



RMB SERIES: ACCESS PROGRAMMES AND REFORMS IN THE CROSS-BORDER RMB MARKET

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TABLE OF CONTENTS

1	Introduction	5
	Part A: A snapshot of the existing channels for access to the cross-border RMB market	5
	Chapter I: Inbound access to the PRC market	6
2	QFII regime	6
2.1	Overview	6
2.2	Eligibility requirements for QFIIs	7
2.3	Investment scope	8
2.4	Investment restrictions	8
2.5	QFII quota management	8
2.6	Restriction on repatriation of QFII funds to outside Mainland	8
3	RQFII regime	9
3.1	Overview	9
3.2	Remittance of funds	9
4	Access to the CIBM	10
4.1	Overview	10
4.2	Eligible foreign investors to access CIBM	10
5	QFLP regime	11
5.1	Overview	11
5.2	Prior to QFLP regime	11
5.3	Summary of QFLP regime	11
5.4	Key features of Foreign Equity Investment Enterprise and FIE Manager	12
6	RQFLP regime	13
6.1	Overview	13
6.2	Unique features of RQFLP regime	13
6.3	Eligibility requirements	13
7	Stock connect	13
7.1	China's equity market	13
7.2	Overview	14





7.3	The “home rules” principle	14
8	Mutual recognition of fund between Hong Kong and Mainland China	15
8.1	Overview	15
8.2	Application regulations and the “home-rules” principle	16
8.3	What types of SFC authorised funds will be considered under the MRF regime?	16
8.4	Eligibility requirements for northbound funds	16
8.5	Requirements on the Hong Kong management company	16
8.6	Investor protection and ongoing duties	17
8.7	Key PRC requirements	17
8.8	Recent clarification on conversion of MRF proceeds	17
9	Access to “B” shares	17
9.1	Overview	17
9.2	Trading in “B” shares	18
9.3	Conversion of “B” shares	18
	Chapter II: Outbound access to the international market	18
10	QDII regime	18
10.1	Overview	18
10.2	Divided regulations – a key feature of the QDII regime	19
10.3	Differences in sources of funds and onshore selling activities	19
10.4	Differences in permissible offshore investments	21
11	RQDII regime	21
11.1	Overview	21
11.2	Foreign exchange quota	21
11.3	Custody account	22
11.4	Remittance	22
11.5	Other issues	22
12	QDLP regime and QDIE regime	22
12.1	QDLP regime	22
12.2	QDIE regime	23
13	Stock connect and MRF	23
14	Who are the PRC authorities responsible for regulating the existing access channels?	23





Part B: A forward looking view to the cross-border RMB market	24
15 What's next - anticipated new access channels	24
15.1 Expansion of stock connections to other stock and exchanges connection	24
15.2 Platforms facilitating the trading of RMB products between the PRC and international markets	25
15.3 Panda Bonds	26
15.4 QDII2	28
16 Recent trends and related developments	28
16.1 Move from individual quota to overall market quota	28
16.2 Regulatory approach: from case-by-case approval to pre-deal registration and filing system	29
16.3 Infrastructure to support access to product trading	29
16.4 Implication of potential special drawing rights inclusion on cross-border RMB flows	31
16.5 FTZ	32
16.6 Use of negative list approach	32
17 Considerations and opportunities for investors	33
17.1 Challenges for onshore market	33
17.2 Fluctuations and Turmoil of Onshore Markets	33
18 Glossary	35
19 Individual Firms Disclaimers	37





1 Introduction

On 1 December 2015, the IMF announced that RMB will be included in the basket of currencies comprising IMF's Special Drawing Rights.

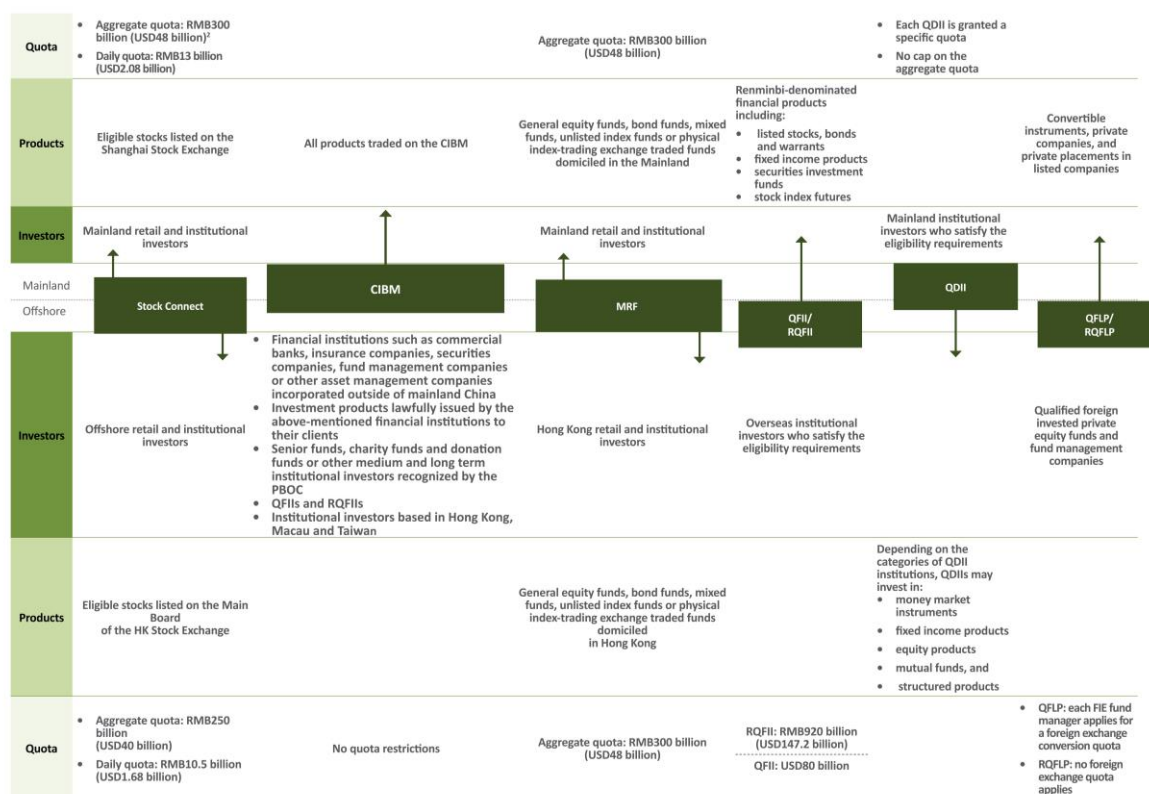
This represents the recognition of RMB at the highest level of global finance and an acknowledgement of the efforts of the PRC authorities in the past decade to broaden the onshore and offshore access to the PRC capital markets. We expect the IMF's announcement will further open China's capital markets to the international market by increasing foreign investors' appetite to invest in, and hold, RMB denominated assets, and will encourage a wider use of RMB in cross-border transactions. We also expect that the IMF's announcement will encourage the PRC authorities to introduce further initiatives to facilitate the flow of cross-border RMB.

We therefore take this opportunity to recap on the existing access programmes in the cross-border RMB market and, based on these existing programmes, predict what we can expect next.

Capitalised terms used in this paper are set out in the Glossary in paragraph 18.

Part A: A snapshot of the existing channels for access to the cross-border RMB market

The following diagram provides a snapshot of the channels currently available for offshore and onshore investors to invest into, and out of, the mainland China.



* Conversion rate between Renminbi (or RMB) and US dollars used throughout this article is US\$1 = RMB6.25.





As shown in this diagram, each of the access programmes is targeted at a different set of investors, facilitates access to a wide range of products and is subject to specific limitations (for example, quota, lock-up periods, repatriation of funds and remittance of funds). These access programmes have been designed to complement, rather than replace, each other, and represents China's continuing efforts to facilitate and maximise cross-border RMB flow.

Chapter I: Inbound access to the PRC market

For the purposes of Chapter I of this paper, "inbound access" refers to access by offshore investors to onshore products (see paragraphs 2 to 7) and access by offshore institutions to onshore investors (see paragraph 8).

2 QFII regime

2.1 Overview

The QFII regime is a major policy initiative first launched in 2002 to enable specified types of institutional foreign investor to invest in the PRC securities. Since 2002, there have been substantial changes to the QFII regime to lower the entry barriers for foreign institutions to qualify for the QFII regime, expand the investment scope and further relax quota administration and foreign exchange control.

As of 23 February 2016, 279 foreign institutions were approved as QFIIs holding an aggregate QFII investment quota of US\$80.795 billion¹.

(a) Key changes under the 2012 Revised QFII Rules

- (i) CSRC lowered the qualification threshold for a QFII license.
- (ii) QFIIs are permitted to invest in the fixed income products traded on the CIBM.
- (iii) QFIIs may engage more than one securities dealer to trade securities in each stock exchange.
- (iv) The RMB account structure has been modified so that a QFII may open a maximum of six RMB deposit accounts designated for securities trading for different clients.

(b) Key changes under the 2016 Revised QFII FX Rules

- (i) Previously, a QFII was required to apply to the SAFE for an investment quota after obtaining a license from the CSRC. Under the 2016 Revised QFII FX Rules, a QFII is only required to make a filing with the SAFE if the quota, calculated at a certain percentage of its asset value or assets under management, is above US\$20 million but no more than US\$5 billion ("**Base Investment Quota**").² The same filing process applies to existing QFIIs wishing to increase their quota (provided that the increase would not result in its cumulative investment quota exceeding the Base Investment Quota). QFIIs wishing to

¹ According to the statistics published by the SAFE on its website at <http://www.safe.gov.cn>.

² 2016 Revised QFII FX Rules, paragraph 6. However, sovereign wealth funds, central banks and monetary authorities are generally not subject to any Base Investment Quota.





increase their quota above the Base Investment Quota will be subject to the SAFE approval.

- (ii) The lock-up period for all QFII to repatriate their investment principal has been aligned to 3 months, starting from the date on which the inbound remittance of investment principal by the QFII reaches US\$20 million.³
- (iii) The previous requirement that all investment principal must be remitted into the PRC within 6 months of the SAFE approval has been removed, although any investment quota which is not used within one year of the relevant filing or approval may be revoked by the SAFE at its discretion.⁴

The 2016 Revised QFII FX Rules represents yet another step by the Chinese regulators to harmonize and align the various routes to access the PRC market. The 2016 Revised QFII FX Rules bring greater alignment between the SAFE's policies for QFIIs and RQFIIs, particularly with respect to the new rules allowing the QFII's quota to be calculated on a combined basis with the quota under the RQFII programme.

2.2 Eligibility requirements for QFIIs

To qualify as QFIIs, applicants must:

- (a) meet certain assets-under-management thresholds and other financial requirements – these vary depending on the type of QFII applicants (as shown below):

Applicant	Operating History	Net Assets	Asset Held or Managed (during Preceding Accounting Year)	Other Requirements
Asset Management Institutions	2+ years	N/A	at least US\$500 million	N/A
Insurance Companies	2+ years	N/A	at least US\$500 million	N/A
Securities Companies	5+ years	at least US\$500 million	at least US\$5 million	N/A
Commercial Banks	10+ years	N/A	at least US\$5 million	Tier one capital at least US\$300 million
Trust Companies	2+ years	N/A	at least US\$500 million	N/A
Other Institutional Investors	2+ years	N/A	at least US\$500 million	N/A

- (b) have an investment team that meets its home country professional-qualification standards;
- (c) have a satisfactory internal control system and corporate governance structure;
- (d) have not been subject to any material penalties imposed by any regulatory authorities in the past 3 years; and
- (e) come from a jurisdiction with a well-established legal and regulatory regime, which has entered into a memorandum of understanding with the CSRC and has a good relationship with the CSRC.

³ 2016 Revised QFII FX Rules, paragraph 11. Previously, the lock-up period for principal repatriation was 1 year for non-open-ended QFII funds.

⁴ 2016 Revised QFII FX Rules, paragraph 12.





Apart from the above eligibility requirements for QFIIs, the PRC regulators have a general preference for long-term buy-side foreign institutional investors such as pension funds and mutual funds.⁵

2.3 Investment scope

QFIIs are permitted to invest in the following financial instruments:

- (a) shares, bonds and warrants traded or transferred in the stock exchanges;
- (b) fixed income products traded in the CIBM;
- (c) securities investment funds, including open-ended index exchange-traded funds, close funds, Open-ended Funds, monetary market funds and other funds recognised by the stock exchanges;
- (d) stock index futures; and
- (e) other financial instruments permitted by the CSRC.

QFIIs are also allowed to participate in the subscription of initial public offering of shares, further issuance of shares, rights offer of shares and bond issuance.

2.4 Investment restrictions⁶

Investments by QFIIs are subject to certain concentration limits:

- (a) a QFII shall not hold more than 10% of the total outstanding shares in a single A-share listed company; and
- (b) the aggregate shareholding of all foreign investors in a single A-share listed company shall not be more than 30% of the total outstanding shares.⁷

2.5 QFII quota management

- (a) **Transfer of QFII quota** – A QFII is prohibited from transferring, reselling or leasing an investment quota. Any QFII who breaches this requirement will be subject to penalties and may have its investment quota revoked.⁸
- (b) **Relaxation of quota management** – Previously, the SAFE restricted the flexibility of QFIIs in allocating its QFII quota across different Open-ended Funds or proprietary funds or funds for clients. The 2016 Revised QFII FX Rules have lifted such restriction.

2.6 Restriction on repatriation of QFII funds to outside Mainland

There is now a three-month lock-up period for QFIIs, during which no repatriation of principal is allowed.

⁵ The 2012 Revised QFII Rules and a CSRC press release.

⁶ These investment restrictions apply to QFIIs as well as all types of foreign investors investing in “A” shares.

⁷ These restrictions do not apply if the QFII is conducting a strategic investment pursuant to the Administrative Measures for Strategic Investment of Foreign Investors in Listed Companies.

⁸ 2016 Revised QFII FX Rules, paragraph 12.





After the expiry of the lock-up period, repatriation of funds by QFIs is allowed but will be subject to the following restrictions:

- (a) **Open-ended Funds** – Open-ended Funds established by QFIs are allowed to repatriate or remit funds, without the SAFE approval, on a daily basis (relaxed from a weekly basis), provided that the monthly aggregate repatriation does not exceed 20% of its total onshore investment at the end of the preceding year.
- (b) **Other QFIs** – There is no SAFE approval required for repatriation of the capital and profit (relaxed from profit only), provided that the total monthly repatriation (including capital and profit) does not exceed 20% of its total onshore investment at the end of the preceding year.

3 RQFII regime

3.1 Overview

The RQFII regime is a modified version of the QFII regime which is designed to facilitate the use of RMB held outside the PRC for investment in the PRC securities market.⁹ The RQFII regime has been expanded to countries including Hong Kong, Singapore, London, France, Korea, Germany, Qatar, Australia, Switzerland and Luxembourg.¹⁰

3.2 Remittance of funds

The repatriation mechanism under the RQFII regime is different from that under the QFII regime.

There is no lock-up period in respect of any Open-ended Fund managed by RQFIIs, but the lock-up period for other RQFIIs is generally 1 year. During the lock-up period, no repatriation of principal is allowed.

An RQFII with an approved investment quota may appoint a custodian bank to remit funds (both inbound and outbound).

- (a) **Open-ended Funds** – Open-ended Funds established by RQFIIs can repatriate or remit funds on a daily basis and such repatriation of principal will neither reduce its investment quota (ie the investment quota is utilised on a revolving basis) nor require an audited report or tax certification.
- (b) **Other RQFIIs** – For RQFIIs other than Open-ended Funds,
 - (i) the investment principal must be remitted in full into the PRC within six months from the date on which the RQFII quota is granted;
 - (ii) after the expiry of the one-year lock-up period, repatriation of funds by RQFIIs may be carried out by the custodian bank of the RQFII but any portion of the investment principal that has been repatriated out of the PRC cannot be remitted back onshore and the investment quota of the RQFII will also be reduced accordingly; and

⁹ The RQFII Measures.

¹⁰ The RMB Internationalisation Report (2015), published by the PBOC in June 2015.





- (iii) remittance of RMB funds (or foreign currency funds after conversion) can be conducted on a monthly basis.

4 Access to the CIBM

4.1 Overview

China's onshore bond market is one of the world's largest credit markets and is growing rapidly as the government tries to shift debts away from commercial bank balance sheets and on to a broader investor base.

The PRC bond market comprises an exchange-based market and the CIBM.

- (a) The exchange-based bond market, regulated by the CSRC, facilitates public offers on the SSE and the SZSE and private placements to individuals and small- and medium-sized institutional investors.
- (b) The CIBM, regulated by the NAFMII under the supervision of the PBOC, is an over-the-counter wholesale market for institutional investors.

The CIBM is currently the platform with the most active bond issuance and trading activities in Mainland China.¹¹

4.2 Eligible foreign investors to access CIBM

Efforts have been made to open up the CIBM to foreign investors since 2005. The most significant and recent milestone relaxations were announced in 2015 and 2016:

- (a) On 14 July, 2015, the PBOC promulgated the PBOC Circular on Certain Issues Concerning Foreign Central Banks, International Financial Institutions and Sovereign Funds Making RMB Investment into the CIBM (the "**Circular 2015**"), permitting these three types of entities to engage in bond trading, bond repurchase, bond lending, bond futures, interest rate swap and other trades permitted by PBOC, without PBOC approval or any quota restrictions.
- (b) On 17 February, 2016, the PBOC promulgated the Announcement of 2016 No. 3 which further relaxed the rules applicable to foreign institutional investor accessing the CIBM. The Announcement of 2016 No. 3 will replace all existing rules (except Circular 2015) to the extent that they contravene provisions of the Announcement of 2016 No. 3. Entities which will benefit from the Announcement of 2016 No. 3 are:
 - (i) financial institutions such as commercial banks, insurance companies, securities companies, fund management companies or asset management companies incorporated outside of mainland China;
 - (ii) investment products lawfully sold by the above-mentioned financial institutions to their clients;

¹¹ Practices and procedures in the Chinese and international primary debt capital markets jointly published by the International Capital Market Association (ICMA) and the NAFMII in September 2015.





- (iii) medium and long term institutional investors recognized by the PBOC including senior funds, charity funds and donation funds;
- (iv) QFII and RQFII; and
- (v) institutional investors based in Hong Kong, Macau and Taiwan.

No prior approval is required for the above mentioned foreign institutional investors to access the CIBM. The two ground-breaking features of the Announcement of 2016 No. 3 are the removal of prior approval and quota requirements for all CIBM participants. This significantly simplifies previous administrative burden and will no doubt attract more qualified foreign investors (particularly medium and long term investors) to invest in the CIBM in the future.

5 QFLP regime

5.1 Overview

The QFLP regime provides foreign investors with a new channel to access the onshore unlisted equity market. It was first introduced as a pilot programme in Shanghai in 2010¹² and has subsequently been launched in other PRC cities such as Beijing, Tianjin and Chongqing.

5.2 Prior to QFLP regime

Before the launch of the QFLP regime, Management Enterprises faced the obstacle of foreign exchange control when investing in unlisted companies' shares. In addition, as a result of the difficulties in converting foreign currency into RMB for investment purposes, Management Enterprises have also historically been unable to invest into and/or establish RMB Funds without, for example, partnering with a domestic joint-venture partner.

The QFLP regime therefore aims to solve these problems by providing a channel for converting foreign currency into RMB for investment into RMB Funds.

5.3 Summary of QFLP regime

In respect of the QFLP pilot programme in Shanghai, the QFLP Rules applies to:

- (a) the FIE Manager, either being the GP or the fund manager; and
- (b) Foreign Equity Investment Enterprises or a foreign invested PE,

that have obtained a pilot QFLP qualification.

Only those Foreign Equity Investment Enterprises with the pilot QFLP qualification can convert foreign currency into RMB for its equity investment in PRC.¹³

¹² QFLP Rules.

¹³ With an aim to promote the use of the QFLP regimes, the Circular on Reforms of Regulation for Conversion of Foreign Exchange Capitals of Foreign-invested Enterprises was issued by the SAFE on March 2015 and effective as of 1 June 2015, relaxing its foreign exchange control and allowed, amongst others, "foreign-invested equity investment enterprises" to directly convert foreign exchange capitals injected by foreign limited partner to the relevant invested target's account without having to take into consideration foreign exchange quota issues. However, in practice, a Foreign Equity Investment Enterprise will still need the QFLP qualification to convert the foreign capitals into RMB.





In other areas with QFLP pilot program such Tianjin and Beijing, the PRC authorities adopted the similar requirements and procedures for setting up QFLP fund.

5.4 Key features of Foreign Equity Investment Enterprise and FIE Manager

Pursuant to the rules of the QFLP pilot program in Shanghai, the table below summaries the key features of a FIE Manager and a Foreign Equity Investment Enterprise:

	FIE Manager	Foreign Equity Investment Enterprise
Form	May be in a form of a partnership or a limited liability company. ¹⁴	May be in the form of a partnership.
Capital requirements	A minimum capital commitment or registered capital of US\$2 million which must be paid in cash.	A minimum aggregate capital commitments of US\$15 million, which must be contributed in cash. The minimum capital commitment for each limited partner is US\$1 million. There is no requirement for a minimum capital commitment of the GP.
Name requirements	Must include the words "equity investment fund management" (股权投资基金管理) in its name.	Must include the words "equity investment fund" (股权投资基金) in its name.
Investor requirements	At least one investor, and the business scope of such investor or any of its affiliates shall be related to equity investment or equity investment management.	Practically speaking, Foreign Equity Investment Enterprises are mostly established to participate in the QFLP pilot program. Therefore, in practice, the investors of the Foreign Equity Investment Enterprises will satisfy the requirements for the foreign investors under QFLP pilot program.
Personnel requirements	Must have at least two senior management members ¹⁵ who meet certain conditions.	None.
Permitted activities	An FIE Manager is permitted to, among others: <ul style="list-style-type: none"> • sponsor and establish an RMB Fund; • provide investment management and related services to RMB Funds; and • provide equity investment consulting services 	A Foreign Equity Investment Enterprise is permitted to: <ul style="list-style-type: none"> • subject to applicable PRC laws, use its proprietary funds to make portfolio investments (for example, forming new enterprises and investing in existing enterprises); • provide management consulting services to its portfolio enterprises; and • conduct other businesses permitted by the Shanghai AIC. Foreign Equity Investment Enterprises may use their foreign currency for portfolio investment in the PRC.
Prohibited activities	Apart from being the manager of the Foreign Equity Investment Enterprises, the FIE manager is an ordinary FIE which is subject to the common prohibition on FIE and as such will be prohibited from, for example, investing in sectors that fall within the prohibited category for foreign investors.	Foreign Equity Investment Enterprises (are prohibited from, among others: <ul style="list-style-type: none"> • investing in sectors that fall within the prohibited category for foreign investors; • trading in shares and enterprise bonds on secondary markets (except for shares held after the listing of portfolio companies); • engaging in financial derivative transactions; • directly or indirectly investing in non-proprietary real property; and • providing loans or security to a third party.

¹⁴ Theoretically, the onshore FIE Manager can be either in the form of a wholly foreign-owned entity ("WFOE") or in the form of limited partnership. In practice however, we understand that the Shanghai Financial Service Office prefers the use of WFOEs.

¹⁵ Senior management member as referred to in the QFLP Rules in Shanghai means an individual holding the position of deputy general manager or above, or an equivalent management position.





Procedure for establishment	<p>A partnership GP shall be registered with the Shanghai AIC.</p> <p>A corporate GP shall obtain the prior approval of the Shanghai MOC.</p>	<p>Registration with Shanghai AIC.</p> <p>Prior approval of the Shanghai MOC is required where an FIE intends to invest in a PRC fund in the form of a company.</p>
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6 RQFLP regime

6.1 Overview

The RQFLP regime was introduced by Shanghai in 2012 as an extension of the QFLP regime to allow qualified foreign fund managers and asset management companies to use their offshore RMB for direct investment in RMB private equity funds set up in Shanghai.

6.2 Unique features of RQFLP regime

Whilst the RQFLP regime is an extension of the QFLP regime and is loosely based on the RQFII regime, it has a number of unique features:

- (a) **Use of offshore RMB** – In contrast to the QFLP regime, qualified foreign participants under the RQFLP regime will use offshore RMB rather than foreign currency to make capital contributions to RMB private equity funds in Shanghai.
- (b) **Private investments** – Whilst the RQFII regime is limited to investments of offshore RMB in the Mainland Chinese public securities and debt markets, the RQFLP regime focuses on the use of offshore RMB capital to make equity investments in non-listed companies, private placements in listed companies and industry investment funds in the PRC.
- (c) **Foreign exchange quota** – In contrast to the QFLP regime, foreign investors using offshore RMB in onshore investments under the RQFLP regime is reportedly not subject to any foreign exchange conversion quota (although RMB quotas may still apply).

6.3 Eligibility requirements

The PRC regulators have yet to publish detailed rules on the RQFLP regime. However, we suspect the rules will largely follow those of the QFLP regime. Therefore, participants in the RQFLP regime will most likely include well-established foreign fund managers with offshore RMB fundraising capacity for offshore RMB and Hong Kong subsidiaries of the PRC asset management companies and brokerage firms.

7 Stock connect¹⁶

7.1 China's equity market

China has two stock exchanges supervised by the CSRC: the SSE and SZSE. The types of shares that are listed and traded on the two exchanges are "A" shares and "B" shares. The table below compares the key features of "A" shares and "B" shares:

¹⁶ For the purpose of this paper, the discussion below will only focus on the northbound leg of the Stock Connect, by which means the offshore investors are provided with the access to the Mainland Chinese A share market.



	Currency	Stock exchange	Investors
"A" shares	Renminbi	SSE and SZSE	<ul style="list-style-type: none"> Onshore institutional and individual investors Hong Kong, Taiwan and Macau residents who live in China Offshore institutional investors investing through QFII and RQFII schemes Offshore institutional and individual investors investing through Stock Connect
"B" shares	Denominated in Renminbi but traded in US dollars or Hong Kong dollars	SSE ("B" shares traded in US dollars) SZSE ("B" shares traded in Hong Kong dollars)	<ul style="list-style-type: none"> Offshore investors Onshore investors in the secondary market with foreign currency accounts

Please refer to paragraph 9 for further details on trading of "B" shares.

7.2 Overview

Stock Connect is a joint initiative of the CSRC and the SFC launched in November 2014 which allows mutual stock market access between the SSE and HKEX.

7.3 The "home rules" principle

One of the founding principles of Stock Connect is that "home rules" apply. This means investors must comply with the rules of the market where the stocks are listed and traded. In respect of the northbound shares, the application of the PRC "home rule" gives rise to the following key issues:

- (a) **Mismatch in the settlement cycle** – The settlement system for shares traded on the "A"-share market operates on a T+0 model for delivery of shares and on a T+1 model for cash payments.
- (b) **Recognition of offshore investors' beneficial ownership of Stock Connect northbound shares**
 - (i) Stock Connect involves two levels of titles:
 - (A) holding by HKSCC in ChinaClear, as the nominee for CCASS clearing participants; and
 - (B) holding by offshore investors as beneficial owners.
 - (ii) To address the international markets' concerns about the recognition of beneficial ownership under a nominee structure under Stock Connect, the CSRC confirmed in the CSRC FAQ that overseas investors holding Stock Connect northbound shares through HKSCC are entitled to the proprietary interests in the relevant northbound shares as shareholders and, as beneficial owners of the Stock Connect northbound shares, must exercise their rights over the shares through HKSCC as the nominee.



- (c) **Restrictions on trading activities, such as no day trading and limited margin financing and stock lending and borrowing** – As a general rule, PRC law requires trading in listed shares to be transacted on a stock exchange. The Stock Connect rules prohibit off-exchange transfers or short selling of “A” shares except in certain circumstances such as margin financing and stock lending.

8 Mutual recognition of fund between Hong Kong and mainland China¹⁷

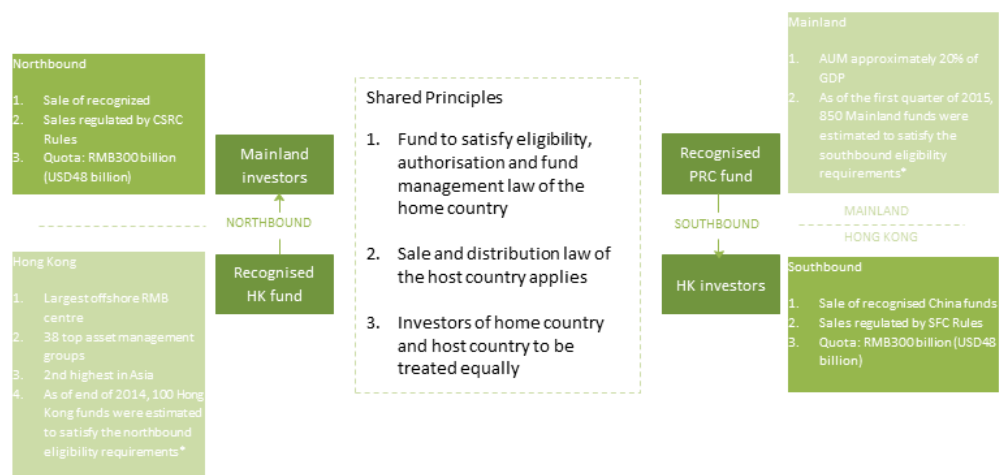
The MRF channel provides a different channel for fund managers based in Hong Kong to offer retail funds to the PRC onshore market. Unlike the channels described at paragraphs 2 to 7 above, the inbound access through the MRF is intended to give offshore fund managers access to the investor base in the PRC.

8.1 Overview

Stock Connect is now complemented by a similar link for mutual funds, the MRF. Launched in May 2015, MRF allows retail public funds initially offered in Hong Kong to be sold to retail investors in the PRC and vice versa.¹⁸

The eligibility requirements for a recognised Hong Kong fund applying for northbound registration are set out in the SFC MRF Rules and the eligibility requirements for a recognised PRC fund applying for southbound registration are set out in the CSRC MRF Rules.

The diagram below highlights the key features of MRF.



* CSRC press conference regarding the mutual recognition of funds between the Mainland and Hong Kong held on 22 May 2015.

The initial investment quota is set at RMB300 billion for the aggregate value of Hong Kong funds offered in the PRC. The same quota applies to the value of PRC funds offered in Hong Kong. The MRF regime adopts an overall market quota (not pursuant to specific quota granted for individual institutions), which is subject to on-going monitoring by the Chinese regulators.¹⁹

¹⁷ For the purpose of this paper, the discussion below will only focus on the northbound leg of the MRF regime, by which means the SFC authorised funds seek CSRC registration in the PRC and are sold to the PRC investors.

¹⁸ MRF Memorandum.

¹⁹ The MRF 2015 Guidelines.





8.2 Application regulations and the “home-rules” principle

Like the Stock Connect, the “home-rule” principle applies to MRF. In other words, for a northbound fund:

- (a) its investment activities, custody of fund assets, fund valuations, fee arrangements, taxation, fund investor meetings and constitution documents will continue to be regulated by Hong Kong law (and the fund’s constitutive documents); but
- (b) its sale and distribution in the PRC must comply with PRC law.²⁰

8.3 What types of SFC authorised funds will be considered under the MRF regime?

Standardised funds including equity funds, bond funds, mixed funds and index funds (including exchange traded funds) are eligible under the MRF regime.²¹ Gold ETFs, listed Open-ended Funds, fund of funds, structured funds and guaranteed funds are not eligible for the time being.

8.4 Eligibility requirements for northbound funds

Hong Kong funds seeking CSRC registration must:

- (a) **existence** – be established, operated and publicly distributed in accordance with Hong Kong laws and regulations;
- (b) **approval** – be authorised by the SFC;
- (c) **trustee and custodian** – have a trustee or custodian that meets the SFC’s regulatory requirements;
- (d) **track record** – have at least a one-year track record (from the date of SFC authorisation), with not less than RMB200 million assets under management (or its equivalent in another currency) by reference to the fund’s latest audited annual report and “bring down” by the fund manager to the date of the CSRC application; and
- (e) **offshore investments** – not primarily invest in the PRC market.

The value of the shares or units sold to PRC investors must not be more than 50% of the value of the fund’s total assets under management. A recognised Hong Kong fund must primarily invest in assets outside the PRC – this means PRC assets must not exceed 20% of its assets.

8.5 Requirements on the Hong Kong management company

The CSRC Rules require the management company of a recognised Hong Kong fund to:

- (a) be licensed by the SFC to conduct Type 9 (Asset Management) regulated activities;

²⁰ The CSRC MRF Rules.

²¹ These are generally mutual funds meeting the requirements of Chapter 7 of the Code on Unit Trusts and Mutual Funds issued by the SFC from time to time.





- (b) not delegate any of its investment management activities to entities in any other jurisdiction, but it may delegate its investment management function to a party operating in Hong Kong and may appoint an investment advisor anywhere; and
- (c) not have been the subject of any major regulatory action by the SFC in the past three years or, if it has been established for less than three years, since the date of its establishment.

8.6 Investor protection and ongoing duties

The management company of a recognised Hong Kong fund must ensure that investors in both Hong Kong and the PRC receive fair and the same treatment, including in respect of investor protection, exercise of rights, compensation and disclosure of information.

8.7 Key PRC requirements

The key challenge for a recognised Hong Kong fund is the appointment of a Mainland agent and distributor.

(a) Mainland agents

Each recognised Hong Kong fund must be represented by an appropriately qualified agent in the Mainland with respect to its Mainland operations. A Mainland agent must be approved by the CSRC to perform public fund management or custodial activities. Eligible agents include asset management companies, banks and securities companies.

(b) Mainland distributors

Fund distribution in the Mainland must be conducted through a qualified distributor, who may be appointed by either the fund manager or its Mainland agent. Eligible distributors include commercial banks, securities companies, futures companies, insurance companies, securities consultancy companies and independent fund distribution companies.

8.8 Recent clarification on conversion of MRF proceeds

In the MRF 2015 Guidelines, the PBOC and the SAFE clarified that funds raised by MRFs can be converted freely between RMB and foreign currencies (subject to the overall quota control) and transmitted cross-border without approval from the SAFE on a case-by-case basis. In fact, the MRF 2015 Guidelines expressly encourage settlement via RMB.

9 Access to “B” shares

9.1 Overview

B Shares are issued in the form of registered shares and are traded on SSE and SZSE. B shares carry a face value denominated in RMB but transactions are settled in foreign currencies (US dollars on the SSE or Hong Kong dollars on the SZSE). Generally speaking, “B” shareholders are entitled to the same rights as “A” shareholders except that “B” shareholders receive their dividends in foreign currencies.





9.2 Trading in “B” shares

In order to trade “B” shares, a foreign investor must first contact an AFB, who will then relay the order to an ALB.

B-share transactions are settled on a trading day plus three days for clearance (T + 3) basis. Trading of B-shares is scripless and must be conducted on the exchange floor. Neither off-exchange crossing nor short-selling is permitted. In addition, as nominee accounts are not permitted in the PRC exchanges, shareholders must declare their holdings to the local registrar and can only hold shares in accounts under their own names.

9.3 Conversion of “B” shares

PRC companies are now able to convert “B” shares to “A” shares. Existing holders of “B” shares in a PRC company going through such conversion process will usually be offered a cash option to receive a cash equivalent amount for their “B” shares as an alternative to converting their “B” shares into “A” shares.

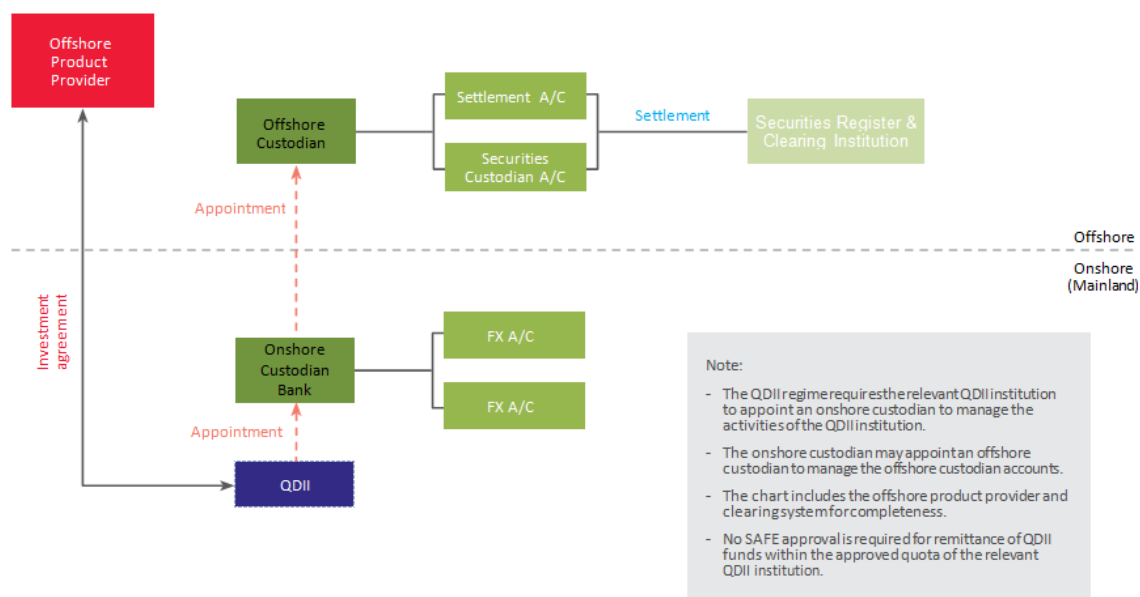
Chapter II: Outbound access to the international market

10 QDII regime

10.1 Overview

The QDII regime is a mirror image of the QFII regime. It enables domestic Mainland Chinese institutional investors with a QDII license and quota approved by the relevant PRC regulatory authority to invest in offshore markets. Each QDII is granted a specific quota by the SAFE.

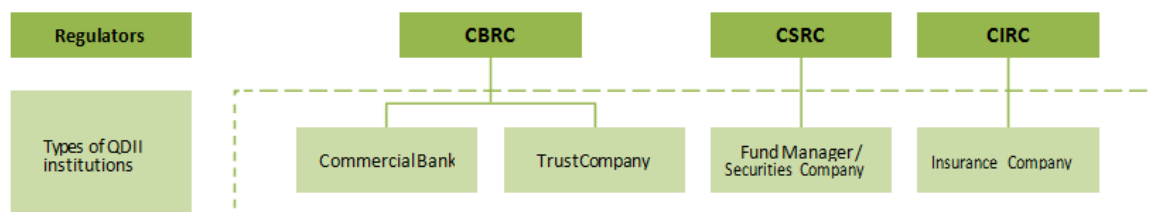
The chart below shows the basic operation of the QDII regime:





10.2 Divided regulations – a key feature of the QDII regime

There are four categories of QDIIs, each of which, as shown below, are regulated by different regulators and subject to different rules.



10.3 Differences in sources of funds and onshore selling activities

Due to restrictions under the PRC Securities Law, a QDII institution (other than QDII insurance companies) is required to repackage an offshore investment product as its own QDII product for sale to its PRC investors. The PRC regulators impose different requirements on QDII institutions with respect to:

- the channels through which QDII institutions may raise funds onshore;
- the onshore selling activities that QDII institutions may undertake; and
- the investment criteria that onshore investors must satisfy and the investment restrictions that QDII institutions shall observe.

The following table highlights the main differences between the QDII regulations applicable to onshore QDII products launched by QDII banks, trust companies and fund managers/securities companies:

Type of QDII institution	Source of funds	Onshore selling activities	Investment criteria
Commercial bank	<ul style="list-style-type: none"> A QDII bank may raise funds under the “offshore wealth management regime”, i.e. by issuing foreign currency or Renminbi denominated wealth management products onshore. 	<ul style="list-style-type: none"> A QDII bank’s selling activities are regulated as part of a commercial bank’s wealth management regime, which is subject to the CBRC’s rules for selling wealth management products. A QDII bank must file its QDII product plan with the CBRC before launching any new type of QDII wealth management product. 	<ul style="list-style-type: none"> A QDII bank must adopt a “suitable products to suitable clients” principle, i.e. the QDII bank will need to classify its wealth management products and clients into five risk rated categories respectively, with prohibitions on sales of complex risky products to clients without sufficient investment experience or risk appetite. Additional restrictions on QDII products invested in overseas listed equities: <ul style="list-style-type: none"> the minimum investment amount for a single investor in a QDII product is RMB100,000 (or its equivalent in foreign currency); and





			<ul style="list-style-type: none"> - each investor must have experience in investing in equities and the QDII bank must formulate specific evaluation procedures to confirm suitability.
Trust company	<ul style="list-style-type: none"> • A QDII trust company may set up trust schemes for a single domestic investor or several domestic investors for offshore investments. Such offshore investments are made in the name of the trust company, according to the investment provisions set out in the relevant trust document. • A QDII trust company must file its QDII trust scheme with the CBRC before launching an onshore trust scheme. 	<ul style="list-style-type: none"> • A QDII trust company may “repackage” the offshore investment products through trust schemes offered to domestic institutional investors or individual investors who have the ability to bear investment risks. 	<ul style="list-style-type: none"> • The minimum investment amount for a single investor (institutional or individual) is RMB1 million (or its equivalent in foreign currency). • The following financial criteria apply to a “qualified individual investor” for collective trust schemes: <ul style="list-style-type: none"> - the individual or family financial assets must be above RMB1 million during the subscription period; or - the individual’s annual income must be above RMB200,000.
Fund manager / securities company	<ul style="list-style-type: none"> • A QDII fund manager may raise funds through the public offering of fund units and invest part or all of such funds in offshore investment products. • A QDII securities company may: <ul style="list-style-type: none"> - raise funds for offshore investments by setting up collective schemes; or - accept investment instructions from a single domestic investor and make offshore investments according to the provisions set out in the relevant asset management agreement. 	<ul style="list-style-type: none"> • A QDII fund manager or securities company must apply to the CSRC for approval of any public offering of fund units (in the case of QDII fund managers) or setting up collective schemes (in the case of QDII securities companies). • The following requirements apply to the initial public offering of fund units or funds raised through the offering of a collective scheme: <ul style="list-style-type: none"> - the minimum offering size is RMB200 million (or its equivalent in foreign currency) for fund units and RMB100 million (or its equivalent in foreign currency) for a collective scheme; and - the minimum number of unit holders is 200 for open-ended funds and 1,000 for close-ended funds; at least two investors must participate in a collective scheme. 	<ul style="list-style-type: none"> • No specific investment criteria for domestic investors.

Unlike the other types of QDII institutions, a QDII insurance company must invest its proprietary funds (ie onshore funds it raises through offering of insurance products to onshore investors in its ordinary business) in its offshore QDII investments, which means the insurance QDII regime provides a prima facie outbound channel for proprietary funds instead of funds on a “for-client” basis.





10.4 Differences in permissible offshore investments

As a result of the different QDII regulatory regimes, different categories of QDII institutions are subject to different types of permissible offshore investments. A summary of the key differences is set out below:

Type of offshore investment products	Commercial bank	Trust company	Fund manager / securities company	Insurance company
Money market instruments	not clear from the CBRC QDII rules	√ (product rated as investment grade or above)	√	√ (issuer rated A or above)
Fixed income products	√ (product rated as BBB above)	√ (product rated as investment grade or above)	√ (issuer recognised by the CSRC)	√ (issuer and product rated as BBB or above)
Equity products (listed on a recognised overseas stock exchange)	√ (shares only)	√ (shares, global / American depository receipts and REITs)	√ (shares, global / American depository receipts and REITs)	√ (shares, global / American depository receipts and REITs)
Mutual funds (authorised by recognised overseas fund regulators)	√	√	√	√
Structured products	√ (issuer rated as A or above)	√ (issuer rated as investment grade or above)	√ (no rating requirement)	√ (structured deposits are listed as a type of permissible fixed income products under the 2007 Insurance QDII Measures)

There also exist various types of investment restrictions applicable to different offshore investment products invested different types of QDII institutions. For example, in respect of the QDII securities companies and QDII fund management companies, the CSRC provides that the market value of the investment in unlisted structured investment products which are illiquid assets shall not exceed 10% of the net value of the QDII fund.

11 RQDII regime

11.1 Overview

The RQDII regime, launched in November 2014, permits Qualified RQDIIs to invest in overseas RMB-denominated products using their own RMB funds or RMB funds raised from the PRC institutional or individual investors.²²

The “divided regulations” feature of the QDII regime (set out at paragraph 10.2 above) also applies to the RQDII regime.

11.2 Foreign exchange quota

Unlike the QDII regime, RQDIIs are generally not subject to approval from the SAFE for obtaining any foreign exchange quota. Qualified RQDIIs may invest as much RMB funds as they are able to raise from domestic investors, provided that the amount of funds are within the maximum amount reported to or approved by the regulatory authorities.²³

²² The PBOC RQDII Notice

²³ Article 3 of the PBOC RQDII Notice





11.3 Custody account

To invest in overseas RMB-denominated products, Qualified RQDIIs must open a domestic RMB custody account with a domestic custodian bank that is qualified to carry on custody business. A domestic custodian bank may open a domestic RMB custody account for each product of a RQDII.²⁴

11.4 Remittance

An RQDII must remit:

- (a) the RMB funds to the overseas RMB custody accounts through the domestic RMB custody accounts; and
- (b) the RMB-denominated overseas investment principal and profit to domestic RMB custody accounts through overseas RMB custody accounts.²⁵

11.5 Other issues

Although not specified in the PBOC RQDII Notice, we understand from market practice that the RQDII regime largely follows the existing QDII regime in most aspects. Therefore, the analysis in paragraphs 10.2, 10.3 and 10.4 above are also applicable to the RQDII regime.

12 QDLP regime and QDIE regime

Whereas the existing QDII regime focuses on onshore investors' investments in the international securities market, the QDLP and QDIE regimes allows onshore investors to access a wider range of offshore products or assets (including, in particular, equity investments in overseas unlisted entities and overseas regulated commodities markets).

12.1 QDLP regime

The QDLP regime was implemented on a pilot basis in Shanghai in April 2012 and Qingdao in February 2015.²⁶

- (a) **Shanghai** – Under the Shanghai Pilot QDLP Measures, the QDLP regime allows qualified foreign-invested fund managers established by foreign managers having majority ownership in the GP²⁷ in Shanghai to raise money from QDLPs for the purpose of investing into offshore markets.
- (b) **Qingdao** – Under the Qingdao Pilot QDLP Measures, foreign investors can establish an investment entity in Qingdao as a general partner and set up a qualified domestic investment fund with QDLPs to invest in the overseas market.

²⁴ Article 2 of the PBOC RQDII Notice

²⁵ Article 3 of the PBOC RQDII Notice

²⁶ The Shanghai Pilot QDLP Measures and the Qingdao Pilot QDLP Measures.

²⁷ Note that this foreign majority shareholding requirement has been relaxed recently. In 2015, Shanghai expanded its QDLP regime to foreign-invested fund managers with domestic majority shareholder(s). China International Fund Management Co., Ltd. became the first QDLP that is majority-owned by an onshore fund management company (Shanghai International Trust Co., Ltd.). Prior to this expansion, most QDLPs are majority-owned by foreign hedge fund managers. Please see "Shanghai QDLP expanded to include domestic fund firms", AsianInvestor, 10 July 2015.





Unlike the QDII investment funds that are issued to retail investors (see paragraph 10.3 above), the QDLP regime provides a new channel for Chinese onshore capital from a wider group, for example, institutional investors and high net-worth individuals, to be invested in the offshore market.

Since its establishment, the QDLP regime has been expanded to, China's other FTZs including the Qianhai zone and the Tianjin zone.

12.2 QDIE regime

The QDIE regime, launched in December 2014²⁸, is similar to the QDLP regime offered by Shanghai and Qingdao but is more far-reaching than QDLP in the following aspects:

- (a) **Majority shareholding** – both foreign managers and domestic managers can be the majority shareholder under the QDIE regime, while the QDLP regime originally required foreign majority shareholder(s);
- (b) **Investment scope** – the QDIE Measures do not impose any restriction on the investment scope of the “foreign investment entity”²⁹, while the QDLP regime is implementing a transitional arrangement to allow investment in the offshore secondary market for now and a wider market in a later stage; and
- (c) **Qualified limited partners** – the QDIE regime targets a wider group of onshore limited partners, while the QDLP regime more focuses on institutional limited partners and high-net-wealth individual.³⁰

13 Stock connect and MRF

We discussed inbound access to the PRC market through the northbound routes of the stock connect and MRF in Chapter I. The stock connect and the MRF also operate as outbound access channels (through their southbound routes) by allowing PRC investors or fund managers respectively to access the international market.

Through southbound trading under the stock connect, PRC investors may trade the stocks listed on HKEX directly via the SSE trading platform. Similarly, the southbound MRF regime enables fund managers based in the PRC to register PRC public funds in Hong Kong for offering to the Hong Kong retail investors.

14 Who are the PRC authorities responsible for regulating the existing access channels?

The existing access channels are primarily regulated by the following regulators - their key duties and functions are summarised below:

Regulator	Functions	Key duties and responsibilities
PBOC	The PBOC is the central bank of the PRC. Its key duties and functions include formulating and implementing monetary	The PBOC is primarily responsible for overlooking QFII investments in the CIBM, RQFII business, the CIBM and the

²⁸ The QDIE Measures.

²⁹ Although it is generally understood that QDIEs cannot invest in the areas forbidden by the Administrative Measures for Outbound Investment (Order of the Ministry of Commerce [2014] No.3).

³⁰ For example, the minimum investment amount from an individual QDIE is RMB2 million in Shenzhen, lower than the RMB5 million minimum implemented under the Shanghai QDLP regime, according to some reports.



	policies, formulating and enforcing relevant rules and regulations and regulating the PRC financial markets.	RQDII business.
CBRC	The CBRC is the primary regulator of the PRC responsible for supervising the PRC banking institutions and their respective business activities. Its key duties and functions include formulating supervisory rules and regulations governing banking institutions, conducting on-site investigations and off-site surveillance of the banking institutions and taking enforcement actions.	The CBRC is primarily responsible for overlooking the offshore investment business of QDII / RQDII banks and trust companies.
CSRC	The CSRC is the primary regulator of the PRC securities and futures market. Its key duties and responsibilities include, amongst others, the formulating of the relevant rules and regulations on the PRC securities and futures market and supervising the issuance, listing, trading, custody and settlement of securities.	The CSRC is primarily responsible for overlooking the QFII/RQFII business, the Stock Connect business, the MRF business and the offshore investment business of QDII/RQDII securities companies and fund management companies.
CIRC	The CIRC is the primary regulator of the PRC insurance market.	The CIRC is primarily responsible for overlooking the offshore investment business of QDII / RQDII insurance institutions.
SAFE	The SAFE is supervised by the PBOC. It is primarily responsible for regulating the flow of foreign exchange in the PRC, foreign exchange expenditure and outward remittances.	The SAFE is primarily responsible for overlooking the QFII business, the RQFII business, the QFLP business, the QDII business for all types of QDIIs and the QDLP and QDIE business.
NAFMII	The NAFMII was founded in 2007 under the approval of the State Council of the PRC. The NAFMII is a self-regulated organisation. Its key duties and responsibilities include promoting and facilitating the development of China over-the-counter financial market, especially the interbank bond market.	NAFMII is primarily responsible for overlooking the inter-bank bond repurchase business and inter-bank derivative business in the CIBM.

Part B: A forward looking view to the cross-border RMB market

15 What's next - anticipated new access channels

In April 2015, Zhou Xiaochuan, the governor of the PBOC, announced that China would accelerate reforms and opening up of its capital market with the aim of making RMB convertible on capital account.³¹ The PBOC also indicated to KWM in November 2015 that the PBOC is keen to accept a wider range of issuers in the CIBM in order to facilitate the internationalisation of RMB. We therefore expect to see further reforms of the PRC securities market across a range of areas.

15.1 Expansion of stock connections to other stock and exchanges connection

(a) Shenzhen-Hong Kong stock connect

Anticipated as the “next step” after the launch of Shanghai-Hong Kong Stock Connect, the Shenzhen-Hong Kong Stock Connect has been widely discussed and mentioned in numerous occasions by leaders in Hong Kong and the PRC. The plan was officially included in the “Work Plan on Promoting the Shenzhen-Hong Kong Co-operation” issued by Shenzhen Qianhai Administration Bureau on 4 December 2014. However no timetable has yet been confirmed.

Currently ranked amongst the top 10 largest in the world by market capitalization, at just over US\$4.4 trillion³² by July 2015, the SZSE is the fourth largest stock exchange in the world by turnover, averaging over US\$495 billion per month.³³

³¹ IMFC Statement by ZHOU Xiaochuan, Governor, People's Bank of China” dated 18 April 2015.

³² Wall Street Journal, July 10, 2015.

³³ Bloomberg.





Contrary to the large-scale state-owned enterprises typically listed on the SSE, the SZSE is more tilted towards mid-caps, with a significant proportion of companies from cutting-edge industries such as software, high-tech and biotechnology. As such, it is expected that the Shenzhen-Hong Kong stock exchange will not merely be an extension of the Shanghai-Kong Kong Stock Connect but will cover a new dimension of companies, stocks and opportunities.

(b) CEINEX

The CEINEX is a joint venture between the SSE, Deutsche Börse and China Financial Futures Exchange launched in November 2015. The new exchange, based in Frankfurt, aims to improve European investors' access to PRC securities.

The CEINEX will focus on growing spot transactions denominated and settled in RMB at the initial stage and will gradually shift its focus on RMB-denominated financial derivatives when market condition allows.

(c) Shanghai-London Stock Connect

Similar to the Shanghai-Hong Kong Stock Connect, the Shanghai-London Stock Connect, which is expected to grant access for British investors to trade Chinese shares listed in Shanghai, was announced in September 2015.

However, the Shanghai-London connect may face more challenges in comparison to the Shanghai-Hong Kong Stock Connect (for example, time-zone differences, uncertainty of short selling and asset substitutability, different mechanisms from the two stock exchanges of T+0 trading and the issue of taking RMB as the sole settlement currency).

(d) London-Hong Kong Connect

A cooperative memorandum was announced in October 2015 to kick-off a preliminary study to build a trading link between HKFE and LME, as well as a clearing link between HKFE Clearing and LME Clear (commonly known as the London-Hong Kong Connect). It is expected that the London-Hong Kong Connect will allow Europe-based investors to access RMB-denominated futures and other commodities products. Regulatory approvals are still pending and no timeline has been announced.

15.2 Platforms facilitating the trading of RMB products between the PRC and international markets

(a) Shanghai INE – RMB commodity futures

The INE, being the first exchange aiming to grant direct trading access to overseas participants outside the Mainland China to trade onshore, launched in the Shanghai FTZ in November 2013.

INE was established as a key initiative to promote Shanghai as Mainland China's key hub for commodities trading and to provide trading, clearing and delivery services for energy derivatives (such as futures and options over crude oil, natural gas and petrochemical products).

The INE published its full set of rules in September 2015. These rules set out detailed guidance governing, amongst others, futures trading on INE, requirements for onshore members,





requirements for overseas special participants and information disclosures, futures clearing, risk management, delivery and settlement banks.

It is anticipated that the INE may launch its first batch of product in 2016.

(b) Shanghai Gold Exchange – International Board

The SGE launched a gold trading platform with eleven RMB-denominated gold contracts on its International board, namely the SGEI, in the Shanghai FTZ. SGEI allows international investors to use RMB to directly trade in precious metals such as gold and silver and to use physical gold services such as storage, trusteeship, delivery, leasing and transit.

(c) FX market – announced in November by the PBOC

On 25 November 2015, the PBOC announced the first batch of Foreign Sovereign Institutions that have been officially registered to enter the CFETS.

The first batch of approvals granted to three central banks, namely Hong Kong Monetary Authority, Reserve Bank of Australia, and National Bank of Hungary. The International Bank for Reconstruction and Development, International Development Association, Trust Funds of World Bank Group, and Government of Singapore Investment Corp, are the other four institutions to be admitted to the domestic market.

15.3 Panda Bonds

(a) Overview

Each of HSBC, BOC (Hong Kong) and Standard Chartered (Hong Kong) were recently approved by the PBOC to issue up to RMB one billion (in the case of HSBC and Standard Chartered) and RMB ten billion (in the case of BOC) in the CIBM. China Merchants Group (Hong Kong) also issued 366-day commercial paper on the CIBM in November. NAFMII recently announced on its website that it has approved for registration onshore RMB bond issues by the Republic of Korea and the Province of British Columbia, Canada. The types of entities that have issued onshore RMB bonds in the CIBM to-date are:

- international development institutions – International Finance Corporation and Asian Development Bank;
- financial institutions – Bank of China Hong Kong, HSBC and Standard Chartered Hong Kong;
- sovereigns – Republic of South Korea and Province of British Columbia³⁴; and
- non-financial enterprises – Daimler and China Merchants Group (Hong Kong).

The significance of the recent issues is:

- (i) offshore issuers' access to the CIBM;

³⁴ <http://www.nafmii.org.cn>





- (ii) relaxation of, and clarity about, how the PRC rules apply to offshore issuers; and
- (iii) China's willingness to accept a number of offshore debt issuance techniques,

all at a time when the gap between onshore and offshore interest rates are converging and the PRC government is reported to intend to avoid further lowering the value of the RMB against the US dollar.³⁵

(b) Similarities and differences between the offshore market and the CIBM

(i) Similarities

The aim of any offshore issuer is to replicate what it does in other markets so as to minimise the effort required to issue bonds. To a large extent, the recent onshore RMB bond issues facilitate that approach.

- (A) The recent onshore RMB bonds indicate a willingness by the PRC authorities to recognise overseas accounting principles and audit procedures.
- (B) Generally speaking, standards of disclosure in leading offshore markets are acceptable in the PRC.
- (C) The onshore RMB bond market is largely a fixed rate, fixed term (three years is common), RMB-only market. Terms and conditions therefore provide less options than in offshore markets and reflect local issuance procedures. Issuers are free to adopt usual tax redemption, events of default and bondholder meetings provisions but PRC law must be used as the governing law and local arbitration will apply if there is any dispute. In our experience, offshore issuers are able to satisfy themselves as to the implications of undertaking PRC law-governed obligations.
- (D) A key relaxation is an issuer's ability to invest the onshore RMB bond proceeds with a local bank, the CIBM or to remit the RMB proceeds offshore. Whilst issuers are not able to convert the proceeds into a foreign currency onshore, they may do so offshore. Bond redemption and interest payment will need to be made in RMB (again, accessed from offshore).

(ii) Differences

The onshore RMB bond market is a domestic market and like any other domestic market has its own unique features such as:

- (A) the local approval regime – all the recent onshore RMB bond issues have been conducted on a "pilot" basis meaning no PRC law expressly applies to offshore issuers.
- (B) the issuance documents are in Chinese;

³⁵ South China Morning Post Tuesday, September 29, 2015 "Yuan trades at strongest level since devaluation".





- (C) a rating by an onshore rating agency is generally required for onshore issuers; and
- (D) offshore issuers will need to become familiar with the way bonds are issued onshore - a bond is not actually “issued” (in either bearer or registered form) but rather the central depository electronically records the bond details from information fed to it by the issuer and bookrunner.

15.4 QDII2

On 22 October 2015, the PRC State Council announced its further news about the long anticipated QDII2 regime.³⁶ The anticipated QDII2 regime will offer an unprecedented channel for the PRC individual investors to invest offshore and represents a significant step in the liberalisation of the investment landscape and capital account regulation in the PRC.

Initially the program will be limited to the Shanghai FTZ. It will then be rolled out to the rest of Shanghai and five other pilot cities: Tianjin, Chongqing, Wuhan, Shenzhen and Wenzhou. Due to recent depreciation in RMB, it is unclear when the program will be implemented.

- (a) **Quota** – As a general rule, PRC investors are only allowed to convert US\$50,000 of RMB in any year and can invest offshore only indirectly by purchasing financial products through Chinese financial institutions. Under the QDII2 regime, investors who are resident in one of the approved zones and who have at least RMB 1,000,000 in financial assets will be subject to relaxed currency conversion restrictions and will be able to make direct offshore investments.
- (b) **Investment scope** – QDII2 will permit a broad range of offshore investments. Eligible investment classes are expected to include shares, bonds, funds, insurance products, foreign exchange and derivative products, greenfield and joint venture projects as well as real estate.³⁷
- (c) **Accounts** – To make a direct offshore investment under the QDII2 regime, a PRC individual investor will be required to open a free trade bank account for overseas direct investment, which will consist of an onshore RMB account and an onshore foreign exchange account.

16 Recent trends and related developments

16.1 Move from individual quota to overall market quota

Previously, most of the existing access programmes operated on an aggregate and/or daily investment quota regime (for example, an approved QFII or RQFII would be granted individual investment quotas). Since September 2015, the NDRC announced that it will set a National Annual Quota that can be raised by entities (and their controlled subsidiaries and branches) in the PRC.³⁸ Once the aggregate registered foreign debt reaches the National Annual Quota, the NDRC will make a public announcement and will reject any foreign debt registrations and filings.

³⁶ See point 18 in the Opinion on Furthering Economic System Reform in 2015 prepared by the NDRC and issued by the State Council on 8 May 2015.

³⁷ The SH FTZ 40 Plans.

³⁸ The NDRC Notice.





16.2 Regulatory approach: from case-by-case approval to pre-deal registration and filing system

Before the NDRC Notice, an offshore debt issuance by an onshore entity required NDRC approval on a case-by-case basis. Under the new system, issuers are required to register certain information (including an application report, the key terms of the issuance or incurrence and the remittance details) with the NDRC prior to issuing and/or incurring a foreign debt.

This system applies to:

- (a) offshore bonds and loans (whether denominated in RMB or otherwise) issued by an onshore entity with a maturity of more than one year; and
- (b) international issuances or loans incurred by offshore branches and subsidiaries controlled by a PRC entity.

16.3 Infrastructure to support access to product trading

- (a) China International Payments System

With RMB becoming the second largest cross-border payment currency in China and the fourth most used payment currency globally, it is imperative to build infrastructure to support the development of RMB business. The CIPS, which started operation on 8 October 2015, marked a sea change from the previous clearing processes for RMB cross-border settlements.

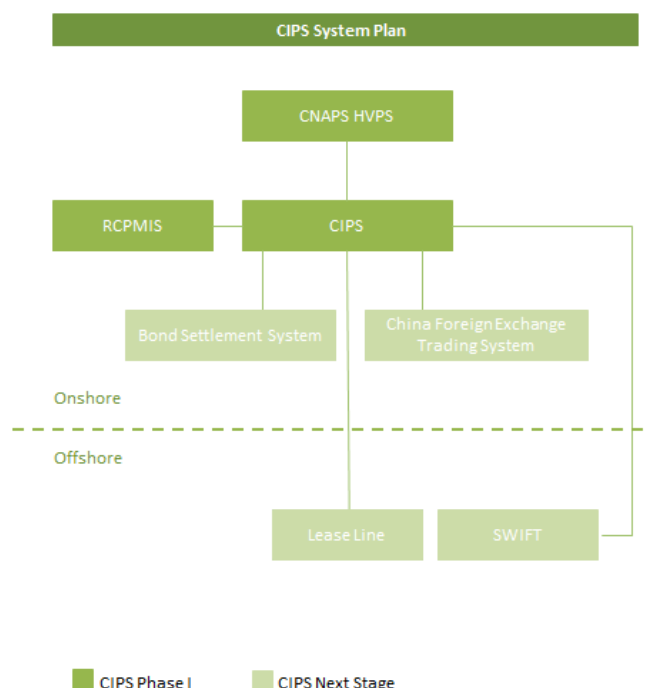
Compared to previous settlement arrangements, which was through offshore clearing banks in Hong Kong, Singapore, or London, or with the help of a correspondent bank in mainland China, the new system expands operating time to cover 17 time zones in Asia, Africa, Europe, and Americas. Foreign banks could now take a more active role in clearing and settlement for cross-border RMB transactions.

The establishment of CIPS expects to boost RMB liquidity globally by cutting transaction costs and processing times.

The CIPS is designed to be built in two phases. The first phase will be used to support cross-border goods and services trade settlement, direct investment, as well as cross-border financing and individual fund transfers, however excluding capital-related settlement.

The CIPS first phase has the following features: real time gross settlement of fund transfer of both individual customers and financial institutions; one-point entry by all direct participants for centralized clearing through a shortened route of clearing to achieve efficiency; the adoption of ISO20022 message dash board for straight-through processing of cross-border businesses; its operation hours covering the time zones of Europe, Asia, Africa and Oceania, where the RMB business essentially take place.





(b) FTZ accounts

The Shanghai FTZ officially launched in September 2013. In May 2014, the PBOC issued the Circular³⁹ specifying framework and requirements of establishing FTAs and use of capital accordingly.

Firstly, financial Institutions in Shanghai may establish a special FTU, and provide innovative financial services for the investment and financing activities of entities in SFTZ and foreign institutions via FTAs.

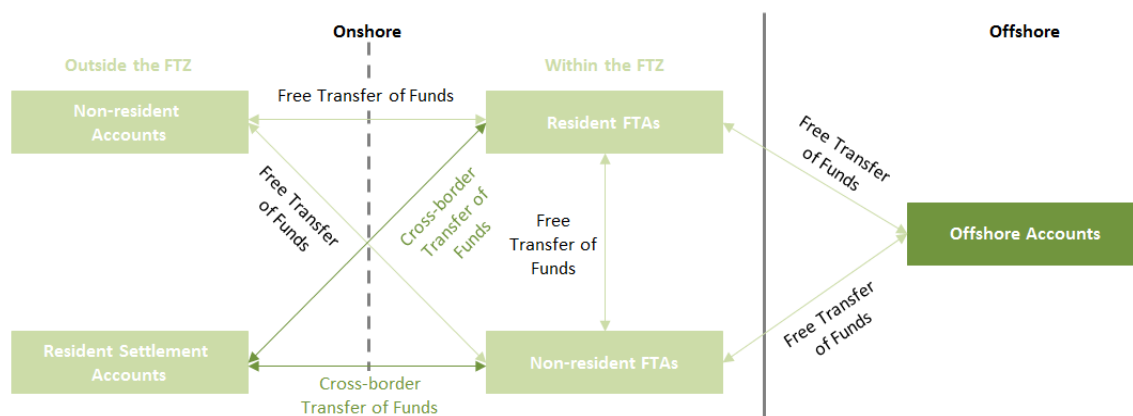
Secondly, with FTAs, qualified entities in FTZ would be allowed to open FTAs and effect cross-border capital transfer on the basis of “Limited Capital Permeation” with non-FTZ areas in China.

Companies operating in Shanghai FTZ would be allowed to use FTAs to borrow offshore loans (foreign debt) of up to twice the company’s capital from outside mainland China.

On 29 October 2015, the PBOC announced further measures to allow more opening up of the financial system within the Shanghai FTZ.⁴⁰ The measures indicated the PBOC’s aims to realize convertibility of the RMB under the capital account first in the Shanghai FTZ and also specifically mentioned its plans to support platform-building in Shanghai FTZ, including CFETS, SSE and Shanghai Futures Exchanges.

³⁹ On May 21, 2014, the PBOC announced The Circular on the Implementation Rules on Separate Accounting Business In the China (Shanghai) Pilot Free Trade Zone (interim) and The Rules for the Prudential Management of Risks Relating to Separate Accounting Business in the China (Shanghai) Pilot Free Trade Zone (interim) - 2014 Circular 46.

⁴⁰ Ministry of Commerce, CBRS, CSRC, CIRC, SAFE, and Shanghai People’s Government.



(c) the CFETS

Founded in 1994 as an outcome of forex system reform, the CFETS, also known as the National Interbank Funding Center, is the only foreign exchange and interbank money market in China, created and governed by the PBOC.

CFETS provides an electronic bidding system for matching spot trading of the RMB against the U.S. dollar, Hong Kong dollar, Japanese yen and Euro, and increasingly the cross-rate trading for certain foreign currencies. In addition, instruments traded at CFETS include lending denominated in Renminbi as well as selected foreign currencies, governments, securities, and Repo transactions. CFETS also handles foreign exchange clearing for all the trading members in its foreign exchange market. Through the National Interbank Funding Center, the CFETS also operates markets for RMB interbank lending and RMB bond trading.

Members of CFETS range from domestic commercial banks and their authorized branches, non-banking financial institutions such as insurance companies, securities companies, fund management companies, and financial companies, to foreign financial institutions that are authorized to handle Renminbi business.

16.4 Implication of potential special drawing rights inclusion on cross-border RMB flows

The SDR is not a currency itself and is rarely used directly for trade, commerce or finance. For this reason, the announcement that RMB is to be included in the basket of currencies comprising the IMF's SDR should not cause any abrupt change to day-to-day global business. However, this inclusion is nevertheless significant because it represents international recognition of the RMB as one of the most fundamental global currencies.

This recognition at the highest level of global finance is an important milestone indeed in the journey of the RMB to full internationalisation and becoming a global reserve currency. Hopefully, it will increase the appetite of foreign investors to invest in, and hold, RMB denominated assets and encourage wider use of RMB in cross-border transactions. It should be seen also as an acknowledgment of the significant steps which Chinese authorities have taken along the path which they have chosen to broaden the onshore/offshore access to the Chinese capital markets. More recently, these include the expansion of the issuer base for the onshore interbank bond market to include foreign financial institutions and highly rated foreign sovereigns and the relaxation this year





for foreign access to trade in the onshore interbank bond market. It would be reasonable to expect that the IMF's announcement could only encourage further developments in these and similar initiatives by Chinese authorities to liberalise capital controls.

16.5 FTZ

The Shanghai FTZ takes a leading role in the internationalisation of RMB. As a pilot programme, it has implemented a number of measures to facilitate capital control relaxation:

- (a) ***Simplified cross-border payment procedures*** – entities in Shanghai FTZ can open capital accounts without prolonged government FX registration approvals and banks in Shanghai FTZ are now authorised to carry out FX registration and RMB cross-border settlement for capital items and current items directly.
- (b) ***Free trade accounts*** – entities in Shanghai FTZ can open FTAs and transfer funds freely between FTAs, other offshore accounts and onshore NRAs.
- (c) ***Loosening of control over cross-border finance*** – controls over outbound security and FX finance have been relaxed so entities in Shanghai FTZ may now borrow offshore RMB funds subject to certain requirements.
- (d) ***RMB convertibility*** – entities in Shanghai FTZ enjoy full capital account RMB and FX convertibility (for example, FIEs) can immediately convert foreign exchange into RMB and utilise RMB hedging, whereas a non-Shanghai FTZ FIE must wait until there is a commercial contract requiring hard currency payment before it can make the conversion).⁴¹
- (e) ***Deposit rate liberalisation*** – entities in Shanghai FTZ may be offered higher interest rates for foreign exchange and RMB deposits with banks due to the loosening of the statutory interest rate limits.
- (f) ***Others*** – the Shanghai FTZ is also listing some previous restrictions on investor qualifications, shareholding percentages and permissible business scopes.

We anticipate other FTZs in the PRC will soon follow these relaxations.

16.6 Use of negative list approach

The negative list was an innovative management approach and administrative mode introduced in Shanghai FTZ when the pilot zone was launched in September 2013. It only lists out restricted areas while those not on the list would be free to enter for foreign investors. The Shanghai government published the list of areas that are off-limits or come with restrictions to investors in the FTZ. The list initially included 190 clauses of restrictions and prohibitions, covering a broad range of activities.⁴²

The negative list has been deemed as a major step taken in the FTZ, attempting to create a bridge to international investment management standards, by regulating only the forbidden areas for foreign investors; while in other sectors foreign investors will be treated equally with domestic ones. The list

⁴¹ According to the SH FTZ 40 Plans, the pilot QDII 2 regime to be initially launched in Shanghai FTZ forms part of the RMB convertibility process.

⁴² PBOC website - <http://shanghai.pbc.gov.cn/fzhshanghai/113580/263536/index.html>, October 2013





is also expected to be amended from time to time in accordance with future development in the FTZ and relevant legislations, to further open up the investment opportunities for foreign investors.

17 Considerations and opportunities for investors

17.1 Challenges for onshore market

- (a) Banks (both domestic and foreign) cannot participate directly in the bond futures contract which makes trading less liquid as they hold most of the underlying instruments; therefore, hedging is more expensive which could potentially undermine liquidity.
- (b) The repo market is predominantly pledge; therefore, it cannot be used for market making purposes which would allow dealers to provide better liquidity by finding bonds that they don't have in their inventory to deliver to customers.
- (c) There is currently no PRC legislation expressly recognizing the legal concept of “netting” to support an industry-wide clean netting opinion under PRC law, which may have capital charges implications for financial institutions’ derivatives transactions with PRC counterparties.
- (d) Few international ratings for onshore bonds means offshore investors cannot utilize them in order to compare the credit quality of these bonds with known international names.
- (e) Domestic ratings do not sufficiently differentiate the quality of issuers as most issuers are rated at the highest tier (over 70%) - there is a need to liberalise the credit ratings business in China.
- (f) Development of a KYC utility in China or a connection to existing global utilities is still needed in order to facilitate client on-boarding and encourage the adoption of best practices.
- (g) Clarification required of the tax treatment on the interbank bond market, in addition to withholding tax and tax filing requirement.
- (h) Inclusion of CIBM on global fixed income indices.

17.2 Fluctuations and Turmoil of Onshore Markets

The Chinese A-share turmoil over the summer of 2015, and the Renminbi’s unexpected devaluation, have raised real concern towards the economic slowdown of China and the possible wider impact to the global markets. While the local authorities have committed to further capital account opening and market liberalization regimes, the impact of the recent stock market volatility on the pace and momentum of further opening-up is uncertain, and the market sentiment from both domestic and foreign investors have showed concerns over a possible setback in RMB internationalization progress.

Despite the slowing down of the pace (for example, the delayed launch of the Shenzhen-Hong Kong Stock Connect Program), we think the stock market turmoil has not stopped China from pushing ahead with policy liberalization (for example, in February 2016, the PBOC has taken a significant step in opening up the China interbank bond market to eligible overseas institutional investors, including commercial banks, insurance companies, securities firms, asset management companies, as well as





other medium to long term type of institutional investors).⁴³ The turmoil in equities has also led to increased interest in bond markets as well as the bond futures which are currently not allowed to trade by banks.

⁴³ The PBOC Announcement of 2016 No. 3, dated 17 February 2016:
<http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3021203/index.html>





18 Glossary

Term	Definition
2012 Revised QFII Rules	Provisions on Issues concerning the Implementation of the Administrative Measures for Securities Investment Made in China by Qualified Foreign Institutional Investors amended by the CSRC on 27 July 2012
2016 Revised QFII FX Rules	The revised Foreign Exchange Administrative Rules on the Domestic Securities Investment by Qualified Foreign Institution Investors issued by the SAFE on 3 February 2016
AFB	Authorised foreign broker
ALB	Authorised local broker
CB	Central Bank
CBRC	China Banking Regulatory Commission
CCASS	Central Clearing And Settlement System
CELINEX	China Europe International Exchange AG
CFETS	China Foreign Exchange Trade System
ChinaClear	China Securities Depository and Clearing Corporation
CIBM	China's inter-bank bond market
CIPS	China International Payment System
CIRC	China Insurance Regulatory Commission
CNAPS	China National Advanced Payments System
CSD	Central Securities Depository
CSRC	China Securities Regulatory Commission
CSRC FAQ	The FAQ issued by the CSRC on 15 May 2015
CSRC MRF Rules	The Provisional Rules for Recognised Hong Kong Funds issued by the CSRC on 22 May 2015
FIE	Foreign invested enterprises
FIE Manager	An onshore foreign invested equity investment management enterprises
Foreign Equity Investment Enterprises	PRC Funds with investment from foreign investors
Foreign Sovereign Institutions	Offshore central banks, international financial institutions and sovereign wealth funds
FTA	Free trade accounts
FTZ	Free Trade Zone
FTU	Free Trade Account System
FX	Foreign exchange
GP	General partner
HKEX	The Stock Exchange of Hong Kong Limited
HKSCC	Hong Kong Securities Clearing Company Limited
HVPS	High-Value Payment System
IMF	International Monetary Fund
INE	International Energy Exchange
KYC	Know your customer
LME	London Metal Exchange
Management Enterprises	Foreign fund sponsors
MRF	Mutual recognition of funds
MRF 2015 Guidelines	Operative Guidelines on Regulating the Proceeds Raised from Cross-border Issuance of the China mainland and Hong Kong Securities Investment Funds published jointly by the PBOC and the SAFE in November 2015
MRF Memorandum	The Memorandum of Regulatory Cooperation concerning Mutual Recognition of Funds between the PRC and Hong Kong signed by the SFC and the CSRC on 22 May 2015
NAFMII	National Association of Financial Market Institutional Investors
National Annual Quota	An annual quota for overall foreign debts
NDRC	National Development and Reform Commission
NDRC Notice	The Notice on Promoting the Reform of the Filing and Registration System for Issuance of Foreign Debt by Corporates (Fa Gai Wai Zi [2015] No 2044) published by the NDRC on 16 September 2015
NRA	Non-resident accounts
Opened-ended Funds	Open-ended securities investment funds set up by public offering outside the PRC, where at least 70% of the fund assets are invested in the PRC; the investment quota in respect of an Open-ended Fund is utilised on a revolving basis.
Panda Bonds	RMB denominated bonds issued by foreign entities in the PRC
PBOC	People's Bank of China
PBOC 2010 Notice	The Notice on Issues Concerning the Pilot Program on Investment in the Interbank Bond Market with RMB Funds by Three Types of Institution Including Overseas RMB Clearing Banks issued by the PBOC on 16 August 2010
PBOC RQDII Notice	The Notice on Matters concerning the Overseas Securities Investment by RMB Qualified Domestic Institutional Investors issued by the PBOC in November 2014
PE	Private equity





PRC	The People's Republic of China (excluding Hong Kong, Macau and Taiwan)
QDIE	Qualified Domestic Investment Enterprise
QDIE Measures	The Shenzhen Municipal People's Government forwarding Municipal Finance Office's Interim Measures regarding the development of QDII overseas investment pilot work (Shenfuban Notice [2014] No.161) issued by the office of the People's Government of Shenzhen municipality on 8 December 2014
QDII	Qualified Domestic Institutional Investors
QDII2	Qualified Domestic Individual Investors
QDLP	Qualified Domestic Limited Partnership
QFII	Qualified Foreign Institutional Investor
QFII SAFE Guidelines	The Operational Guidelines for Quota Management of Qualified Foreign Institutional Investors, set out in the schedule to the 2016 Revised RQFII FX Rules
QFLP	Qualified Foreign Limited Partner
QFLP Rules	The Implementing Measures on the Launch of the Pilot Programme for Foreign-Invested Equity Investment Enterprises in Shanghai jointly promulgated by the Shanghai Municipal Financial Services Office, the Shanghai Municipal Commission of Commerce and the Shanghai Administration for Industry and Commerce on 24 December 2010
Qianhai FTZ	Qianhai Free Trade Zone in Shenzhen
Qingdao Pilot QDLP Measures	The Implementation Measures on the Pilot Programme for QDLP jointly published by the Qingdao Municipal Finance Service Office and other principal government authorities
Qualified RQDIIs	Domestic financial institutions who have obtained permits to engage in offshore securities investment business
RCPMIS	RMB Cross-Border Payment & Receipt Management Information System
RMB	Renminbi, the lawful currency of the PRC
RMB Funds	RMB-denominated funds
RQDII	RMB Qualified Domestic Institutional Investors
RQFII	Renminbi Qualified Foreign Institutional Investor
RQFII Measures	The Measures for the Pilot Programme of Securities Investment in China by RMB Qualified Foreign Institutional Investors jointly published by the CSRC, the PBOC and the SAFE in March 2013
RQFLP	Renminbi Qualified Foreign Limited Partner
RWA	Risk-weighted assets
SAFE	State Administration of Foreign Exchange
SDR	IMF's Special Drawing Rights
SFC	Securities and Futures Commission
SFC MRF Rules	The Mutual Recognition of Funds between the PRC and Hong Kong issued by the SFC on 22 May 2015
SGE	Shanghai Gold Exchange
SGEI	Shanghai International Gold Exchange
SH FTZ 40 Plans	A series of plans jointly published by the PBOC, the MOC, the CBRC, the CSRC, the CIRC, the SAFE and the Shanghai Municipal Government on 29 October 2015 which promising to publish the implementing rules for the QDII2 pilot regime in Shanghai FTZ at an appropriate time
Shanghai FTZ	Shanghai Free Trade Zone
Shanghai Pilot QDLP Measures	The implementation measures on the pilot programme for QDLP business issued by Shanghai in April 2012
SSE	Shanghai Stock Exchange
SWF	Sovereign Wealth Funds
SZSE	Shenzhen Stock Exchange





19 Individual Firms Disclaimers

The information set out in the white paper is intended to provide a comprehensive summary based on publicly available information as of 13 April 2016. ASIFMA, J.P. Morgan and King & Wood Mallesons have used their best endeavor to accurately summarize all the key access channels available and anticipated reforms but there is no assurance that the information included herein is complete due to the rapid and on-going regulatory developments in the PRC.

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