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China opens up interbank bond market to foreign institutional investors

Introduction

In February 2016, the People's Bank of China ("**PBOC**") in a significant move announced the opening of China's interbank bond market to a wide array of foreign institutional investors.

Further to that announcement, on 27 May 2016, the Shanghai headquarters of PBOC ("**PBOC Shanghai**") and the State Administration for Foreign Exchange ("**SAFE**") published the much anticipated rules (the "**Foreign Institutional Investor Rules**") implementing the opening up of the interbank bond market.

Following these developments, a wide range of foreign institutional investors can now invest in China's burgeoning interbank bond market without prior approval or licence from Chinese regulators.

We set out below:

> the key features of the framework under the Foreign Institutional Investor Rules; and

> a discussion of certain key legal and documentation issues to be considered under the Foreign Institutional Investor Rules.

Key Features

Who are eligible investors?

"**Eligible Investors**" that are permitted to invest in the interbank bond market are:

> foreign banks, insurers, securities brokers, fund managers and other financial institutions;

> investment products issued by the financial institutions mentioned above; and

> other medium or long-term institutional investors (such as pension funds, charity funds and donation funds) recognised by PBOC.

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What products can be traded?

An Eligible Investor can:

- trade bonds in the inter-bank bond market; and
- based on its hedging needs, enter in transactions such as:
    - bond lending;
    - bond forwards;
    - forward interest agreements; and
    - interest rate swaps ("**IRS**").

Where to trade and settle?

Eligible Investors can trade in the China Foreign Exchange Trade System and National Inter-bank Funding Center ("**CFETS**"), which is the trading execution facility for the interbank bond market.

Each of China Central Depository & Clearing Co., Ltd. ("**CCDC**") and Shanghai Clearing House ("**Shanghai Clearing**") provides bond registration, depository and settlement services for the interbank bond market.

On the same day that PBOC Shanghai and SAFE issued the Foreign Institutional Investor Rules, CFETS, CCDC and Shanghai Clearing jointly issued an operational guide on the network connection and account opening procedures (including the application forms) for foreign institutional investors wishing to trade in the interbank bond market.

How to start trading?

Onshore settlement agent

Each investor intending to participate in the interbank bond market is required to appoint an onshore settlement agent.

While no formal licence or prior approval from the Chinese regulators is required to access the interbank bond market, the settlement agent is responsible for checking the qualifications and eligibility of the investors and reporting to PBOC Shanghai investments made by such investors on a timely basis.

The key services provided by a settlement agent include:

- filing with PBOC Shanghai on behalf of Eligible Investors;
- assisting with the opening, updating and/or cancelling onshore cash and bond accounts;
- providing bond trading agency and bond settlement agency services; and
- providing asset custodian services.

Account structure

Unlike the Shanghai-Hong Kong Stock Connect Scheme where all the foreign investors only have one omnibus account opened with China Securities Depository And Clearing Corporation Limited, each Eligible Investor (including investment products issued by foreign financial institutions) will have its own individual bond account with CCDC and/or Shanghai Clearing. Importantly, bonds held in such accounts will be segregated from the assets of the settlement agent and CCDC/Shanghai Clearing.

Key Legal and Documentation Issues

Determination of "medium or long-term investors"

Based on the definition of "Eligible Investors", if an investor is not a type of entity that has been expressly listed (such as a bank or financial institution), it would need to be a "medium or long-term institutional investor" recognised by PBOC in order to invest in the interbank bond market.

The settlement agent will be the gatekeeper who will make the critical determination of whether the relevant investor meets such condition. To this end, we note that no guidance or criteria has been published on how to determine whether an investor is a "medium or long-term institutional investor".

It remains to be seen how settlement agents will make this assessment in practice, in particular, whether they will mainly take into consideration the entity type of the investor and/or the estimated investment term provided by the investor.

There have been speculations that hedge funds and private equity funds may not fall within the scope of Eligible Investors but this remains to be confirmed by settlement agents and the regulators.

Application of mandatory clearing requirements

If an Eligible Investor trades in derivatives which are of a type that is subject to mandatory clearing requirements in China such as RMB interest rate swaps, the following questions may be relevant:

> Will the mandatory clearing requirements have extra-territorial effects on Eligible Investors such that these requirements apply to them?

> If so, given that mandatory clearing requirements in China only apply to financial institutions, would the Eligible Investor be considered as a financial institution under Chinese law?

  This may not be a straightforward question for entities such as pension funds and donation funds.

> For an Eligible Investor from a jurisdiction (e.g., an EU jurisdiction) where its mandatory clearing requirements have also become effective, how are the mandatory clearing requirements in its home jurisdiction and in China to be reconciled?

We understand that in many jurisdictions, investors cannot clear derivatives in a foreign clearing house unless such foreign clearing house has been recognised by the competent authority in that jurisdiction (e.g., recognition as a third country CCP by ESMA in the EU).

On 31 May 2016, Shanghai Clearing received a no-action letter from U.S. Commodity Futures Trading Commission for its registration as a Derivatives Clearing Organisation ("***DCO***"). This means that U.S. banks can clear their proprietary trades with Shanghai Clearing as a direct clearing member (but not for clients) so long as such trades are subject to mandatory clearing in China.

However, if a foreign institutional investor is from other jurisdictions such as the EU, there is some uncertainty as no equivalent of a DCO registration or third country CCP recognition (or no-action letter or exemption for such registration) has been granted to Shanghai Clearing by authorities from such other jurisdictions yet.

Application to QFII/RQFII

SAFE has specified in its rules that investments in the interbank bond market by QFII/RQFII are subject to the current foreign exchange rules applicable to QFII/RQFII.

Further clarification is required on:

- whether QFII/RQFII can access the interbank bond market both in its capacity as a QFII/RQFII and as an Eligible Investor;
- if the answer to the question above is yes:
  - whether and how a QFII/RQFII's investment as an Eligible Investor in the interbank bond market would affect its investment quota as a QFII/RQFII;
  - how a QFII/RQFII's account with CFETS, CCDC and/or Shanghai Clearing for its new capacity as an Eligible Investor would be opened; and
  - from a cash remittance perspective, whether there could be potential payment netting arrangement if a QFII/RQFII wants to (a) remit money out of China in its capacity as a QFII/RQFII for its proprietary trade and (b) remit money into China in its capacity as an Eligible Investor, at the same time (or vice versa).

Pledging of bonds

Given recent relaxation on cross-border financings, questions have been raised whether a foreign investor (such as QFII/RQFII) could grant a pledge over its securities holding onshore China to facilitate offshore loans and financings.

Traditionally, although there is no express prohibition, regulators of QFII/RQFII hesitate allowing QFIIs/RQFIIs to grant a pledge over the assets (e.g., shares, bonds) that QFIIs/RQFIIs hold in China. The regulators' concern seems to be that creation of pledge or security interest arrangement over a QFII/RQFII's onshore assets could lead to onshore financing activities by QFII/RQFII which are not within the approved scope of activities for QFII/RQFII.

Given market trends and developments, relevant regulators and securities registration institutions will no doubt have to consider whether and how the Eligible Investors would be able to create a pledge or enter into security interest over the bonds they hold onshore.

Documentation

There are four major types of documentation an Eligible Investor needs to consider:

> **Agency and custody agreement**

An Eligible Investor needs to enter into a trading agency agreement and settlement agency agreement with its settlement agent and a custody agreement with its custodian. The settlement agent and the custodian would likely be the same entity.

As there are only a few settlement agents in the market, there might be limited room for negotiation for such agency agreements between an Eligible Investor and a settlement agent.

> **Spot bond trading**

Bonds are traded through the electronic system of CFETS. An Eligible Investor can submit its instruction through its settlement agent to CFETS. Accordingly, extensive documentation is unlikely to be required for spot bond trading.

> **Derivatives trades**

As mentioned above, an Eligible Investor can also trade in certain OTC derivatives for hedging purposes. This is not the first time foreign entities are permitted to trade derivatives in the interbank bond market. In July 2015, PBOC issued a notice regarding RMB investment in the interbank bond market by offshore central banks, international financial organisations and sovereign wealth funds (together, "**Specified Entities**") to allow those entities to trade in bond lending, bond forwards, forward interest agreements and IRS.

In a subsequent Q&A published by PBOC regarding investment in the interbank FX market by Specified Entities, PBOC clarified that a Specified Entity could choose to document its trades under an ISDA Master Agreement or NAFMII Master Agreement.

As the Q&A was in relation to FX trades of Specified Entities, it remains to be seen whether PBOC would provide similar flexibility for an Eligible Investor to choose between the ISDA Master Agreement and NAFMII Master Agreements in documenting its RMB-denominated derivative trades.

> **Bond repos**

Eligible Investors are not yet allowed to trade in bond repos.

However, if this is allowed in the future, an Eligible Investor might be required to enter into the China Inter-bank Market Bond Repurchase Master Agreement for its bond repo transactions.

The Way Forward

The opening up of the interbank bond market to a wide range of foreign institutional investors is a major milestone towards the internationalisation of RMB and liberalisation of the Chinese financial markets. While some issues and uncertainties remain to be clarified, this is a welcoming major step by the Chinese regulators.

As the internationalisation and liberalisation efforts continue to gain momentum, we look forward to the regulators setting up a bond connect arrangement between China and the offshore bond market (such as Hong Kong) in the near future. A direct bond connect platform will bring a number of other benefits including participation from an even wider range of foreign investors, greater efficiency for foreign investors who do not need to worry about setting up administrative process onshore China, as well as allowing eligible Chinese investors investing abroad through the platform.

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