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2 November 2015

China's SFTZ to step up currency and financial market liberalisation.

Contents

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Background

On 29 October 2015, the Shanghai people's government and six Chinese ministries jointly published a key policy paper on pursuing financial innovation in the Shanghai Free Trade Zone ("**SFTZ**") and developing Shanghai as an international financial centre. The 40-point plan outlines further steps in the convertibility of RMB with respect to capital account items, and seeks to enhance cross-border usage of RMB and the further opening up of China's financial markets. It is, arguably, the most significant official endorsement of financial reform in the SFTZ since the People's Bank of China published its 30-point plan in December 2013 (see our earlier alert). Detailed implementation rules remain to be issued by the relevant government authorities.

Capital account liberalisation and two-way cross-border investment

The plan contains significant developments which, if implemented, will enhance the convertibility of the RMB and open up additional cross-border investment options to SFTZ financial institutions.

> **Capital outflow:** evaluating the possibility of expanding the USD50,000 individual annual quota on conversion of RMB to foreign exchange.

> **Outbound investment:** evaluating the launch of a pilot programme and implementing rules to enable qualified Chinese domestic individuals to make overseas industrial, fixed asset and financial investments. Together with the expansion of the quota mentioned above, this "**QDII2**" scheme would, when launched, significantly expand the available channels for domestic individuals to invest overseas which are currently limited, generally, to participation in the Shanghai-Hong Kong Stock Connect securities trading link and indirect

investment through financial products under the Qualified Domestic Individual Investor (QDII) scheme.

No further details of this QDII2 scheme are offered in the plan. However, previous reports indicate that investors under the plan must be of age 18 and above with average financial assets of RMB1 million over the past three months, and locations contemplated for the plan's rollout include Tianjin, Chongqing, Wuhan, Shenzhen and Wenzhou (in addition to Shanghai).

> **Inbound portfolio investment:** the development of a regime for qualified institutional and individual investors to invest in the domestic and overseas securities and futures markets is to be accelerated. Specifically, the plan mentions opening up of the domestic markets through the SFTZ's free trade account mechanism, thus indicating that the authorities are seeking to develop an additional channel of cross-border portfolio investment in addition to the Qualified Foreign Institutional Investor ("**QFII**") and Renminbi Qualified Foreign Institutional Investor ("**RQFII**") schemes, and Shanghai-Hong Kong Stock Connect – this possibly being a reaction of the Chinese authorities to the volatility in the A-share market over the summer of 2015.

The plan goes on to:

- support the establishment by the Shanghai Stock Exchange of a platform for trading international financial assets to enable overseas long-term capital to trade domestic equities, bonds and fund products, and
- explore the possibility of overseas institutional investors participating in the price discovery process for domestic IPOs (which would significantly expand the QFII regime with respect to overseas institutions' involvement in the A-share market).

> **Convertibility:** evaluating the launch of a pilot programme for currency convertibility in the SFTZ and allowing non-financial enterprises to convert RMB and foreign exchange in the SFTZ within quotas to be defined. This may mean enhanced convertibility in the SFTZ's free trade account system, which currently allows free movement of RMB and foreign currency funds between the SFTZ and outside China but limits free convertibility in the SFTZ to those items which already apply some form of convertibility under general rules (such as current account items and foreign direct investments).

> **Investment management:** securities companies and fund managers are set to be able to offer more diverse products and the scope of existing cross-border investment schemes will be broadened.

- eligible insurance funds and other forms of long-term capital will be permitted to invest overseas through securities and futures companies in the SFTZ.

- securities and futures companies in the SFTZ will be permitted to participate in a pilot programme to trade overseas securities, futures and derivatives. They will also be permitted to undertake cross-border asset management in the SFTZ (which is currently available only to fund managers, through the Qualified Domestic Limited Partnership ("**QDLP**") and Qualified Domestic Investment Enterprise schemes) and cross-border brokerage, and conduct spot and derivatives trading of foreign exchange through the inter-bank foreign exchange market (in which there is currently only one securities company participant).
- fund managers will be permitted to set up SFTZ subsidiaries to undertake overseas asset management and overseas investment advisory business, as well as special index fund subsidiaries (which may facilitate cross-border investment in such products). The implementation of these changes will open up further lines of business for fund managers (whose subsidiaries' businesses are limited under the current rules to entrusted investment and mutual fund distribution) in the SFTZ.
- the plan also supports project companies specialising in outbound private equity investment to be established in the SFTZ, as well as investments by eligible investors in outbound private equity investment funds. This will broaden the QDLP scheme (which is currently limited to secondary market trading).

Cross-border RMB

The plan outlines measures to increase global usage of the RMB in cross-border investments, thus making the RMB a more globally acceptable currency.

> **"Panda" bonds:** the rules will be changed to allow the overseas parent and subsidiary entities of SFTZ enterprises to issue RMB bonds onshore in the People's Republic of China (the "**PRC**") and for the proceeds of issue to be used outside the PRC as well as domestically. Current issuers of these bonds have been limited to multinationals such as HSBC, Bank of China and Daimler (the current rules limit the types of issuers to "international development institutions"). It has been reported that the People's Bank of China is at an advanced stage of drafting the revised rules (however, the draft is not publicly available).

> **Other reverse RMB instruments:** existing avenues for investment of offshore RMB in the mainland (such as RQFII) will be expanded, with a greater range of RMB financial assets to be offered abroad (this may include certain financial products such as structured deposits and trust products, which are currently only available to domestic PRC investors). This complements recent initiatives such as cross-border interbank certificates of deposit and offshore loans borrowed through

the SFTZ's free trade accounts, which seek to allow greater reverse RMB flows into the SFTZ.

> **Cross-border RMB financing**: recent initiatives encouraging cross-border lending of RMB between members of multinational corporate groups are to be further expanded, with new rules that will permit sole proprietors to provide RMB financing to their overseas businesses.

Financial sector market access

The plan announces regulators' intentions to continue the gradual process of liberalising the entry by foreign investors to the PRC financial markets, and points to several pioneering developments in market access regulation being initiated.

> **Negative list:** the plan seeks to apply the "national treatment" principle of negative list management in the financial services sectors, and promises further opening up of the market to foreign and private capital. The negative lists currently operating in China's four free trade zones do not exclude the separate "prudential financial" measures, which can impose additional requirements on foreign investors in these sectors. Full implementation of the plan would, accordingly, make equal treatment of foreign and domestic investors in these sectors the default position, with the only permitted exceptions being those special measures set out in the negative list.

> **National security:** the plan mentions that a national security review regime will be piloted with foreign investors in the financial sectors in the SFTZ on a pilot basis. The current rules on national security review of foreign investment, which do not apply to the financial sector, have envisaged the creation of a separate national security regime for the financial sector ever since the regime was put in place in 2011.

> **Network expansion:** the plan will support banks operating in the SFTZ through newly-incorporated subsidiaries, branches, and special business branches and subsidiaries. This may allow banks in the SFTZ to diversify their products at a faster and more structured pace (e.g. by setting up consumer finance companies).

> **Securities companies:** the plan indicates that foreign financial institutions are to be permitted to set up securities joint venture companies in the SFTZ without the requirement for the Chinese joint venture partner to be a securities company. This offers, as has similarly been extended to Hong Kong and Macao investors under the Closer Economic Partnership Arrangements between the Mainland and Hong Kong/Macao ("**CEPA**"), foreign investors looking to set up such ventures in the SFTZ additional flexibility of partner selection than is available under national rules. No mention is made of any limit on the number of joint ventures a single foreign investor may have either in the SFTZ or in Shanghai as a whole (though as is the case with CEPA, if the foreign ownership percentage is further increased from the

current 49 per cent. under national rules, it is possible that the authorities will seek to limit the number of such ventures). Foreign investors will also be permitted to set up joint venture securities investment consultancy companies in the SFTZ.

> **Bilateral concessions:** the plan provides for an unspecified gradual increase in the foreign ownership percentage of financial institutions whose investors' jurisdictions have free trade agreements with China.

Overall, the plan foreshadows several eagerly anticipated developments in the fields of currency convertibility and financial innovation for investors as well as market participants. The pace at which these reforms will be implemented is likely to depend on continued stability in the financial markets and the outcome of China's discussions with the International Monetary Fund for the RMB to be included in the basket of currencies that make up the Special Drawing Rights (SDR).

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Reference

Notice of the People's Bank of China, Ministry of Commerce, China Banking Regulatory Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission, State Administration of Foreign Exchange and Shanghai Municipal Government on Further Piloting Financial Opening Up and Innovation in the Shanghai Free Trade Zone and the Proposals to Accelerate the Construction of Shanghai International Financial Centre (中国人民银行、 商务部、 银监会、 证监会、 保监会、 外汇局、 上海市人民政府关于印发《进一步推进中国（上海）自由贸易试验区金融开放创新试点 加快上海国际金融中心建设方案》的通知), 29 October 2015

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