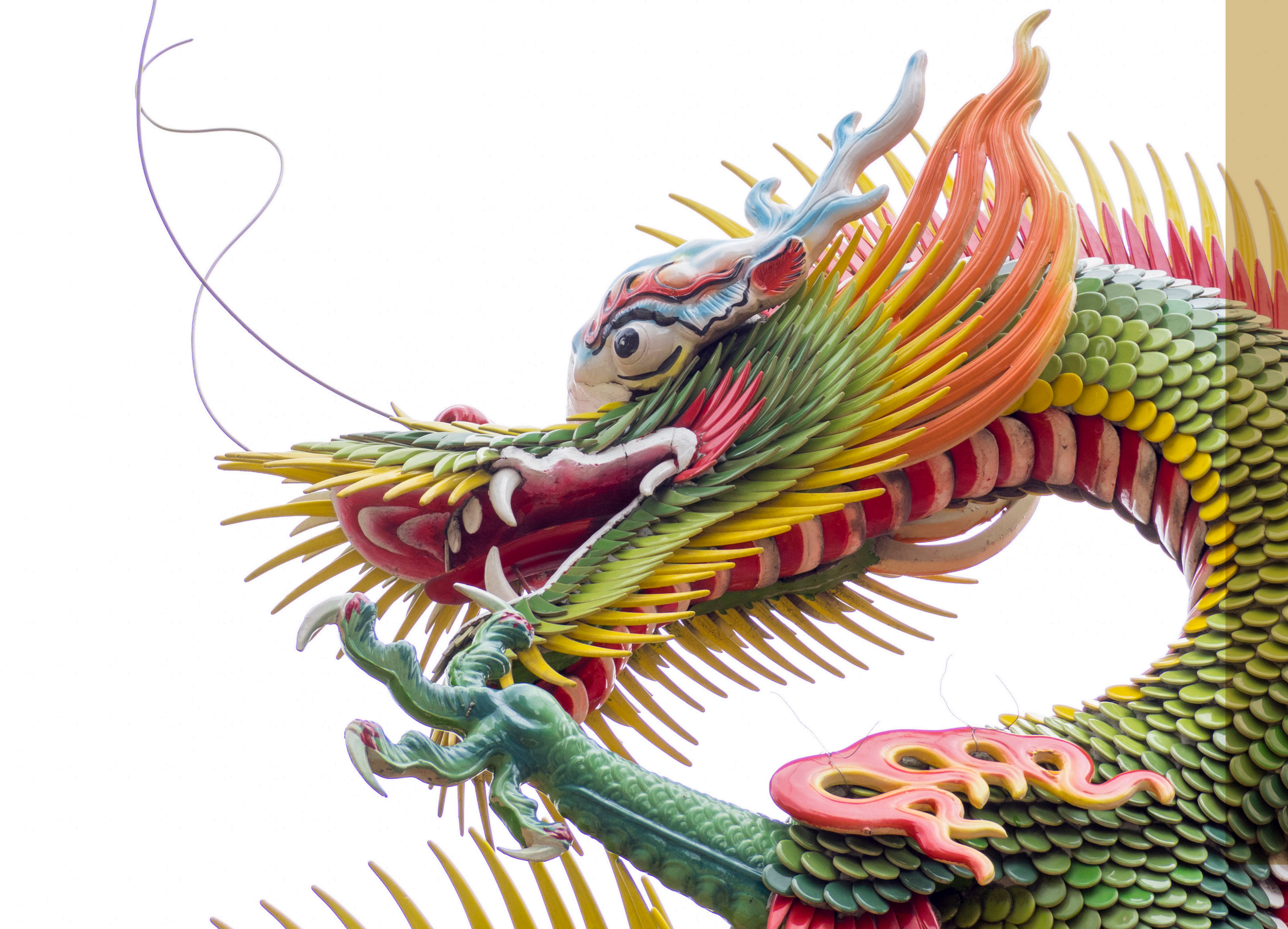
WILL CHINA LIBERALISE OR TIGHTEN ITS GRIP ON THE MARKET FOLLOWING THE STOCK MARKET CRASH?



WILL CHINA[1] LIBERALISE OR TIGHTEN ITS GRIP ON THE MARKET FOLLOWING THE STOCK MARKET CRASH?

In recent years China has implemented a range of initiatives to promote cross border investment and open up its capital markets. In November 2013 the 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. While China seemed set on market liberalisation, bail-out measures taken by Chinese regulators in response to the stock market crash in mid-June 2015 are delivering mixed messages. Here Clifford Chance experts explore the attempts to open up China's capital markets, recent regulatory interventions and the outlook for China's future development.

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 it's capital markets, with a view to promoting economic development.

Overview of the key programs opening up the PRC capital markets

QFII & RQFII programs

Since their introduction in 2002 and 2011 respectively, China's Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) programs have grown into a major channel for foreign investors to access China's 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). Since UBS AG was granted the first QFII license in mid-2003, 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 14 jurisdictions, and not simply subsidiaries of Chinese companies. By July 2015, 276 QFIIs had obtained a total quota of USD76 billion and 135 RQFIIs had been granted a total quota of RMB399 billion (roughly USD66 billion).

1 For the purpose of this briefing, "China", "PRC" or "Mainland China" does not include Hong Kong, Macao and Taiwan.

The QFII and RQFII regimes are largely similar in terms of regulators, application procedures, investment scope, quota administration, although there are some differences on aspects such as liquidity and repatriation of funds. Over the years the PRC regulators have revised the relevant rules to lower entry barriers, simplify licence 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. However, there are still limitations under the programs such as quota restriction, capital mobility and account structure. The PRC regulators also indicated that they were considering further enhancements which may include a merger of the QFII and RQFII schemes. Although there is no clear timeline on the potential merger, once realized, it will be a significant step in opening up the PRC market, along with the stock connect program as discussed below.

Shanghai – Hong Kong Stock Connect

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 liberalisation of China's Capital markets and provides unique opportunities for investors globally. 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.

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 is anticipation in the market that the quotas will be increased in the second half of 2015 as the regulators grow more comfortable with the stability of the program.

Adding Stock Connect to the QFII/RQFII tools available for accessing the Chinese A share market is an incredibly important development towards the liberalisation of RMB. While it is true that the QFII and RQFII programs will no longer have a "monopoly" on investments into A shares, Stock Connect does not make QFII/RQFII redundant. 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 liberalised gradually by introducing more programs to facilitate cross-border investments.

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.

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, in due course. After that is achieved, China's combined exchanges would form the biggest stock market in the world outside the U.S. A similar program to connect the bond markets of mainland China and Hong Kong is being considered by the relevant regulators which, if successful, may add another channel for foreign investors to tap into the world's third-largest debt market. In addition, the potential expansion to asset classes such as commodities may allow Hong Kong Exchange and Clearing Limited (which recently acquired the London Metal Exchange) to challenge Singapore's status as the commodity hub in Asia. As a recent development, as one of the outcomes from the 7th China-UK Economic and Financial Dialogue concluded in September 2015, both sides will support the SSE and the London Stock Exchange Group to carry out a feasibility study on London stock connect.

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 (roughly USD50 billion) for each of the Hong Kong and mainland funds. In contrast to the more commonly-seen "passport" regimes elsewhere in the world, MRF allows a fund that has been authorised by or registered with the relevant authority in one jurisdiction (e.g. Hong Kong) (Home Jurisdiction) to obtain authorisation or approval from the regulator in the other jurisdiction (e.g. China) (Host Jurisdiction) so as to offer to the public in the Host Jurisdiction.

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 recognised 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 MRF between the mainland and Hong Kong marks another big step forward in deepening their financial ties. From China's perspective, the MRF represents a milestone to open up its capital market and to further its ambition to introduce international competition with a view to developing domestic fund management institutions. It is likely that the MRF will go beyond China and Hong Kong. As another note-worthy policy outcome under the 7th China-UK Economic and Financial Dialogue, both sides welcome the initiative to establish a

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Yin Ge, Counsel, Clifford Chance

working group on MRF involving the regulators and market participants on both sides. Some also expect similar arrangements with jurisdictions like Luxembourg and potentially UCITS funds, which may happen in the fullness of time. Of course, from PRC regulators' perspective, they need to be prepared that the coordination with regulators in jurisdictions other than Hong Kong is likely to be more challenging, given the level of difference in regulatory system and market practice. In respect of Europe, one also assumes that funds would need to be either UC ITS or AIFMD compliant which raises a whole new set of challenges.

Foreign participation in the domestic futures market

While China has been committed to increasing accessibility to it's domestic capital markets, the domestic futures market has still been largely closed to foreign investors. An exception is that QFIIs and RQFIIs may invest in stock index futures, subject to the approval and any agreed trading quota granted by the China Financial Futures Exchange. In June 2015, CSRC issued rules to allow foreign investors and brokers to trade designated domestic futures products in China. This is an important step forward towards opening China's futures market, which has been long-awaited by many market participants.

According to the relevant CSRC rules, as from 1 August 2015, foreign investors and brokerage firms are permitted to trade designated futures products in China. From CSRC's perspective, the intention is to introduce better international practices to, and improve the price discovery function of, the China market through increased liquidity. Crude oil futures will be the first designated futures products for foreign investment and are expected to be launched on the Shanghai International Energy Exchange (sponsored by the Shanghai Futures Exchange) by the end of 2015. It is believed that the choice of crude oil futures is driven by the PRC government's intention to gain some pricing power, as China has recently become the largest importer of crude oil in the world. In April 2015 it surpassed the US with imports of 7.4 million barrels per day, according to the Financial Times.[2]

Other developments for inbound investment

In addition to the above programs, there could be alternative ways to enter into China's capital market including using a wholly-owned onshore subsidiary (WFOE), although it may not be as straight-forward as it sounds. Interestingly, this route mentioned under the 7th China-UK Economic and Financial Dialogue as well. To be specific, if China government agrees to allow qualified WFOEs or joint venture companies to engage in private fund management business in China, including trading securities on the secondary market.

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Tiecheng Yang, Partner, Clifford Chance

2 China oil imports surpass those of the US (*Financial Times, 10 May 2015*)

Generally speaking, the PRC regulators have been making continuous efforts to promote foreign investment over the years. The development of Shanghai and other Free Trade Zones and the introduction of so-called "Negative List" administration reform have represented part of such efforts.

Programs to promote outbound investment

There are also some programs available in China under which domestic mainland 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. By July 2015, SAFE has approved an aggregate quota of roughly USD90 billion to 132 QDIIs in total.

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. 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 by Zhou Xiaochuan, the governor of the PRC central bank, in a speech at the International Monetary and Financial Committee on 18 April 2015.

How have Chinese regulators responded to the stock market turmoil?

China's stock market dropped significantly in mid-June 2015, and by early July around a thousand of the shares listed on PRC stock exchanges were suspended for trading. The A share index fell by a third in a few weeks, losing over RMB20 trillion (roughly USD3.5 trillion).

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.

According to press reports, some foreign-invested onshore companies trading in PRC securities or futures have been the targets of such investigations. The China Securities Regulatory Commission (CSRC) is also reportedly paying attention to foreign investors' shorting of A shares or the A share index (such as the SGX FTSE China A50 Index Futures) via offshore transactions. At the same time, there are some in the Chinese market who blame the market plunge on hostile foreign investors seeking to make profits from a falling A share market. The PRC stock exchange has imposed a three month suspension of trading on 34 securities accounts which have been involved in frequent order routing and cancelling, one of which belongs to a trading subsidiary established by an international hedge fund. As a related effect, RMB has undergone a depreciation recently.

The market volatilities and RMB depreciation have caused concern among foreign investors about the stability of the Chinese market. But what may be more worrying are the PRC regulators' interventions to rescue the market, which seem inconsistent with the government's stated aim to "let the market play a decisive role." Now, with the stock market becoming stabilized and the RMB depreciation slowing down, the noises around "malicious shorting" and blame on foreign investors are also fading from the market. At the same time, after a round of market investigations, it seems the regulators have not discovered any material violation by foreign investors.

What's the outlook?

Some commentators have raised concerns that the recent stock market chaos and the subsequent bail-out measures may delay China's financial reforms to a certain degree. While the potential impact of the recent economic climate on the market liberalisation reforms cannot be ignored, we believe that China's development still depends upon market liberalisation and RMB internationalisation in the long run. Domestically, before the stock market crash, further reforms to promote capital account liberalisation had been set in the State Council's work plan and the central bank's RMB internationalisation report for 2015. Internationally, China is still keen to have RMB included in the International Monetary Fund's Special Drawing Rights (SDR) basket of currencies and have China A-shares included in the MSCI Index. It is only a question of time until these happen. The government has made further commitments to open up its capital markets during the latest round of China-US and China-UK Strategic and Economic Dialogues in June and September 2015 respectively. In addition, the recent milestone development of the Trans-Pacific Partnership (TPP) led by the US but excludes China has gained much coverage and attention within China. It is anticipated that China would accelerate its market liberalisation process to maintain competitive in the region.

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