Growing Asia's Markets

China's Capital Markets

The Pace of Change Accelerates

June 2019

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ASIFMA is a independent, regional trade association with over 125 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, **we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia.** ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive **consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice.** Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on **global best practices and standards to benefit the region.**

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ASIFMA would like to extend its gratitude to all of the individuals and member firms who contributed to the development of this paper.

A. Executive Summary

The period since 2017 has been one of considerable breakthroughs in the liberalisation of China's capital markets. ASIFMA has addressed these changes in three previous reports: – *Foreign Institutional Investment in China: An Asset Management Perspective*, March 2019; *China's Capital Markets: Continuing to Navigate the Road Ahead*, March 2018; and *China's Capital Markets: Navigating the Road Ahead*, March 2017. All of these are found on the ASIFMA website. Some content is retained from these earlier reports where the situation has not changed and the information remains valid.

China's capital markets, already among the largest in the world, are playing a key role as the country becomes a consumption-driven economy, seeking to break through the middle-income trap as it deals with an aging society and the threat of slower economic growth. China's developmental capitalism model has large-scale state enterprises and innovative private sector companies coexisting, and both rely on global and domestic equity markets for growth and capital.

Meanwhile, China is trying to move away from the over-reliance on debt funding through its banking system – including a largely unregulated "shadow banking" system –to a capital markets model where capital sourced from equities and bond issuance becomes more the norm. The China bond market is already the world's third largest after the United States (US) and Japan. For its bond markets to achieve their full potential, significant reforms are underway to improve price discovery and transparency. To reform its markets and introduce higher levels of sophistication and competition among domestic participants, China has also sought to gradually open its capital markets to foreign participation.

On this journey, ASIFMA and its 125 member firms stand as both participants and observers. ASIFMA members and staff have contributed their international experience and expertise to this report, and welcome efforts to introduce greater foreign participation, while recognising the complexity of systemic changes that began with the re-establishment of the Shanghai Stock Exchange (SSE) and creation of the Shenzhen Stock Exchange (SZSE) in 1990. Given the acceleration of change since the first ASIFMA Capital Markets report in 2017, the title of this report reflects that China's capital markets are reaching an inflection point, in which they will ultimately mirror the best practices in international markets, while striving for financial products, services and systems that best serve China's evolving economy and capital markets institutions.

ASIFMA views its role as an interactive one with China's regulatory authorities, providing feedback on practical issues arising from policy change as viewed by its collective experts, as well as from an international perspective. As markets evolve, so does the need for regulatory wisdom and flexibility to encompass the needs of market practitioners, whether domestic or international. As China's domestic economy deepens and matures, it is also experiencing a slowdown in the frantic pace of growth of the last two decades. As growth slows, efficient, stable, well-designed capital markets become critical, more than ever, to China's national objectives of sustainable growth and to support the transition from an export-driven to a consumption driven economy.

At the same time, integration with international markets and capital flows will play an increasingly critical role in stabilising domestic markets, attracting additional inbound capital, broadening the range of financial services available to domestic investors, and providing an additional means of risk diversification to help stabilise China's domestic market.

China's capital market reforms: Reaching an inflection point?

While gradually bringing improvements to the basic mechanisms of its capital markets, China has taken a leadership position in a new and emerging capital markets sector, green finance and green bonds issuance. Climate Bonds Initiative figures show that total green bond issuance from China in 2018 reached US$31.2 billion (RMB 210.3 billion) including US$30.9 billion (RMB 208.9 billion) from Chinese issuers on both domestic and international markets, and US$208 million (RMB 1.4 billion) in green panda bonds issued by Hong Kong issuers. In addition, there was a US$17.7 million loan (RMB 122 million) aligned with the Loan Market Association/Asia Pacific Loan Market Association (LMA/APLMA) Green Loan Principles.[1] If bonds aligning only with Chinese definitions are factored in, total issuance in 2018 was Uni$42.8 billion (RMB 282.6 billion), representing a 12% increase over 2017. Industrial Bank of China became the second largest issuer globally in 2018 with US$9.6 billion, and China remained the second largest green bond market in the world at a time when other markets are looking increasingly at green finance.[2]

China is also a world leader in the adoption of technology-led solutions and should build on this enviable record of exploiting technology to make China's financial markets the best in the world for investors by offering innovative, high-quality services at low cost. An aspect of this strategy should be to allow the e of alternative trading systems and venues across all financial products thereby driving down the costs, raising the quality of services and fostering market liquidity and efficiency.

These examples demonstrate the sizeable transformation of China's capital markets as policymakers adapt them to the complex requirements of a growing economy, an ever more sophisticated investing public, and engagement with the international investment community.

The current wave of policy changes began in November 2017, with the prospective elimination of foreign ownership limits on banks while allowing overseas firms to take majority stakes in local securities ventures, fund managers and insurers. This was partly superseded in August 2018 when the China Banking and Insurance Regulatory Commission (CBIRC) announced the elimination of limits on foreign ownership of Chinese financial institutions, removing ownership caps that were part of the previous ruling.

The first months of 2019 saw a series of developments providing further opening to international financial institutions, as well as developments that would profoundly affect international demand for Chinese equities and fixed-income securities. In January 2019, the China Securities Regulatory Commission (CSRC) published draft rules combining its two long-standing inbound investment schemes, the Qualified Foreign Institutional Investor (QFII) and the yuan-denominated Renminbi (RMB) Qualified Foreign Institutional Investor (RQFII) into one, together with the removal of quantitative criteria that hampered inbound investment. In the same month, the People's Bank of China (PBOC) announced it would allow Standard &

Poor's (S&P) Beijing subsidiary to conduct credit rating activities domestically and to register for bond rating services in China's interbank market. More recently, in May 2019, CBIRC announced plans to remove limits on ownership in local insurance companies by foreign institutions and reduce size requirements for foreign banks that operate onshore.

As a result of operational enhancements by PBOC, Ministry of Finance (MOF), and State Administration of Taxation (SAT), Bloomberg confirmed in January that Chinese RMB-denominated government and policy bank securities would be added to the Bloomberg Barclays Global Aggregate Index starting in April 2019 and phased in over a 20-month period. Just a month later, on the equities side, the global index provider Morgan Stanley Capital Investment (MSCI) announced in February 2019 that it would quadruple the weighting of Chinese mainland shares in its global benchmarks in three steps, in May, August and November 2019. FTSE Russell (the trading name of Financial Times Stock Exchange International, the British provider of stock market indices and data services) announced in September 2018 that it would add shares to its FTSE Emerging Index in three phases from June 2019 to March 2020.

There were also important incremental changes that should be noted. Such developments have drawn positive feedback from international market participants, whose interest in engaging with China's capital markets continues to gather pace. There has been a visible improvement in trading suspensions, which hovered for many years in the 150-200 range. These have dramatically dropped to single digits by the end of 2018. MSCI's decision in March 2019 to expand the proportion of Chinese A shares in its global benchmarks built on its earlier decision to include 234 A-shares in its global and emerging markets indices from June 2018. This led to CSRC quadrupling its Northbound Daily Quota. After the launch of the Hong Kong-based Bond Connect scheme in July 2017, the PBOC has continued to evolve and improve the scheme, announcing in July 2018 a decision to allow same-day bond delivery versus payment (DVP) and block trading.

Many practical issues have been addressed in the course of these market-opening measures. In September 2018, at the request of the industry, the Stock Exchange of Hong Kong Limited (HKEX) confirmed that investors would have the flexibility under the implementation of new Northbound Investor identification (ID) to assign Broker-to-Client Assigned Numbers (BCANs or investor IDs) at either the Fund Manager or at the Fund ID level. This has meant that post-trade allocation across Special Segregated Accounts (SPSAs) would be possible if the BCAN is set up at the fund manager level, resolving long-standing industry concerns re implementation of Northbound ID. Concerns with regard to sufficient offshore RMB (CNH) liquidity during rebalancing events were also addressed by measures undertaken by the Hong Kong Monetary Authority (HKMA) with PBOC support.

These concerns were raised among the recommendations on equities in our March 2018 update to our March 2017 paper, in order to improve transparency and capital market efficiency. The Industry appreciates China's actions to address these concerns. Improvements to the China Foreign Exchange Trading System (CFETS) foreign exchange platform could ultimately bring foreign exchange (FX) trading in China on a par with that of other key international markets. CFETS implemented its version of the NEX

Group FX trading platform in February 2018, but similar constraints apply to the new platform. ASIFMA has recommended previously that the CFETS be allowed to compete or collaborate with other FX platforms.

In November 2018, MOF and SAT jointly confirmed a three-year waiver of the Value Added Tax (VAT) and corporate income tax (CIT) on interest income received by overseas institutions from investing in Chinese bonds, also a subject of ASIFMA representations to China's regulatory authorities.

However, from a practical standpoint, the implementation of these measures has not been as smooth as would be ideal. Some of these regulatory changes, although welcome, have given market practitioners insufficient time to respond. Providing ample notification of new rules as well as allowing sufficient time for public comment and implementation will significantly improve the regulatory rule making process. The Industry would appreciate more preparation time for significant changes like the Closing Auction on the SSE, which was rushed into place with limited consultation and testing on 20 August 2018 in order to go live two weeks before rebalancing. More advance coordination would help to ensure sufficient industry buy-in as well as to minimize implementation risks.

Conversely, other policy changes once introduced have been implemented more slowly than some market practitioners would like. It was a year before regulatory authorities approved the first majority stake in a domestic financial firm by an international bank, and licenses for some international rating agencies and bank card payment firms were still pending as of April 2019. UBS was the first international bank to be allowed to take a majority position in its Chinese joint venture, UBS Securities Co., in November 2018, a year after the initial announcement. In March 2019 CSRC accepted applications for 51% stakes in joint ventures for JP Morgan Securities (China) Company Limited and Nomura Orient International Securities Co. Limited; in April Credit Suisse also had its application accepted. As of April 2019, Fitch Ratings was still waiting approval despite having opened a wholly owned office in Beijing, Fitch Bohua, in November 2018 in advance of obtaining a license. Bank card payment firms Visa and Mastercard were also awaiting approval to process RMB payments a year after both companies submitted applications in early 2018.

We draw on the collective experience and expertise of our membership to suggest how they believe China's capital markets might adapt to accommodate the needs of an economy increasingly driven by global competition, innovation, and responsiveness to the needs of consumers. We believe that by carefully choosing the right settings, China has an abundance of opportunity to build on the experience of developed markets, avoid their past mistakes, and leapfrog their successes.

While we have set out specific recommendations at the end of each chapter, we do not list them in any order of importance or prescribe a sequence for their implementation. The reality is that governing a country the size of China is extremely complex and our key message is to propose what is achievable rather than suggest policymakers adhere rigidly to a particular order of action. Moreover, over-emphasis on the order of implementation could risk bogging down reforms in regulatory inertia or disagreement on nonessentials. At the same time, we recognise capital market reforms are highly inter-connected. A policy goal such as increased fixed income secondary market liquidity cannot be achieved without implementation of a whole cluster of smaller reforms such as close-out netting, establishment of a classic repo market, participation of banks in bond futures markets, automation of post-trade processing, not to mention many other reforms. To that end, we have focused this paper on the key recommendations needed if China's capital and financial markets are to reach their full potential.

We also recognise that, for reform to work, technical cooperation across multiple agencies is required. Taskforces should be formed to address problems by analysing them holistically and in an interconnected manner. To that end, we welcome the creation of the Financial Stability and Development Committee (FSDC) in July 2017, headed by Vice Premier Liu He. Seeking wide industry input throughout the analytical stage is key to understanding significant operational and implementation aspects and ensuring the overall workability of changes in both domestic and international contexts.

China has relied to date on a highly successful approach involving limited experiments and pilot programmes as test cases for reform, and only expanding them after careful and deep assessment. With significant international developments occurring at a faster and faster pace, whether such a cautious and incremental approach will continue to serve China's capital markets well requires careful consideration. While we do not call for a "big bang" approach to market change, we welcome signs of an accelerated reform programme that have emerged over the past year. With the end of the global low-interest rate environment nearing, we have seen global capital seeking higher yields in markets such as the US and other economies constraining capital available to markets like China. At the same time, rising geopolitical tensions, an easing of Gross Domestic Product (GDP) growth, and a build-up in debt create pressure to build a financial infrastructure that is both flexible and robust. Pressure from the US and the European Union (EU) to open up ownership of financial institutions and to level the playing field may help to accelerate execution of a policy that has already been adopted in principle, but the wider trends of protectionism in the US and other developed markets are damaging not only to China but to the global economy.

A broad reform agenda that encourages development of deeper, more liquid capital markets with greater choice of investment products is critical to sustaining China's growth as traditional drivers weaken, whether in terms of external trade, domestic infrastructure investment or appetite for risk on the part of global investors. At the end of the day, what is paramount is domestic capital market reform primarily for the benefit of the Chinese economy and its citizens and consumers, including minimising malfeasance, transitioning from over reliance on retail participation to more professional investors, and proper supervision of financial market participants including over technology firms. Our contribution is based on what has worked in the developed markets including lessons learned from the global financial crisis and if applied in China, how that can benefit its economy and citizens. There is no single easy answer to these questions, but rather a constellation of inter-related actions leading to the larger goal of a capital market to support consumer-led economic growth. We believe the ASIFMA recommendations in this paper chart such a path.

1. China's Capital Markets: An Overview

1a. Equities

Solving the many practical barriers to trading is essential if China is to balance liquid, transparent markets with less volatility in its equity market, which is in the interest of all investors and the economy as a whole. Utilising technology advances, in which China is a leader, to make the markets more efficient while properly supervising the market and its participants, including new entrants, is paramount to China's role as a world leader. To this end, adopting global standards would be helpful on such matters as settlement of securities, to move to a DVP system to minimize counterparty exposure, the development of an efficient stock borrow loan environment to provide investors with the ability to hedge their market risks, the ability to offer QFII and RQFII investors the ability to sell through multiple brokers to ensure best execution, as well as the extension of block trading hours.

1b. Fixed Income

Fixed income embraces a highly diverse range of products and markets ranging from plain vanilla, risk-free assets like government bonds to more complex but economically beneficial instruments such as asset backed securities (ABS). As such, one size does not fit all, and reforms need to be carefully considered in light of the requirements of each product or market.

One of the key reforms that would impact not just fixed income products but all asset classes is the continued development of a liquid secondary bond market, including improvements to the price discovery process and measures taken to increase trading in key benchmark and 'off-the-run' issues.

Improvements in secondary liquidity can only happen with the development of a "classic" repo market to better develop a deeper two-way market, as repo markets facilitate participants going both short and long in debt securities. It also requires the further development and increase in the accessibility of derivatives and other hedging instruments, both over-the-counter (OTC) as well as listed derivatives, to a wider set of investors. Close-out netting must also be put into place to facilitate further growth in derivatives trading. Continued improvements in key access channels for bond investors, to hedge interest rate risk and currency exposures, is also extremely important and it has been positive to see continued progress in this area. For foreign investors, when using these access channels, the ability to clearly demonstrate best execution is a key priority. Lastly, giving investors options to use, where agreed by relevant parties, legal documentation used in other markets (such as that used by the International Swaps and Derivatives Association (ISDA), or the Global Master Repurchase Agreement (GMRA) will greatly increase confidence and desire to invest.

In the municipal bond market, the troubled local government financing vehicles (LGFVs) have diversified their funding beyond shadow markets to meet their financing requirements. They have started issuing bonds in both the local currency and US dollar bond markets, a number of which have been rated by the leading global ratings agencies, thus increasing transparency and the development of a mature credit market.

1c. Foreign Exchange

The upgrade of the CFETS platform with the NEX Markets platform has brought electronic execution in line with that of developed markets. However, there are further opportunities to improve efficiency and drive down costs of execution as well as addressing the settlement risk, which will deliver higher levels of prudent risk management and enhance financial stability. We continue to recommend, as we have since our 2017 White Paper, that other platforms be allowed to collaborate or compete with CFETS to improve efficiency and drive down costs of execution.

Given that FX options have been a permitted instrument for a number of years, there is also an opportunity to introduce new products to provide end users with a wider opportunity to hedge their currency exposures at a lower cost. Hedging is an important risk management tool for Chinese companies to manage their foreign currency exposures when trading internationally. Evidence indicates that, in general, firms will avoid incurring these costs by leaving their exposures unmanaged that could leave them at a competitive disadvantage.

The developed-country FX markets have evolved, in part, due to lessons learned from experiences of major market events and as a result have become more efficient. China has the opportunity to leverage these lessons and market practices to improve the efficiencies in its domestic market and to enhance access and risk mitigation for investors.

This being said, these new developments need to be adopted in a safe and steady manner to ensure a stable RMB policy to support its economic development and avoid market speculation. However, given the importance of the FX market, a failure to reform or reforming at too slow a pace, is likely to have significant impact on the continued development of the Chinese economy to its own detriment.

1d. Laws and Regulation

As China seeks to achieve the dual goals of greater access to its markets, as well as ensuring their stability, the future evolution of China’s markets will benefit from greater transparency and consistency in policy and regulation setting. These should include more open market consultation processes allowing for public comment, sufficient notification of new rules and adequate lead time for issues to be raised and changes to be implemented. This will result in better regulation that will ultimately help in professionalising the market as well as in eliminating bad practices. China may also wish to consider issuing notifications in other languages, especially English. English-language documentation has become an established international practice for financial services consultations in most regions. This supports efficiency and effectiveness of the consultation process in an international context, significantly increases external investor confidence and reduces perceived regulatory risk.

As in all markets, there is a need for China to implement a resolution and recovery regime consistent with the Financial Stability Board's Attributes of Effective Resolution Regimes for Financial Institutions. In China, this would provide clarity about an investor's place in the credit structure of its banks. In March 2018, as part of a broad regulatory update of capital bond issuance, PBOC referred for the first time to bonds eligible for Total Loss Absorbing Capacity (TLAC). Issuance of TLAC bonds would be credit positive for banks' depositors and senior debt holders because it would provide a larger cushion to absorb losses and recapitalise a failing bank. The official reference to TLAC signals that China is starting to implement its own adaptation of the international resolution framework.

Welcome progress is being made on close-out netting, as regulators work with international counterparts on a compatible rules framework to allow derivatives dealers and repo traders inside or outside China to collapse offsetting trades into a single net payment, if a counterparty defaults. Without netting, firms face potential claims for gross exposure, rather than net exposure as in countries where close-out netting is enforceable. Lack of clarity on close-out netting has long been extremely problematic for foreign and domestic banks seeking to be more active in China, undermining liquidity in both the derivatives and repo markets which is fundamental to the broader growth and development of its capital markets.

CBIRC has taken ownership of drafting a report outlining a way forward on close-out netting. ASIFMA serves as part of the United Kingdom (UK)-China Netting Working Group which was set up in December 2017 to advise CBIRC, whose report we hope will be adopted by the State Council in 2019 and ultimately endorsed by the Supreme People's Court.

1e. Market Infrastructure

In order to minimise risks for entities clearing on the Shanghai Clearing House (SHCH), there is an immediate need to consider incorporating enforceability of close-out netting in statute, supporting the exchange of margin through amendments to the Securities Law and allowing for third party custodians to hold initial margin on behalf of the posting counterparty. The close-out netting safe harbour is also needed to protect China's futures exchanges from the risk of margin being clawed back in the event of members' insolvency.

We recommend PBOC, in conjunction with the SHCH, prioritising the application for the recognition of SHCH as an equivalent clearinghouse under European legislation and as a Derivatives Clearing Organisation (DCO) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the United States (Dodd Frank).

Allowing international investors to achieve the operational efficiencies of omnibus trading in line with most other key markets would also be welcomed by international institutions. The introduction of the northbound BCAN ID at the fund manager level is a useful and important step in the right direction, helping international participants manage their average pricing and post-trade allocation requirements. The BCAN ID at the fund manager level allows for average pricing across underlying fund IDs, and helps to facilitate some of the benefits the industry is trying achieve via omnibus trading. Measures such as these significantly improve meaningful access to China's capital markets by international firms.

While China's priority it to develop its own market infrastructure, it is equally important to ensure that it considers compatibility with international standards, if it is to continue to deepen market access and particularly if it seeks to expand use of the RMB as an international currency. This includes compatibility with international standards for payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories, and alignment with the Principles for Financial Market Infrastructures (PFMI) issued by the Committee on Payments and Market Infrastructures (CPMI) and International Organisation of Securities Commissions (IOSCO). Also important is settlement of RMB on a payment-versus-payment (PVP) basis as highlighted in the regulatory guidance on mitigation of settlement risk from the Basel Committee on Banking Supervision (BCBS).

1f. Market Access

The "New Foreign Investment Law", passed on the final day of the National People's Congress on 15 March 2019, which will come into effect on 1 January 2020, will ultimately replace the Wholly Foreign Owned Enterprises (WFOE) and joint venture (JV) laws by merging them into one new law. Meanwhile, there have been significant developments since 2017, progressively expanding the scope of foreign ownership of financial institutions. At present, and until the new foreign investment law comes into effect, regulatory responsibilities are spread across several agencies.

The first set of ownership opening measures came in November 2017, when the State Council Information Office announced that direct or indirect foreign ownership of securities investment companies, fund management companies and futures companies will be relaxed to 51% and that, after three years, foreign ownership limits will be lifted. The 2017 changes were superseded on 23 August 2018, when CBIRC announced that foreign banks may now acquire 100% of Chinese banks and asset managers. At the same time, CSRC issued a consultation document entitled Draft Measures on Equity Interest in Securities Companies.

While these market-opening measures are welcomed, foreign financial institutes would like to see 100% ownership as soon as possible. In addition, many of the requirements in the consultation document are troubling to foreign firms, including new qualification requirements, which include a RMB 100 billion net asset requirement for controlling shareholders and disclosure requirements that may be difficult to comply with in practice. Other issues of concern include new caps on ownership of securities companies by non-financial institutions, lack of clarity on implications for existing shareholders, and the failure to take into account parent entities of direct shareholders for the purposes of compliance.

ASIFMA believes that there is still much to be done to create a level playing field between domestic and foreign firms, addressing indirect impediments and hidden barriers that international firms face. These impediments and hidden barriers prevent foreign firms from availing themselves of the new ownership rules, and which will prevent the Chinese economy from fully benefitting from the opening up. Experience with the new ownership rules so far also indicates that licensing may remain problematic, with different licensing rules for existing JVs versus new JVs. China's companies and financial institutions have traditionally been able to access North American and EU financial markets, benefitting from and helping them maintain their depth and liquidity, supported by a developed legal framework, with no ownership restrictions or restrictions in license scope. This has been changing due to trade tensions between China and the United States (US) and the EU (as well as indeed between the US and the EU themselves).

The sooner that domestic and international participants are treated the same in all markets, the better this will be for capital markets and ultimately the underlying economy, job creation, and their citizens. China is the world's second largest economy by nominal Gross Domestic Product (GDP) and provides a tremendous opportunity for the cross-flow of investment where it is needed most. China's capital markets and economy stand to benefit if international financial firms have full access to the China market, in conjunction with equal access provided to Chinese financial firms in the EU, the US, and other developed markets. ASIFMA has identified a number of level-playing-field issues in the areas of ownership and licensing for foreign-owned securities joint ventures (JVs), cyber security, cross-border data transfer, and other matters.

Streamlined and simplified market access programmes, in particular, would lower the significant costs and risk international firms face in investing in China and enhance the attractiveness of Chinese investment products to international asset managers. Among the most effective reforms would be:

- Enablement of international institutions to acquire bond underwriting and settlement licenses on a fair and transparent basis,
- Expanding the scope of permissible securities for access programmes,
- Amendment of Stock Connect rules to enable affiliates of exchange participants to borrow and lend stock,
- Clarification of the China Inter-Bank Bond Market (CIBM) rules on quota limitations,
- Increasing the scope of firms allowed to issue Panda bonds,
- Improvement of the Panda bond accounting rules and allowing international credit rating agencies to rate them, and
- Adoption of a more flexible interpretation of the Cyber security Law.

A more robust credit system would strengthen and attract more investors to fixed income markets in particular.

Finally, on behalf of international firms represented within our membership, we note and welcome the steady expansion of China's various access programmes, acknowledging the complexity and sophistication of solutions required to integrate such a large market internationally. To that end, we suggest the continued simplification of these measures, improving clarity and consistency among them wherever possible, on-going dialogue and consultation that includes both domestic and international market participants so that issues can be identified, discussed and solved as efficiently as possible.

B. Introduction

In the two years since ASIFMA's first white paper on China's capital markets, external factors have emerged as major challenges for China. While political turmoil may subside given political and electoral cycles, China's rise is no longer seen as an unqualified gain to the global system, and in some quarters is perceived as a threat. Consistent with ASIFMA's mission, our aim in this paper is not only to enumerate past successes but to identify those operational, policy and capital market tweaks and modifications we believe to be essential to sustaining China's vigorous economic growth and prosperity.

These developments are daunting, especially as they coincide with a slowing of the Chinese economy from its double-digit growth performance in the 2000s. Added to the economic slowdown are concerns about rising debt levels of China's local governments and non-performing loan ratios at China's banks, both of which may be under-reported. Government policy has been quick to tackle the debt problem, in part a legacy of its US$400 billion fiscal stimulus programme after the global financial crisis in 2008. It has also accelerated the pace of change in its capital markets, which if trade earnings are squeezed, can serve as an alternative growth driver by mobilizing domestic and foreign savings to create wealth through investment in new businesses and technologies. The worsening of China's geopolitical environment in many respects underlines the importance and urgency of continued reform in its capital markets.

Managing this transition well will continue to be the key challenge for policy makers over the medium term and it remains an open question whether China can avoid becoming stuck in the "middle income trap. Increasingly, China is struggling to find the balance between supporting the economy with loose credit conditions as it transitions to a consumption-based economy and preventing a destabilising build-up of debt that could bring a shock to the economy down the road.

Long-term foreign investment is more readily attracted to countries with well-regulated, diverse markets than those heavily reliant on bank lending. Chinese banks traditionally lend short-term, limiting the duration of debt available in the economy. Debt issuance is not yet fully developed as a viable funding mechanism for longer-term infrastructure development. China's capital markets have required domestic banks to make longer-term loans to municipalities, saddling them with underperforming assets and concentrating credit risk in the banking sector. The resulting maturity mismatch is inherently risky. Fortunately, this model is starting to change with the advent of a functioning municipal bond market.

The development of robust capital markets through more accommodative government policies will help increase market transparency. The rash of market manipulation accusations and fraud scandals afflicting Chinese markets has put increased pressure on the government and regulatory authorities to address the problem head on. Extensive financial reporting and proper risk assessment are fundamental to well-functioning capital markets. This will also support better corporate governance and instil greater trust in the marketplace, to the benefit of all market participants and stakeholders.

The substantial infrastructure still needed to spread development geographically, extend social safety nets, improve productivity and sustain high economic growth requires the efficient mobilisation of private and public capital. To ensure continued and sustainable growth, China should continue to pursue government policies that allow for capital market development and that broaden the array of financing and investment possibilities to complement, and ultimately transform, the over-reliance on bank lending and pave a transition to a consumption-based economy.

Structure of the report

The report seeks to provide a current snapshot of China's capital markets from a practitioner's point of view. The first section covers the main pillars of capital markets institutions – equities, fixed-income, foreign exchange (FX), regulatory infrastructure, and market infrastructure.

A second section looks at the markets from the point of view of foreign financial institutions and is broken down into practical knowledge required for investing, operating and raising funds in China. This was also the perspective adopted in ASIFMA's March 2019 report, *Foreign Institutional Investment in China: An Asset Management Perspective* and includes content from that report. ASIFMA's wish in assembling the *China's Capital Markets: The Pace of Change Accelerates* report in this fashion is to serve the needs of both those new to the market and experienced market practitioners, by bringing as much information as possible together in one place. An executive summary and Introduction includes a macro-economic review, together with highlights of the report's major chapters.

The experience of ASIFMA and its members, based on international best practice as well as intimate exposure to China's capital markets, is shared throughout the report, but particularly in the form of recommendations. These are shared in the spirit of providing feedback from some of the world's most prominent financial, legal, and investment firms on current practice and policy in China's capital markets. They are listed at the end of each section, by category, and as a summary list at the end of the report.

C. Macroeconomic Backdrop

China's growth slowed in 2018 to 6.6% for the full year, the lowest growth rate since 1990. A recent paper by economists at the Brookings Institution suggests growth rates were consistently overstated between 2008 and 2016, and that the actual 2018 GDP might be RMB 10.8 trillion (US$1.6 trillion) below the official figure of RMB 90 trillion.[3] On the first day of meetings of the National People's Congress in March 2019, Chinese premier Li Keqiang gave an official growth target in the range of 6-6.5% for 2019, an admission that the slowdown could be worse than last year's, but also an indication that the leadership have set a lower bound for growth and will use all the policy tools at their disposal to meet it.

China's macro-economic challenge in 2019 and beyond is meeting the combined impact of its trade dispute with the US, weakening domestic demand and high levels of off-balance sheet borrowing by local governments. Its 6.4% growth rate in the fourth quarter of 2018 was the lowest since the global financial crisis of 2008, and the previous two quarters also showed sharp deceleration. In fiscal terms, China needs to avoid excessive stimulus while committing to further liberalisation and protection of intellectual property to prevent supply chain relocation and appease the US. According to an estimate by Standard Chartered Bank, full implementation of tariffs threatened by the US in the latest round of trade talks could lower GDP growth by 0.6% and lead to widespread relocation of supply chains, effectively decoupling the two economies.

China's Macroeconomic Growth is Slowing

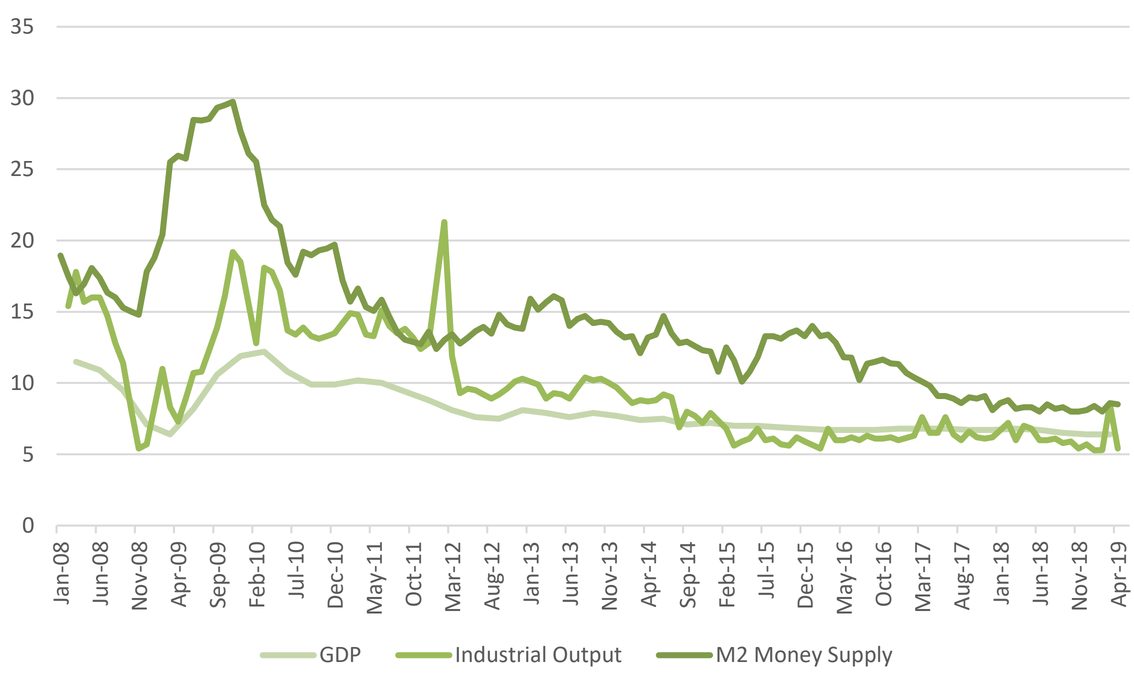

Fig. 1: Year-over-year change in GDP, Industrial Output, and M2 Money Supply (2009-2018)
Source: Refinitiv, WIND Financial Information

2018: Lowest GDP Growth since 1990

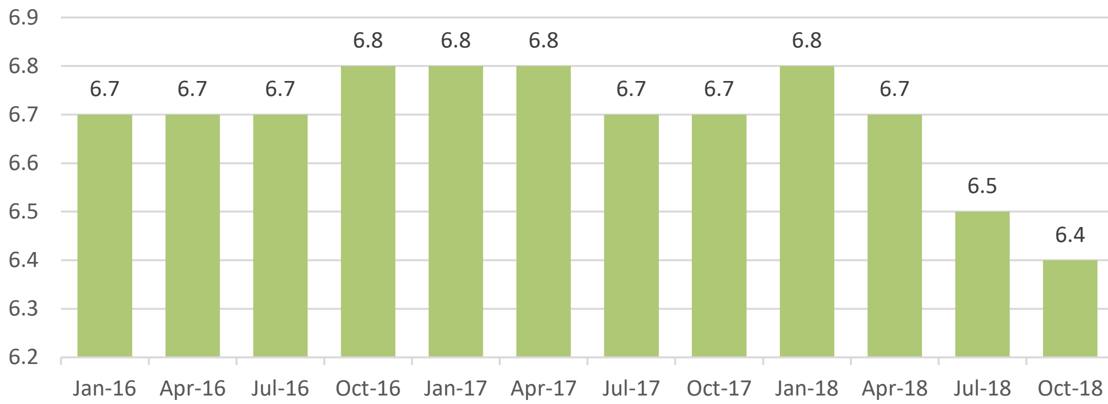

Fig. 2: GDP growth rate (2016-Q4 2018)
Source: TradingEconomics

In the medium term, China will continue to slow down based on demographic fundamentals – an aging population and the shrinking of its working age population, which has already passed the peak of its demographic "dividend" when both an increasing number of young people and declining fertility unleash economic growth.

Another dividend is also running out – the "reform dividend" from China's World Trade Organisation (WTO) accession in 2001. The challenges facing policy makers are on many fronts, from the rapid rise in China's debt-to-GDP level since the global financial crisis of 2008, to the aging population, declining productivity, industrial over-capacity, and the high cost of environmental restoration after decades of environmentally damaging industrial expansion.

Nonetheless, over the next two years China is likely to use all the policy tools it has at its disposal to achieve a minimum annual growth target of 6.2%, in order to meet its policy target to double 2010 GDP by 2020. While it is unclear how much stimulus policy makers will apply, if the trade war with the US gets worse, external demand will be a negative contribution to GDP and an increase in government spending will need to be greater. However, fiscal policy is playing a more important role than monetary policy, and within fiscal policy, decision makers are emphasizing the demand side through tax cuts rather than spending alone.

At the National People's Congress in March 2019, the government lifted its 2019 budget deficit target to 2.8% of GDP from last year's 2.6% and cut business and personal taxes by RMB 1.3 trillion (US$194 billion), more than the RMB 1.1 trillion in 2018 tax cuts. The government also announced cuts in the VAT rate for manufacturing firms from 16% to 13% and reduced the rate for transport and construction firms from 10% to 9%. By reducing the tax burden of households, the calculation is that they will become more confident in consumption and that lower operating costs of business will make it more attractive to invest. The demand impact may thus lead to more organic growth and less reliance on stimulus.

On 30 January 2019, the US Federal Reserve Board (the Fed) suspended its previous plans to continue raising interest rates in 2019 with Fed chairman Jerome H. Powell stating that the “case for raising rates has weakened somewhat” based on sluggish inflation and slowing growth in Europe and China. If sustained, an extended pause in the Fed’s rate hikes will give more breathing space for China’s monetary policy and reduce pressure on China’s currency. It will make policy makers less worried about the possibility of capital outflow, which happened as the US was tightening its monetary policy and China was easing.

Both the US and China seem ready to strike at least a partial deal on trade issues, market access and some general commitments on intellectual property rights and technology transfer. China has promised to import more from the US and will continue to discuss specifics about intellectual property protection and structural reforms. Although the on-going negotiations between China and the US administration have proven unpredictable, even in the worst-case scenario, China has policy reserves that it can deploy quickly to handle a crisis.

These might include a selective loosening of property policy, which could boost growth quickly but with long-term side effects, fully utilizing the local government special bond insurance quota to boost infrastructure investment, and loosening monetary policy through credit channels. If the government turns again to infrastructure investment as part of a stimulus plan, recent policy changes could mitigate the risk of a major expansion of credit. To start with, significant restrictions have been placed on shadow banking channels, with pressure placed on local governments to borrow via the bond market. The latter is sufficiently transparent to make it possible for the government to track debt accumulation as it occurs. For the moment, the question is whether the government can find efficient projects in which to invest.

Asian Debt Comparison (% of GDP)

Indicator	China	India	Indonesia	Korea	Malaysia	Philippines	Taiwan	Hong Kong	Singapore	Australia	Japan
Economy (Overall)	246.4	137.9	71.4	231.3	236.3	104.8	142.8	302.8	320	247.5	393.1
Private Corporate Sector	139.8	53.8	25.2	98.3	101.3	61.4	61.5	232.2	124.7	75.3	103.4
Household Sector	49	15.2	17	94.8	84.2	9.4	45.6	70.6	76.5	130.3	57.4
Government Sector	57.6	68.9	29.2	38.2	50.7	34	35.6	0.1	118.8	42	232.3
External Debt/GDP	11.7	20.1	35.2	23.9	65	21.9	N/A	N/A	N/A	93.5	72.9
FCY of Total Debt	61	63.7	79	73.5	66	97.2	N/A	N/A	N/A	N/A	N/A

Fig. 3: Comparison of Asian countries’ debt as of 31 August 2018
Source: Bloomberg, CEIC, BIS, IMF, national sources, Moody’s, Standard Chartered Research

It is logical to assume that expected returns of infrastructure investment will diminish somewhat over time. Usually, the most productive projects are financed first, and with high-speed rail reaching every part of the country, there will be fewer obvious infrastructure projects left to finance.

Compared with other developing countries, China's private corporate sector debt level is high. However, unlike its peers, very little of China's debt is owed externally and of that portion a modest amount is owed in foreign currency. This gives China more flexibility and less exposure to external shocks although it does not lessen the degree of domestic risk.

D. Equities

While relatively advanced compared to other asset classes, continued evolution of China's equity market is critical to further reform of its financial markets. The continued development of China's equities market is critical because a well-functioning equity market lowers the cost of capital, supporting the most vibrant portions of the Chinese economy. Improvements in productivity — the bedrock of improvements in living standards — almost always come from innovative, young companies, and equity markets serve to channel capital to them. Equity capital is also important for established companies, especially more successful ones, to grow and innovate. Unlike bank loans or bonds, equity is not repaid, encouraging healthy risk taking because the certainty of financing gives managers confidence to design and execute long-term plans. It makes possible long-term investment in research and development, human capital and plant and equipment that produces gains in jobs, higher consumption, and a larger tax base. Because it is an alternative to debt, equity also reduces leverage and hence systemic risk.[4]

A dynamic equity market is essential to achieve the ambitious economic reform plans of the 2013 Third Plenum, which used a seven-year time frame to 2020, to "reach a new stage of development." Moreover, if Shanghai is to become one of the world's global financial centres by 2020, a goal announced by the State Council in 2009, China's stock markets will have to meet global standards.

Since the establishment of the SSE and SZSE in 1990, the Chinese equity market has sped past various milestones. As of December 2018, China (excluding Hong Kong) had the world's third largest stock market with a combined aggregate market capitalisation of US$6.3 trillion. For all of 2018, according to Refinitiv data (the company formerly known as Thomson Reuters) Chinese issuers raised US$55.65 billion in global equity capital markets, down from US$102.2 billion in 2017, and accounting for 8.7% of overall issuance. While A-share Initial Public Offerings (IPOs) on the SSE normalized to US$13.4 billion in 2018, causing Shanghai to sink to sixth place among the top-ranking exchanges for IPOs in 2018, Hong Kong regained the 2018 listing "crown" from New York, with 125 companies raising US$36.5 billion.[5] HKEX accounted for 17.6% of the global IPO market in 2018, due to reforms allowing dual-class shareholding companies.[6] Meanwhile, Chinese companies accounted for 17% of all US IPOs in 2018, mostly in the tech sector, with Chinese tech IPOs outstripping those from Silicon Valley for the third year.

Market Capitalization of the World's Top Exchanges (as of end-December 2018)

	Worldwide Ranking	Ranking in Asia	Market Capitalization (US$ billion)
US (NYSE Euronext)	1		23,211.05
US (Nasdaq)	2		11,218.24
Japan (Japan Exchange Group)	3	1	5,608.26
China (Shanghai)	4	2	5,013.73
Hong Kong	5	3	4,307.77

Europe (NYSE Euronext)	6		4,268.41
UK (London Stock Exchange Group)	7		3,965.35
China (Shenzhen)	8	4	3,355.38
Canada (Toronto)	9		2,216.35
India	10	5	2,179.10
Germany (Deutsche Börse)	11		1,867.31
Switzerland	12		1,603.62
Korea	13	6	1,468.21
Northern Europe (NASDAQ Nordic Exchange)	14		1,432.59
Australia	15	7	1,384.11

Fig. 4: Market Capitalization of the World's Top Exchanges (as of end-March 2019)
Sources: Securities and Futures Commission

China's Markets Shares in Comparison to Total Market Shares

Products	China US$ (m)	World US$ (m)	China's market share to the total market share
Loans	111,012	4,704,114	2.36%
Bonds	1,022,476	4,020,451	25.43%
Equity	55,695	639,391	8.71%

Countries' market shares in comparison to the total market share

	2018		
Countries	**Loans**	**Bonds**	**Equity**
China	2.36%	25.43%	8.71%
Hong Kong	2.42%	0.28%	10.22%
Singapore	1.13%	0.32%	2.26%
India	0.98%	1.00%	2.13%
Taiwan	0.80%	0.51%	0.35%
South Korea	0.13%	3.41%	2.25%
Japan	5.01%	5.11%	7.71%
Malaysia	0.33%	0.45%	0.24%
Indonesia	0.43%	0.11%	0.32%
Thailand	0.03%	0.48%	0.83%
Philippine	0.06%	0.11%	0.74%
US	62.37%	51.40%	34.96%
UK	3.95%	4.69%	7.05%
Europe	20.00%	6.70%	22.23%

Fig. 5: China's market shares in comparison to total market shares (as of end-December 2018) and Countries' market shares in comparison to the total market share (as of end-December 2018)
Source*: *Refinitiv

A healthy equity market would channel capital to China's most dynamic sectors. According to China's National Bureau of Statistics, small and medium-sized enterprises (SMEs) account for over 97% of registered industrial firms in China. SMEs employ nearly 75% of the country's workforce and generate 65% of GDP.[7] But SMEs have a harder time getting capital than slower-growing state-owned enterprises (SOEs). At present, SOEs get over 75% of loans that are extended by state-owned commercial banks. As a result, SMEs often turn to non-bank financing from shadow banks, which is more expensive; central government efforts to restrict shadow banking and replace it with equity finance have helped limit debt levels but SME access to credit remains problematic.[8]

China's private companies have historically displayed higher factor productivity growth compared with SOEs. A study from the World Bank found that private firms enjoyed significantly higher returns on equity between 1998 and 2009. In 2009, private firms' return on equity was 20 (PE)%, compared with 10.1% for SOEs. From 2010 through 2014, private firms raised RMB 660 billion through initial public offerings through the Shanghai and Shenzhen stock exchanges; SOEs raised RMB 166 billion in the same period.[9] While this may look like private firms are more successful at issuing equity capital, many of the SOEs had already raised equity capital prior to 2010 and were consequently collectively less in need.

The programme to diversify the equity of SOEs that began in 2013 under the rubric of "mixed ownership" reform" represents an effort by the State-owned Assets Supervision and Administration Commission (SASAC) which oversees centrally-owned companies to attract private capital, primarily through collaboration with state-owned restructuring funds such as the China Structural Reform Fund.[10]Between 2013 and 2017, according to SASAC, private companies invested RMB 1.1 trillion (US$158.5 billion) in centrally owned SOEs and another RMB 500 billion (US$74.4 billion) in provincial level SOEs in a programme that so far has engaged 50 SOEs in three rounds or batches.[11] Vice Premier Liu He became head of the State-owned Enterprises Leading Group in July 2018, a sign of the importance the central government is giving to the programme.[12]

The reforms are strengthening the competitiveness of China's state sector, but raise questions from the perspective of private equity, where the ethos is to seek profitable exits from business after five or eight years, and direct PE participation in mixed-ownership has been limited.[13] Nonetheless, there are many reasons to support these reforms, which include pressure on "zombie" or non-viable SOEs to shut down and support the expansion of capital investment and asset management companies. According to SASAC, by January 2019, more than 1,900 "zombie" companies had been removed from the SOE system, and the number of SOE "capital investment and operation companies" expanded to 21 in 2019, up from 10 a year earlier.

In 2019, SASAC has said it will experiment with introducing overseas capital into SOE reform, as well as make more "use" of SOE stock transactions on HKEX.[14] Given the scale and significance of the SOE sector, such reforms are critical to improving the return on equity in the state sector as well as allocation of capital. Professionalisation of asset management by the SOEs can help to build the sector's competitiveness; however, for foreign asset managers to participate in the sector, clarification will be needed on rules of the road including exits.

As market channels for inbound investment to China’s exchanges have proliferated, the need for convergence and simplification has increased. In January 2019, CSRC published draft rules to combine the QFII and RQFII channels into one, lower the threshold for overseas applicants and simplify the vetting process. It has also said that it would scrap quantitative criteria for the combined QFII and RQFII schemes and shorten the approval time for applicants.

Reacting in part to these developments, in March 2019, index provider MSCI announced it would quadruple representation of Chinese A shares in its global benchmarks and add 168 mid-cap and 27 small-cap securities listed on the ChiNext Index. It plans to raise its inclusion factor of yuan-traded shares from 5% to 20%, in three stages from May to November 2019. Upon completion, Chinese stocks will account for a 3.3% weighting in the pro-forma MSCI Emerging Stocks Index.

FTSE Russell will also include A shares in three phases starting in June 2019; A shares are projected to account for 0.57% of the FTSE Global All Cap Index after the completion of the first of three phases. The S&P Dow Jones Indices will also include eligible A-shares from September 2019, based on shares that are accessible via the northbound Stock Connect channels. In April 2018, HKEX and CSRC quadrupled the daily northbound trading quotas, and both the PBOC and the HKMA have increased offshore currency resources and swap lines to support the rise in volume. Industry estimates forecast 100 plus billion US Dollars (USD) and 300 billion USD of flows respectively into China’s onshore equities and bond markets in 2018 on the back of these major index inclusion events.

As the flows increase, so too will the diversity of global investors participating in China’s capital markets. Despite the aforementioned reforms which have led to the index inclusions, there remain practical barriers which impede attracting more global institutional investors to China’s equity capital markets. Adopting global standards for matters such as an effective closing auction mechanism (CAS), the development of an efficient stock borrow loan mechanism for hedging , the ability to offer QFII and RQFII investors the ability to sell through multiple brokers for best execution, improvements to the block trading mechanism, and the settlement of securities on a DVP basis are all critical for the further strengthening and globalization of China’s equity market.

1. Market structure

1a. Trading suspensions

We start by commending Chinese authorities on making significant improvements in this area over the past few years since 2015 when, during the height of market volatility in the summer of 2015, on some days trading in over half the stocks was suspended. This exacerbated market anxiety, which spilled into other products domestically, as well as markets globally. Suspensions cause problems for the obvious reason that a suspended stock cannot be bought or sold. For fund managers, widespread suspensions can be a major hindrance to meeting fund redemption obligations.

Total number of companies suspended from trading (2015–2019)

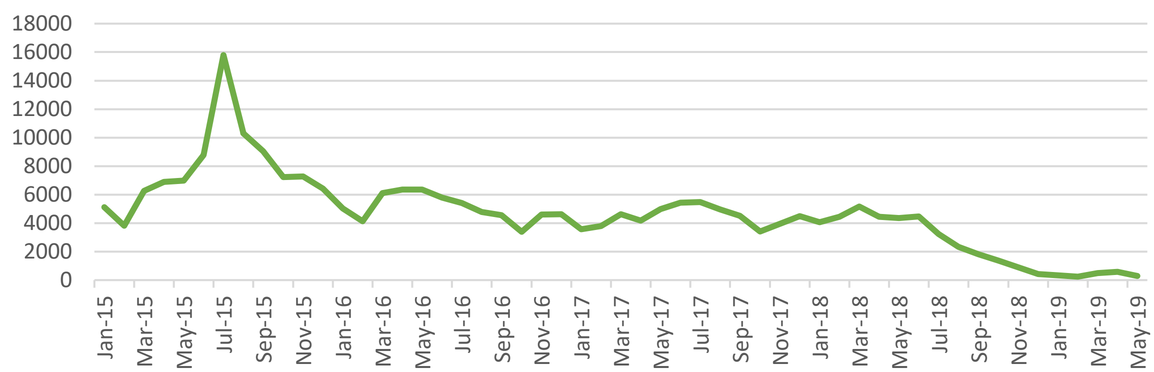

Fig. 6: Total number companies suspended from trading from January 2015 – May 2019
Source*: *WIND Financial Information

While we recognise that a listed company has a right to suspend trading of its shares under specific conditions so that investors have time to digest the significance and implications of such conditions, it is particularly important to foreign investors to know that the liquidity of its shares they hold is reliable. The rights and interest of investors, and the liquidity of the market, should prevail over the rights and interest of listed companies. [15] ASIFMA advocates for continued discouragement of trading suspensions except under exceptional circumstances and set out in transparently applied rules to safeguard market liquidity. On 6 November 2018 CSRC issued the *Guiding Opinions on Improving the Suspension and Resumption of Trading of Shares of Listed Companies* which was followed by SSE and SZSE each issuing a consultation on reducing the types of events under which a listed company may request a trading suspension and the maximum period of such suspensions. Although the final SSE and SZSE guidelines issued on 28 December 2018 kept the maximum suspension period to 10 dealing days despite our request to shorten it further to five dealing days, we are encouraged to see that the circumstances under which a listed company can suspend trading of its shares are limited. We commend the focus by the exchanges and Chinese regulators on these concerns, as reflected by the number of *trading suspensions falling to single digits* by the end of

2018. ASIFMA encourages continued rigorous monitoring of trading suspensions and enforcement of these guidelines by SSE and SZSE.

1b. Window guidance for trading

CSRC issued a notice on 30 October 2018 that it will, among other things, (a) upgrade the quality of listed companies, strengthen their corporate governance, standardise information disclosure and increase transparency, (b) optimize trading monitoring and supervision, reduce trading obstacles, strengthen market liquidity and reduce unnecessary intervention in the trading process so that the market has a clear expectation of what is being regulated and investors have a fair opportunity to trade, and (c) encourage value investing and unleash the role of institutional investors such as insurance, social security, various securities investment funds and asset management products to bring more medium and long-term capital into the market supervision, reduce trading obstacles, strengthen market liquidity and reduce unnecessary intervention in the trading process so that the market has a clear expectation of what is being regulated and investors have a fair opportunity to trade, and (c) encourage value investing and unleash the role of institutional investors such as insurance, social security, various securities investment funds and asset management products to bring more medium and long-term capital into the market.

Shortly after issuance of the CSRC notice, SSE and SZSE both announced that they would stop giving verbal warnings to brokers, also known as "window guidance", and no longer interfere with trading instructions from foreign institutional investors (FIIs) to their brokers. FIIs welcome the cessation of this practice because it is difficult to tell whether the verbal guidance from the exchange is given to a particular securities broker or to all brokers or if the directive is an official policy.

If it is a policy or directive that is to be applied to the industry, it should be published in the form of a written circular or notice by the relevant authority and not communicated verbally so that there is full transparency on the policy and the scope of its applicability.

1c. Short swing profit rule

In those few jurisdictions where directors, senior managers and substantial shareholders (e.g. holders of 5% or more shares) of a listed company are subject to a short swing profit rule (e.g. where they are required to disgorge any profit from the purchase and sale of shares of a listed company within a six-month period), there are exceptions for investment managers, or alternatively holdings under such rules are calculated on an individual client/fund basis and the rule is triggered at a higher percentage threshold. If the holdings of separate clients/funds have to be aggregated because they happen to be managed by the same investment manager (or an investment manager that is part of a group of investment management companies), as is the case for disclosure of interests in China, the 5% threshold may be reached much sooner, thereby preventing further investment by the investment manager on behalf of all of its clients/funds in the relevant securities. This result unfairly harms investors whose investment manager is impacted by the rule, especially those investment managers who manage investments for multiple clients/funds or are part of a group of investment management companies. It also has the effect of reducing the amount of potential investment by large global asset managers, which are an important source of long-term capital.

For the reasons enumerated above it is important to clarify, for purposes of the China short swing profit rule, that holdings are calculated on an individual client/fund basis and not aggregated across the investments made by an investment manager on behalf of all of its clients/funds or across the investments made by a group of affiliated investment management companies.

1d. Closing Auction Session (CAS)

Some of the largest global institutional investors are passive funds whose performance is benchmarked to the underlying stocks' closing price. While the Industry appreciates the effort by SSE to implement a CAS mechanism in 2018, volumes remain low in both SSE's and SZSE's CAS owing to structural and operational frictions, which need to be addressed. Liquidity is lacking during the close, in stark contrast to markets around the world, per charts below.

Trading volumes across regional exchanges

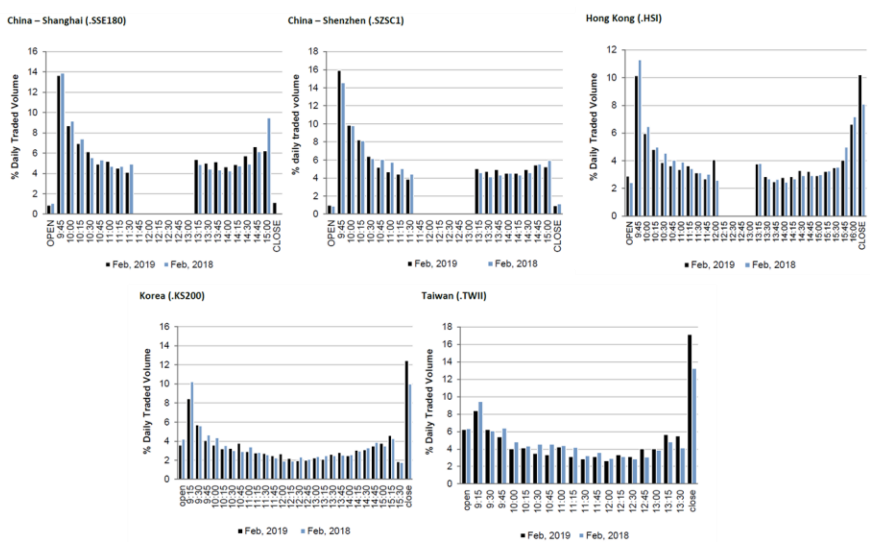

Fig. 7. Trading volumes in SSE, SZE, HK, Korea, Taiwan, 2018-19
Source: Goldman Sachs

Investors and brokers are reluctant to place large orders during the close for fear of impacting market price and/or violating SSE/SZSE "abnormal trading" rules. Clear and consistent messaging from SSE/SZSE market surveillance departments on how brokers may or may not trade during the CAS would be helpful. The SSE/SZSE "Abnormal Trading Rules" circular has already been shared with domestic Chinese brokerage firms and the Industry requests that such should be shared with foreign brokers and investors as well to better ensure compliance. Also, allowing for order cancellations during the CAS, and permitting more order types (for example, a Market on Close or MOC) will help encourage increased broker participation in the CAS. Securities lending and borrowing can also help facilitate increased participation during the close, where large sell and buy orders can be better matched against each other while minimizing price impact.

1e. Electronic trading

Market participants worldwide have benefited enormously from technical innovations in equity markets and the consequent evolution of market structure in recent years. Transaction costs have been dramatically reduced, which translates directly into a lower cost of capital and better investment outcomes. Automation has enabled venues to handle much higher volumes, and intermediaries to customise trades to meet the portfolio objectives of clients in ways that would previously have been technically impossible or prohibitively expensive. As China's stock markets mature, it is important that they continue to invest in technology to provide innovative services to market participants. A 2016 study by the World Federation of Exchanges (WFE) found that advances in trading technology would attract investors and foster healthy liquidity.[16] China's markets are technologically advanced but somewhat disconnected from the rest of the world because of differences in operational structures and systems.

Electronic trading has dramatically improved trading efficiency enhancing connectivity between clients and brokers via third party vendors and by making possible the use of trading algorithms. Connectivity between clients' and brokers' order management systems is an essential way to reduce communication and operational errors. Such a feature is key to clients who are trading baskets (or rebalancing index-based portfolios). In international markets, those connections are commonly done via third party vendors using the Financial Information Exchange Protocol (commonly known as "FIX" connectivity).

Algorithmic trading is essential to many execution strategies in modern markets, and agency algorithms that reflect accepted practice and help clients to achieve best execution (such as Volume-Weighted Average Price, or VWAP, and Time-Weighted Average Price, or TWAP) should be promoted to sustain healthy market evolution.

The risk of making regulatory changes whose impacts on such technologies are uncertain could damage the proven benefits of modern market structures and possibly introduce risks that did not previously exist. Such an outcome would be a loss for Chinese investors, as well as for corporates raising capital, which may hamper the continued development of China's equity market, and more broadly, the domestic economy.

1f. Direct Market Access (DMA)

Direct Market Access (DMA) is an important and common tool used by brokers to provide clients with the ability to submit trading orders directly to the stock exchange. This provides institutional investors with a higher degree of direct control over their trading activities, provisions them with extra IP protection over their trading strategies, as well as lowers their trading fees with the broker. In our day and age of algorithmic and programme trading, DMA has become not just a competitive advantage but a competitive necessity.

In China, DMA was shut down in the aftermath of 2015, but regulators have recently engaged the industry in a consultation to assess re-opening of this channel. However, the proposed draft regulation impose criteria that brokerage firms to qualify must achieve at least a Grade A rating for two out of three years prior to application to use DMA. Very few foreign brokers have the sufficient capital size and profitability to qualify for Grade A; worse, new entrants will be barred from DMA for at least the first two years of operation. We are not aware of profitability prerequisites in other markets for expanding the business scope of securities firms. This rating requirement may be a deal-breaker for foreign players wanting to develop their business in China, deterring them from injecting capital into China and not advantageous to the promotion of investment interest in China.

The new draft language also requires onshore brokers who provide DMA to audit their clients at least twice each year with enhanced due diligence, including on product management models and product structure. While securities brokers onshore are responsible for upholding the integrity of the market, and for monitoring the exchange trading activities of their QFII clients, the due diligence focus should be on risk management controls rather than on verifying their QFII clients' product offerings and other matters ordinarily considered confidential business information.

1g. Omnibus Trading

Global investment managers, who typically manage a large number of individual client portfolios on a discretionary basis, consider "Omnibus Trading" (i.e., the ability to place a single buy or sell order on behalf of multiple underlying fund accounts) to be global best practice, as it allows fund managers to treat all fund clients fairly, receiving the same average price for executions, and therefore to fulfil their "best execution" obligations.

In addition, the ability of for global investment managers to place a single aggregated order on behalf of all individual client mandates they manage, rather than multiple disparate orders for each fund/client mandate, will allow for efficient execution of orders from both a market impact and operational efficiency perspective.

Global best practice suggests omnibus trading does not inhibit transparency of the end investors identity, specifically because investment managers will have full details of their client orders before trading, including having satisfied their own KYC obligations, and allocate shares across those accounts on trade date (i.e. post-trade allocation), which are available to the regulators from a market surveillance perspective.

Although China is an ID market, and Stock Connect has also in November 2018 adopted Northbound ID, the Industry is currently working with HKEX for an Omnibus solution via Stock Connect. An ideal omnibus model would be broadly similar to the current models in the UK and US which sees aggregated orders being placed at the fund manager level (equivalent to Super SPSA level) and subsequently allocated on a post trade basis across the individual underlying accounts (equivalent to sub SPSA level).

1h. Block Trading

A block trade is a transaction between two or more parties for the sale/purchase of a significantly large number of shares in a specific stock (from a dollar value and/or average daily volume perspective). Without an efficient block trade reporting mechanism, these respective orders would likely result in significant market impact and volatility to the market order book. Block trading is frequently utilised by institutional investors (regardless of domicile) in order to transact more efficiently, thereby reducing impact costs (typically the largest component of total transactions costs) & helping achieve their strict best execution obligations to underlying clients (who are often retail in nature).

Although block trading is currently permitted from 3 to 3:30pm, the manual nature of this facility makes it operationally challenging to use effectively, especially for fund managers trading hundreds of underlying funds. ASIFMA suggests a host to host interface to automate and streamline the block trading process. It should be further noted that this block trading window is currently available only for QFII/RQFII investors. Such a facility is currently not available to participants of Stock Connect. Brokers need access to block trading to better source liquidity to match large trades, especially during rebalance days.

1i. Efficient Stock Borrow Loans (SBL)

The Industry is encouraged by several meetings with CSRC and China Securities Financing Corporation (CSFC) and the stock exchanges to explore ideas on suitable measures to grow the Securities Lending industry for both domestic and offshore participants in a manner that is transparent and inclusive. As China experiences significant and high-profile index inclusions into the MSCI, FTSE and S&P indices, the following points highlight the importance of a robust, transparent and well-functioning securities lending and borrowing market.

- It allows active managers to take the other side of passive flows into the close and around rebalances
- It reduces unintended volatility around closing auctions on index events as it allows more sellers to be active as well
- SBL promotes liquidity in the system rather than only having ‘buy and hold’, locking up liquidity
- It serves as a ‘failcover’ mechanism which allows for growth of the Exchange-Trade Fund (ETF) industry when creating and redeeming
- It serves as a ‘failcover’ mechanism which helps around holiday trading and for future changes in settlement cycle (that is, to T+1 or T+2)

The industry is currently exploring options both with the exchanges for SBL within Stock Connect as well as options with CSFC to incorporate QFIIs into China’s onshore SBL framework.

1j. Multilateral trading facilities (MTFs) and alternative trading systems (ATSs)

Institutional investors are driven by the need to manage impact costs of trading and employ a range of tools and strategies to do so. Among such tools are MTFs and ATSs, trading venues other than conventional stock exchanges with alternative matching rules and mechanisms. A variety of trading venues including MTFs and ATSs contribute to an equities ecosystem attractive to institutional investors not only by providing multiple sources of liquidity, but by encouraging competition among service providers, as experience has shown in the US, Europe, and Australia. MTFs and ATSs, where available, may provide extended hours, specialised forms of market data, different matching algorithms, and so on. A choice of trading venue will tend to improve the quality of services provided to investors and brings increased efficiency along with lower costs. While block trading via Stock Connect is under consideration and has the potential to improve best execution, the absence of off market trading remains a barrier to best execution that makes the Chinese exchanges an anomaly among global markets.

2. Primary markets

Orchestrating the timing of public listings by a government authority is unique to China among major markets and introduces undesirable distortions into the capital-raising process. The most obvious distortion is that it prevents companies from raising more capital when their boards and managements think they need it. During those windows when the green light is on and companies are permitted to list, the uncertainty dials up the urgency since companies do not want to risk missing what could be a fleeting opportunity. It would be better to let investors and would-be issuing companies determine listings on their schedule, based on their need for equity capital and their perceptions of market conditions. Impediments to listing also create powerful incentives to seek alternative financing routes—such as "backdoor listings" (reverse mergers), greater reliance on debt or even more creative financing strategies. Finally, the approval process itself is inherently opaque compared to a rules-based approach and runs counter to the widely-held goal of making financial market rules as transparent as possible.

The authorities have indicated they will at some point transition to a registration system rather than one based on application and approval and have the new SSE Science and Technology Board will use a registration system when it starts up. The draft rules of the SSE Science and Technology Board, first announced by President Xi Jinping in November 2018, included a registration-based system limiting official power to control the timing of listings. We believe that will be a positive step and potentially set an example for China's other boards, such as SZSE's ChiNext and the New Third Board set up in Beijing in 2006, as well as the primary exchanges.

The markets need to play a leading role in determining pricing and other issues. The SSE Science and Technology Board should account for the preferences of investors with higher risk appetites. We encourage the new SSE tech board to consider making it optional rather than mandatory for underwriters to invest in new tech board IPOs, remove or reduce the requirement for underwriters to supervise issuer clients for three years, ease post-IPO penalties for underwriters for issuer clients that do not meet profit forecasts or experience profit drops, and remove or reduce limits on share sales by key personnel of issuers.

2a. Pricing of IPOs

This is an area of regulation that differs sharply from other major capital markets. However, as with the policy-based approval system for IPOs, there are signs of a change in thinking in rules for the new SSE tech board, which will allow loss-making firms to raise money publicly for the first time, and allow new board stocks to rise or fall by 20% a day, compared with the 10% cap currently in use. Markets should play a leading role in determining issues like pricing, and the new SSE board should be prepared to address preferences of investors with higher risk appetites.

Other than the prospective SSE Science and Technology Board, Chinese IPOs are priced prior to trading in the secondary market by way of a regulatory ceiling on valuations. Clearly this is unlike the convention of capital markets of North America, Europe and elsewhere in Asia whereby market forces determine the pricing of IPOs. While China's cap on valuations was designed to protect retail investors, the reality is that the policy has resulted in dramatic under-pricing (discounts) of IPOs that surge in price in the secondary market, essentially creating regulation-driven gains immediately upon listing. Who the winners and losers are is obscure due to the lack of transparency.

In addition to the IPO pricing policy, the Chinese regulatory limit on one-day share price gains in the secondary market contributes to inefficient capital markets because IPO discounts narrow over several market sessions rather than adjusting immediately as in other major markets. As of early 2019 the one-day share price limits were set at 44% on the first day and 10% thereafter, following measures introduced in June 2015. The extent of the inefficiency of the pricing of Chinese IPOs is evident from the fact that all 432 new offerings in 2017, and 53 in the first five months of 2018, ended with price gains of 43-44% on the first day, according to Bloomberg data. The downward price limit of 64% from the offer price set by the exchange has never been triggered. The 10% daily swing rule, which has been in place since 2001, means that if stocks rise above or below 10% from the previous day's close, buying and selling can only be done at prices within the range. Regulators have argued that such caps preserve market stability, in stark contrast to other global exchanges where market forces determine the price of a new listing.

With the new SSE Science and Technology Board, which is expected to launch in June 2019, in addition to the increased cap for price movement there will be no daily limits for the first five days of trading in new stocks, compared with the existing 44% limit. The new board, whose rules were finalized on 1 March 2019 after a month-long consultation exercise, aims to implement supply side reform for the financial industry and encourage technology stocks to list in the A-share market, rather than Nasdaq, which has been the most popular venue for Chinese tech stocks since the giant Alibaba listing in 2014. They do not, however, allow same day buying and selling of stocks, which market participants including ASIFMA had pushed for.

2b. Delisting of sub-standard companies

Clear rules and consistent implementation of a process for delisting illiquid and sub-standard companies—those that no longer meet listing requirements — are crucial. From 1995-2016, China delisted only 0.8% of total listings. This is a small amount compared to global rates that range as high as 10% and above and suggests that some substandard companies remain listed on Chinese exchanges that should not be.

In 2014, the CSRC introduced new rules that require more information disclosure and delisting for illegal acts and fraudulent issuance, and on 21 March 2016, authorities delisted ST Boyuan from the SSE due to illegal disclosure of important information. In November 2018, supplementary delisting rules were introduced as a follow-up measure after Shenzhen-listed Changsheng Bio-technology falsified data on rabies vaccines, drawing the attention of President Xi Jinping. The new delisting rules ban companies found guilty of financial fraud in their IPOs from re-listing forever. Companies that are delisted for other reasons need to trade in the over-the-counter (OTC) market before they can apply for re-listing.

2c. Ownership limits

On 28 July 2018, the National Reform and Development Commission (NDRC) announced on its website the lifting of foreign ownership caps on brokerages, life insurers, and commercial banks. This came as welcome news, although details remained that require clarification. The changes included a previously announced decision to allow 51% foreign ownership of brokerages and life insurers, and to remove the cap entirely by 2021. Rules limiting a single foreign financial institution's ownership in a Chinese commercial bank to 20% were abolished, along with a rule limiting investment by multiple overseas financial institutions to 25%. In addition, the NDRC cut the negative list for foreign investment from 63 industries to 48, easing or lifting ownership caps on businesses including ship and aircraft manufacturing, power grids, and crop breeding excluding wheat and corn. Foreign ownership for passenger car manufacturing will be removed by 2022, together with ownership limits on passenger rail transport and shipping, according to the announcement.

Countries around the world use ownership limits for companies and industries representing strategic or national interest. However, they tend to be overused and retained long after the original reasons have become obsolete. For all these reasons, we believe the use of ownership limits should be minimised to the extent possible. As ownership caps are eased or removed in selective industries, it will ease investing in some industries including finance, which ASIFMA has long advocated.

2d. Investor education

It is important for Chinese regulators, exchanges, and brokers to ensure that investors are properly educated about equity investment and risk. Retail investors in particular need to understand:

- That all asset classes have risk—but crucially, also that diversification reduces risk

- That equity investing should be used as just one asset class in a risk-compatible portfolio that includes a number of asset classes
- The importance of having investment objectives, of building a portfolio consistent with those objectives, and of being disciplined about following them
- The importance of costs to long-term portfolio performance

Any expectation by retail investors that government action might “bail them out” of unfortunate investment choices will tend to create “moral hazard”. That is, such expectations promote more risk-taking and less prudence and conflict with the above principles of successful investing. Hence policy makers and industry professionals should avoid creating such expectations.

A consolidated “Golden Source” of equities recommendations for China’s Capital Markets has been discussed and agreed among ASIFMA’s China Equities Working Group, an active and diverse group of industry participants spanning front office and back office, buy side and sell side firms, compliance officers and law firms. Some of these recommendations have been highlighted in earlier sections. The complete list is below.

Recommendations for Equities

Developing the Chinese Equity Markets

1. **Calculate Short Swing Profit Rule on an Individual Client/Fund basis**, rather than at the Fund Manager level, given the large number of funds and clients that many Fund Managers often invest on behalf of (funds currently aggregated as deemed to be “acting in concert”). Large fund managers run the risk of triggering the 5% threshold which may cap their ability to further grow the size of their managed portfolios in China, especially as the weighting increases.
2. **Further enhance the robustness of the Closing Auction Session (CAS):** Volumes remain low in both SSE’s and SZSE’s CAS owing to structural and operational frictions, which need to be addressed. Clear and consistent messaging from Market Surveillance on how brokers may or may not trade during the CAS, allowing for order cancellations during the CAS, and permitting more order types (for example, Market on Close or MOC) will help encourage increased broker participation in the CAS. Securities lending and borrowing can also help facilitate increased participation during the close, where large sell and buy orders can be better matched against each other while minimizing price impact.
3. **Alignment to the international settlement cycle where cash and stock settle simultaneously:** Given a global client base and the operational challenges of the current T+0 settlement cycle, allowing DVP to better protect investors, as well as a move to T+2 or T+1 to better harmonize with global practice can help to reduce settlement risk. We recognise this may be a longer-term solution but note that securities lending and borrowing may help to address some of these operational challenges in the interim (for failed settlement).
4. **Direct Market Access (DMA) Qualification Criteria –** Proposed relaxation of the Third Party Connection rule for Institutional Clients to trade directly via Broker Trading Systems is most welcome, but the current draft rules require that the local securities brokers, possibly including JVs,

offering DMA to have an A grade rating or above in the past 2 years out of 3. This requirement may create a barrier of entry for existing or new securities JVs challenged to meet the profitability level to qualify for an A grade rating. DMA offerings to clients have become a significant contributor to profitability and it may be difficult to achieve such without DMA as a service offering. We are not aware of profitability prerequisites in other markets for expanding the business scope of securities firms. This rating requirement may be a deal-breaker for foreign players wanting to develop their business in China, deterring them from injecting capital into China and not advantageous to the promotion of investment interest in China.

5. **DMA Broker QFII Due Diligence Requirement** – Draft guidelines require that DMA brokers obtain information from clients on trading system structure, functional design, product structure, product management model and risk management control and for such information to be submitted by the local broker, possibly including JVs, to CSRC. Such information is currently already readily accessible by CSRC upon request to QFIIs; hence, concerns have been raised about sharing such confidential information which is considered intellectual property with the local broker. While securities brokers onshore are responsible for upholding the integrity of the market, and for monitoring the exchange trading activities of their QFII clients, the due diligence focus should be on risk management controls rather than on verifying their QFII clients' product offerings and other matters ordinarily considered confidential business information.
6. **Reduce restrictions on derivatives:** Futures contracts and other derivatives are crucial tools for investors to hedge their positions.
7. **Allow Off Market Trading to facilitate Best Execution**, including alternatives to exchanges such as Multilateral Trading Facilities (MTFs) and Alternative Trading Systems (ATSs).
8. **Access channel fungibility and harmonization:** Offer investors the ability to easily switch from one access channel to another for the same beneficial owner without having to liquidate and repatriate investments, with a view towards eventual future consolidation and/or alignment of such channels to improve efficiencies.
9. **Allow investments in the QFII/RQFII and Stock Connect Channels to be settled in CNY**.

Stock Connect (Shanghai and Shenzhen)

10. **Omnibus Trading at the Fund Manager Level:** The ability to trade at the omnibus level remains a key characteristic of mature markets. Although BCANs at the Fund Manager level allow for fair and equitable average pricing and allocations to underlying funds on a post-trade basis, Omnibus Trading at the Fund Manager Level would further improve trading efficiencies and better facilitate Best Execution for clients. Such capability would also help facilitate MOC as mentioned above.
11. **Block Trading:** Although a China block trading window is available for QFII/RQFII investors, such a facility is currently not available to participants of Stock Connect. Brokers need access to block trading to better source liquidity to match large trades, especially during rebalance days.
12. **Efficient Stock Borrow Loan (SBL) environment:** As portfolios grow in size over time and with additional weighting increases, investors will need securities lending and short selling to better

hedge their market exposure. An effective SBL mechanism can also help support failed settlement coverage and Guaranteed Volume Weighted Average Pricing (GVWAP) for best execution.

13. **Holiday Trading:** As China and Hong Kong observe different holiday schedules, Stock Connect is currently unavailable for use during Hong Kong holidays as well as on the day prior. Investors should be able to trade through Stock Connect when the Chinese stock markets are open for trading.
14. **Stock Connect Stability and Risk Reduction**: Continue to work with HKEX to improve Broker-Dealer order throughput capacity via Throttle on Demand, which would provide added flexibility for algorithms, additional volumes in the CAS, and improvements to Best Execution for clients.
15. **Streamline the Real-time Delivery Versus Payment (RDVP) process for USD** to facilitate more global investor participation in the A share market via Stock Connect, as current cutoff windows are too tight (RDVP for CNH works well).
16. **Enhance Special Segregated Account (SPSA) Client Onboarding forms and processes** to streamline and facilitate more efficient SPSA account openings.
17. **Expand or remove the Stock Connect Daily Quota**: Although the quadrupling of the previous daily quotas for northbound and southbound trades in April 2018 was a welcome measure, the Daily Quotas should eventually be removed or expanded to ultimately facilitate a 100% inclusion factor.

QFII/RQFII

18. **Removing the restriction to only sell through the same broker through which the shares were originally purchased.** The lack of choice for investors in Hong Kong through Stock Connect has the potential of impairing best execution.
19. **Block Trading:** Although block trading is currently permitted from 3 to 3:30pm, the manual nature of this facility makes it operationally challenging to use effectively, especially for fund managers trading hundreds of underlying funds. ASIFMA suggests a host to host interface to automate the block trading process.
20. **Improve QFII/RQFII Quota Management:** Account managers should be able to manage, transfer, and re-allocate quotas between different sub-accounts on an ongoing basis without significant administrative inhibitors, given the dynamic needs of clients and the nature of the market.
21. **Elimination of the quota scheme (the total QFII quota was recently increased to US$300 billion):** Although the January 2019 doubling of the QFII quota is a welcome change, elimination of the quota scheme is the natural course as China's capital markets embrace globalization.
22. **Removal of minimum settlement reserve funds to mitigate settlement risks:** Currently QFII/RQFII are obliged to contribute reserve funds to the central depositories in Shenzhen and Shanghai. The contribution is based on prescribed percentages of the investment quota. The funds cannot be used for trading nor repatriation. This should be replaced by an intra-day facility in line with international practice.
23. **Efficient Stock Borrow Loan (SBL) environment:** As portfolios grow in size over time and with additional weighting increases, investors will need securities lending and short selling to better

hedge their market exposure. An effective SBL mechanism can also help support failed settlement coverage and GVWAP for best execution.

E. Fixed Income

A fully functioning, open financial market and efficient capital allocation depends on a strong foundation of liquid and transparent bond markets. The structure of China capital markets has traditionally encouraged corporates to raise capital via equity markets and bank lending at the expense of its domestic bond markets. In recent years a combination of factors including regulatory and other pressures (such as increasing non-performing loans (NPLs) on bank balance sheets and a move away from shadow banking) has prompted a gradual move towards a more traditional capital markets operating model for Chinese corporates.

The lack of market-driven capital allocation and unequal treatment for foreign institutions in China's nascent bond markets – especially with respect to underwriting, market making, derivatives trading with corporate clients and bond settlement agent licensing – remain as significant obstacles to further development. A more market-driven environment combined with best practices such as a liquidation regime and disclosures will expedite the development of an efficient bond market. In this regard, opening access to foreign institutions will help bring in their expertise and experience to promote the evolution and depth of the onshore bond market.

Developing a deep and liquid government bond market typically creates increased opportunities for other issuers. An efficient and deep bond market is one of the useful precursors to relaxing capital controls and facilitating an interest rate-led monetary policy.

1. State of the market

China's US$12.5 trillion onshore bond market is currently the world's third largest by securities outstanding, behind those of the US and Japan. Goldman Sachs projects the market will double in size over the next four years to US$24 trillion. The share of the market narrowly defined as Chinese Government Bonds (CGBs) is projected to double to US$4 trillion by the end of 2022. By comparison, the central government bonds of Germany and France combined amount to US$2 trillion. China's offshore bond market is much smaller than the onshore market, with a total of US$53.7 billion in RMB-denominated Dim Sum bonds outstanding at the end of 2018.

Overseas investors currently hold only 2.4% of the total stock of Chinese bonds outstanding and only 8.5% of CGBs. Foreign inflows have increased rapidly in anticipation that Chinese bonds will be included in the Bloomberg-Barclay Global Aggregate Index from April 2019, and in the nine months to October 2018, the stock of government bonds held by foreigners reached US$155 billion. Sovereign and government issuers dominated the onshore Chinese bonds until 2005, although both financial and non-financial corporates began to issue onshore bonds from 2008.

China is playing a pivotal role in green bond finance. Climate Bonds Initiative data show total green bond issuance from China in 2018 of US$31.2 billion (RMB 210.3 billion) including US$30.9 billion (RMB 208.9

billion) from Chinese issuers on both domestic and international markets, and US$208 million (RMB 1.4 billion) in green Panda bonds from Hong Kong issuers. According to a calculation by FTSE Russell, with onshore green bond finance hitting US$41.4 billion in 2018, of which US$10.5 billion did not align with international definitions. The FTSE Russell figure represented 25% of global green bond issuance in 2018. By either measure, China has become the second largest green bond market after the US.

Bond Market Size by Country (2018)

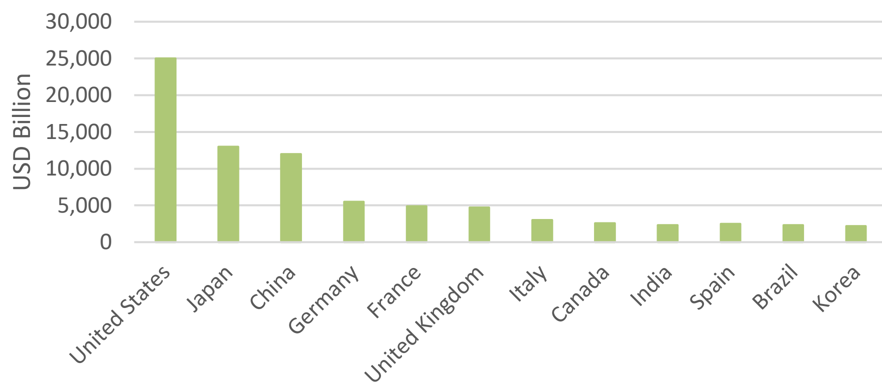

Fig. 8: Bond Market Size by country US$ billions
Source: "Opening of China's Bond Market", State Street Global Advisors, June 2018

2. Types of instruments

The China fixed income market is essentially divided into two separate markets – the interbank bond market and the exchange bond market, with the interbank market being the much larger of the two. The interbank bond market accounts for approximately 90% of the market while the Exchange bond market just 10%. The available bonds in China's market can be grouped into four broad categories:

- Government bonds – issued by MOF, which include local government bonds
- Central bank bills (essentially Treasury bonds under one-year duration) – an actively traded sector of China's bond market and often used in money market and liquidity management portfolios due to the bills' shorter maturities
- Financial bonds – policy bank bonds, commercial bank bonds, and other non-bank financial institution bonds
- Non-Financial corporate bonds – including enterprise bonds, commercial paper (CP) and medium-term notes (MTNs)

Key Features of the Chinese Bond Market

Type	Sector	Key Issuers	% of Total Market	Maturities	Amount Outstanding (CNY 100M)	Market
Rates Market						
Government Bonds	Sovereign	Ministry of Finance	16.83%	3 months - 50 year	150,163.17	CIBM & Exchange
Policy Bank Bonds	Quasi-Sovereign	China Development Bank Agricultural Development Bank of China Export-Import Bank of China	16.47%	6 months - 50 year	146,887.43	CIBM & Exchange
Local Government Bonds (Munis)	Provincial and Local Governments	Provinces and Municipalities	21.78%	1 year - 10 year	194,327.57	CIBM & Exchange
Credit Market						
Corporate Bonds (including MTN)	Corporates	Domestic Nonfinancial Corporates	2.76%	3 year - 30 year & Perpetual	24,603.75	CIBM & Exchange
Financial Bonds	Financials	Domestic deposit taking institutions, securities and insurance companies	7.20%	3 year - 10 year	64,247.63	CIBM & Exchange
Enterprise Bonds	Corporates	Unlisted corporates and private placements (mostly state-owned)	6.82%	3 year - 30 year	60,836.42	CIBM & Exchange
Medium Term Notes	Nonfinancial Corporates	Domestic Nonfinancial Corporates	6.76%	2 year - 15 year	60,339.64	CIBM
Asset Backed Securities	Nonfinancial Corporates	Domestic Nonfinancial Corporates	3.18%	Various	28,334.28	CIBM
Money Market						
Certificates of Deposit	Financials	Domestic Banks	11.12%	3 month, 6 month, 9 month, 1 year	99,196.50	CIBM
Commercial Paper	Corporates	Domestic Nonfinancial Corporates	2.37%	< 1 year	21,153.00	CIBM
Others		Principal-Protected Note, Convertible Bonds and others	4.71%	Various	42,008.72	
			100.00%		**892,098.11**	

Fig. 9 Key Features of the Chinese Bond market as of 17 May 2019
Source: WIND Financial Information

3. Interest rate liberalisation

The first step in developing a vibrant bond market is to liberalise interest rates, a process that is well underway in China. The Chinese regulatory authorities have realised that liberalizing interest rates and removing capital controls benefit the development of a market-oriented banking industry, because it requires banks to diversify, narrowing the net interest margin and shrinking the room for profits. These reforms incentivise banks to lend to SMEs in order to maintain profitability, because the SME sector offers higher returns. Additionally, liberalizing interest rates and removing capital controls encourages China's domestic banks to change their business models, shifting from a heavy reliance on interest income from loans to a focus on providing comprehensive and diversified services to customers, including capital markets products.[17]

While Chinese regulators have taken several steps to liberalise interest rates, and the pace of liberalisation seems to have picked up over the last five years, more can be done. Floors on loan rates have been removed, as have ceilings on rates payable. In theory, this should lead to more competition among banks in both deposit taking and lending. But in practice, such competition is still somewhat constrained. Also, despite the increase in wealth management products available to some consumers, the alternatives for savers to invest their cash are still relatively limited. There has been some speculation that if the PBOC is able to improve open market operations sufficiently to minimize the volatility of short-term money market rates eventually they may be able to scrap the lending and deposit benchmark rates but this remains uncertain for the time being.

3a. Interest rate implications for the markets

As mentioned previously, deregulating deposits should in theory result in increased competition among banks for funding and thus a sharp reduction in their net interest margins. As an aside, higher deposit rates offered via the shadow banking sector may have contributed to this development. It is worth noting that large banks with extensive branch networks and more secure deposit bases may be somewhat less impacted by deregulation. On the other hand, smaller banks will need to innovate to increase the range and variety of deposits, in addition to introducing new financial instruments to attract retail funds.

As banks, especially the small ones, lose deposits they have moved to access capital markets. Reflecting this trend, issuance of negotiable certificates of deposit (NCDs) by China's top five banks surged in the first quarter of 2018 to RMB 424 billion (US$68 billion) as growth in deposits slackened and regulators cracked down on the use of wealth management products associated with shadow banking. NCDs were first launched in 2013 to provide lenders with a bond-like instrument, and by 2018 were the fourth largest bond category after sovereign, local government and policy bank debt, with RMB 9.89 trillion in NCDs outstanding as of the end of 2018. Previously, the CSRC began tightening mutual funds investment into NCDs through the new investment rule for money-market funds in October 2017. Furthermore, CSRC began imposing limits on investment by mutual funds into NCDs in March 2018 to clarify the investment scale of bond mutual funds during the establishment period. From 1 September 2017, PBOC banned issuance of NCDs with maturities longer than one year.

Initially, NCDs were not counted as interbank liabilities, and this would have encouraged the growth in early issuance. Over time the Shanghai Interbank Bond Offered Rate (SHIBOR) and the domestic NCD pricing reference rate will become more important and liberalisation will bring about a more accurate reflection of funding costs. All other things being equal, there may be upward pressure on bond yields for governments, policy banks and credit bonds, driven by increased issuance and higher competition for funding.

Importantly, the introduction of the deposit protection scheme where deposits up to RMB 500,000 are protected will remove the assumption that the Chinese government implicitly guarantees all domestic banks for undefined amounts. More comprehensive bankruptcy legislation for banking sector will help reinforce this point. This would force investors to develop a better understanding of the link between risk and return, and discourage moral hazard

3b. Interest rate implications for institutional investors

Domestic institutional investors already invest in a broad array of products (including simple time deposits, entrusted loans, money market funds and separately managed accounts), all of which benefit either directly or indirectly from an implicit bank guarantee. Our view is that there is frequently an interpretation that the government backs such products, if the issuing entity is an SOE (or a private one, with perceived significance vis-à-vis the government).

The underlying assumption of implicit guarantees has begun to erode with the initiation of an interest rate liberalisation process and will disappear entirely if interest rates are fully liberalised. This change would have a profound impact on the market environment, including dispelling a certain degree of investor complacency and forcing market participants to more carefully evaluate counterparty and credit risk, as well as the risks inherent in investment. The implementation of any policy changes in this area will likely be gradual, giving investors ample time to adapt. In the short term, most institutional investors will likely become more conservative in their investment choices.[18]

4. Primary markets

Bonds can be issued in two ways in China, by tender, through the PBOC issue system and by book building. Treasury bonds, financial bonds and policy bank bonds are issued by tender through the PBOC's issue system. The State Council, MOF and PBOC share responsibility for the issuance guidelines of Treasury bonds. The State Council and MOF determine the annual issuance size of treasury bonds. As for financial bonds, the PBOC verifies and approves issuance. Financial bonds can be issued either at once or in instalments under specified quotas. There are no maturity restrictions for Treasury bonds, policy bank bonds and financial bonds.

The issuance of shorter-tenor non-financial instruments including Super and Short-Term Commercial Paper (SCP), CP and MTNs is regulated by the National Association of Financial Market Institutional Investors (NAFMII), under the supervision of the PBOC. Following a one-time registration, these instruments can be issued in instalments within two years. Securities are issued either via tender or through book building. In terms of maturities, SCPs have a maximum maturity of 270 days; CP has a maximum tenor of one year and while MTNs have no maximum maturity, they are usually no longer than 10 years.

Corporate credit, which typically consists of listed corporate bonds, is issued through a book building process. One key characteristic of book building in China compared with book building in other markets is that in China the process resembles a formal auction. The CSRC regulates the issuance of listed corporate bonds through a verification and approval process. Corporate bonds, which are not classified as 'enterprise bonds' are typically listed and traded on the exchange markets, unlike the other categories of bonds which are for the most part traded on the interbank bond markets. A requirement of corporate (listed) bonds is that funds raised should be used in conformity with national industry policy. There are no maturity restrictions for listed corporate bonds.

Finally, the issuance of enterprise bonds is regulated by the NDRC. The NDRC previously regulated SOE issuance through a formal verification and approval process, but in 2015 the NDRC relaxed guidelines allowing for issuance of enterprise bonds following a registration process. The State Council determines the approved size of the issuance. The issuer determines the rate after taking into account market conditions. Finally, while there are no restrictions on tenor, these are normally longer tenor issuances with maturities longer than 5 years.

Administration of bond issuance in China's bond market is governed by several statutes, categorised as treasury bonds, financial bonds, non-financial enterprise debt-financing instruments (including SCP, CP, MTNs, and private placement notes), listed corporate bonds, enterprise bonds, and non-financial enterprises issuing debt instrument by private placement.

Following the formation of NAFMII on 3 September 2007, a series of rules and guidelines regarding issuance and underwriting, information disclosure, credit rating and market transactions of debt-financing instruments were established for the interbank bond market. NAFMII, under PBOC guidance, has overseen the development of this market. As a consequence, the issuances of all categories of bonds described above (except for treasury bonds) incorporate a due diligence process and have several categories of information disclosure requirements including a prospectus, audited financial statements, details around specifics related to the issuance, the proposed use of funds and other related requirements. Likewise, all bond issues (except for treasury bonds) require both an issuer and an individual debt rating provided by a local credit ratings agency, as one of the conditions for issuance.

Foreign institutions have limited access to fixed income (bond) underwriting. Previously, foreign banks and their joint ventures were allowed to underwrite government bonds, central bank bills, CPs and MTNs and financial corporate bonds. Foreign institutions were then barred from underwriting non-financial corporate bonds on China's interbank market until 2011, when a limited number of such institutions were granted permission by NAFMII to carry out underwriting activity. Access remains relatively limited despite some progress on licensing of a select number of firms approved for Panda bond issuance. However, allowing more foreign institutions to underwrite and lead manage financial and corporate bond issues in China's domestic market would undoubtedly facilitate further market development.

5. Secondary Markets

The establishment of a deep secondary market for government bonds is integral to the overall development of the Chinese bond market and was one of the concerns of respondents to the ASIFMA global investors' survey in November 2016. Benefits of developing a deep and liquid secondary market include establishing a risk-free reference yield curve (that is, a full government bond yield curve), increased investor confidence, capital market efficiency, support for the development of sound corporate debt and money markets, and enabling the government and corporations to tap the market for longer term funding at a lower cost. A liquid secondary market would augment the government's ability to fund large infrastructure projects and urbanisation programmes. Additionally, it promotes financial stability and lowers systemic risk by providing an important interest rate risk management tool for market participants.

Government bond secondary market liquidity relies on seven basic requirements:

- Disciplined issuance and reissuance (tapping of existing issues to enhance issue size and liquidity).
- Liquid "classic" term repo markets that allow efficient borrowing and lending of government bonds (by "classic", we refer to actual title transfer under the terms of the transaction).

- Active, liquid government bond futures markets accessible to a variety of market participants including investors, hedgers, etc.
- A broad range of liquid OTC derivatives instruments, such as interest rate swaps, and exchange-traded instruments, such as ETFs.
- High quality, efficient and cost-effective price discovery, trading, clearing and settlement standards supported by advanced platforms with innovative electronic capabilities.
- A broad, active domestic and foreign investor base (especially money managers and pension funds) providing robust investment products and solutions to end users.
- Market-friendly regulatory, accounting and tax regimes, including no withholding taxes and no transaction taxes.

The PBOC and MOF have implemented rules requiring market makers to display two-way quotes on recently-issued government bonds for each benchmark tenor, which has enhanced market liquidity. Nevertheless, the secondary government bond market still has not attained optimal levels of liquidity, largely due to a buy and hold to maturity strategy employed by many Chinese banks, mostly to meet bank liquidity requirements.

6. Benchmark yield curve

Benchmarks play a critical role in the efficient functioning of both the primary and secondary bond markets. They are used as a bellwether to determine the term structure of interest rates, this includes the market's forward expectations for interest rates and, to some degree, inflation. These benchmarks also provide liquid hedging tools against certain market risks. The existence of a benchmark yield curve, grounded on a liquid government bond market, is a key element for the financial sector to facilitate efficient capital allocation and for policy makers to gauge market expectations.   This is because much of the analysis and pricing activity that takes place in bond markets revolves around the yield curve.

A benchmark yield curve currently exists in Chinese markets for the most actively traded bonds across a range of maturities called the "on-the-run" issues, however the evolution of the benchmark yield curve is not the same as in other developed markets. In fact, the most liquid onshore bond in China is usually a policy bank bond by China Development Bank – and not a CGB (the issue in question is typically a five year or 10-year point on the curve). The MOF has recently improved its issuance schedule for all key tenors with a regular calendar, but each issuance size is still relatively small considering market demand and other government bond markets such as US Treasuries. Additionally, China's commercial banks maintain their capital buffers by buying government bonds and often holding them until maturity. All these factors have resulted in less than optimal liquidity of "on-the-run" CGBs available for trading in the secondary market. Furthermore, liquidity drops off considerably when trading "off-the-run" securities (that is, not the benchmark issues) Market participants have expressed concern that this situation renders the yield curve less accurate as a measure of interest rate expectations. Lastly, establishing liquid and transparent benchmarks at maturity points longer than 10 years is critical for market participants who require longer tenor assets, such as insurance companies. At present, liquidity in longer maturities issues is not deep relative to other markets of similar size.

Actions to increase the issuance size and providing encouragement to market makers to provide pricing transparency are all important steps to developing a strong China benchmark yield curve. Recent efforts to tap benchmark issues more frequently is a positive development in this regard.

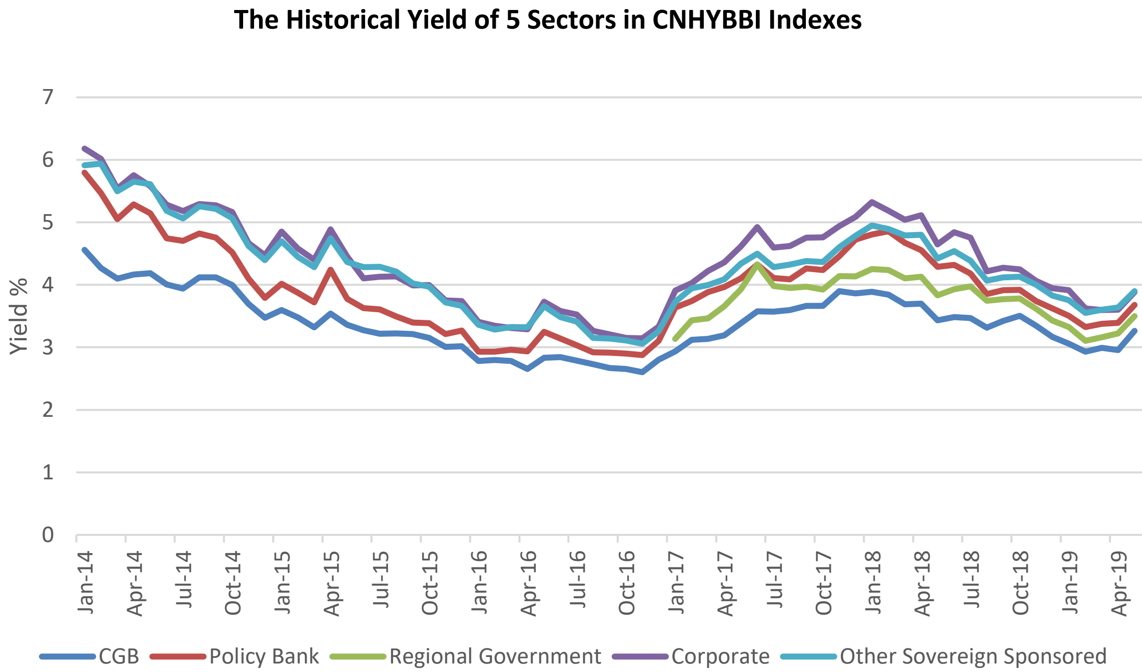

Fig. 10: The Historical Yield of 5 Sectors in CNHYBBI Indexes
Source: FTSE Russell

7. Classic repo market

A classic bond repurchase (repo) market refers to a system within which margining of exposures is standard practice and the bond title is actually transferred as part of the repurchase agreement. This allows market participants to cover short positions (a natural consequence of market making for customers) or re-hypothecate bond proceeds in order to use capital more efficiently. Under a pledge-based repo system, such as employed in the China bond market, actual title is not transferred.

In China, the pledge repo system dominates which means that the bonds cannot be re-used (re-hypothecated). This reduces liquidity and collateral optimisation, stifling the development of a more liquid repo market. Another consequence is concentration of risk in shorter tenors (shorter-term repo) which discourages more participants from being involved in the market due to its sub-optimal structure. In the meantime, since the lenders of capital do not have the immediate and explicit right to liquidate collateral in the event of a (cash) borrower credit event, they are prevented from reducing their counterparty credit and liquidity risk exposures, at least not in a timely manner. In the pledge format of repo, there is no current margin payment mechanism or collateral mark-to-market process, which necessitates higher haircuts to compensate, resulting in limited liquidity for longer tenors. Pledge repos therefore do not give the same explicit level of protection that one would have under the terms of a classic bi-lateral repo.

As a potential alternative, our understanding is that tri-party repo is being currently explored as a means of providing greater protection to the secured cash lender. While this would be a step in the right direction, ultimately repo done using full title transfer, with documentation such as a GMRA)would certainly be a major step forward in bringing significant foreign investor participation into the China repo market. It would also facilitate longer dated repo and improve market liquidity by enhancing the attractiveness of the underlying asset for long-term investors – and facilitating market makers and other participants who wish to lock in longer-term borrows on their short positions. So such a move would benefit greatly not only foreign but also domestic investors and dealers.

Specifically with respect to tri-party repo, as it currently stands under the CIBM model, only the China Central Depository & Clearing Co. Ltd. (CCDC) can act as a third-party institution to provide tri-party repos. Foreign asset managers require international tri-party agents with corresponding capabilities to be able to offer this service. Collateralization through the centralized dealer's long box at a tri-party agent can bring a significant boost to foreign investors' participation and will align and raise China's international profile both regionally and internationally through the adoption of international standards and best practices. Greater participation of long term FIIs in repo activity will increase the overall liquidity of the bond market and offer increased diversity of investors to the China capital marketplace.

We emphasise that the ability to go short is fundamental to market making. Not all market makers, which are critical for developing liquidity in any market, have access to every instrument in their inventory at any given time. Nevertheless, classic repo markets give market makers the ability to quote a price to a client if they are confident in their ability to borrow and deliver that instrument at a good price. This significantly enhances liquidity in the cash market, and thereby serves as a prerequisite for the maturation of the bond futures market and the OTC derivatives market, which require a sufficiently liquid cash market. Repos also allow primary dealers to hedge risk with a wider array of hedging strategies. Importantly, because repos are secured transactions, they broaden funding markets and serve as a critical link between money markets, bond markets, futures markets and OTC derivatives markets.

The PBOC currently has restrictions on onshore banks executing reverse repo with offshore investors, although Offshore Participating Banks (OPBs) and RMB clearing banks can have access to onshore repo under CIBM direct. All offshore public sector investors (central banks and sovereign wealth funds or SWFs) have access to onshore repo as well. The remaining restrictions inhibit offshore participation in the market, which would have brought additional liquidity and depth in the CNY repo markets and ultimately more stable repo rates with more participants entering the market. Efforts to reform and develop China's repo market, including NAFMII's introduction of local GMRAs and the NAFMII Documents, announcement of repo for Bond Connect, CIBM Direct and QFII/RQFII and domestic tri-party repos are important steps in the right direction, but a fully liquid and active classic repo market has yet to develop in China.[19] Ultimately, changes in market documentation (allowing use of GMRA) and structure (classic repo/title transfer) remains as the assured route to creating a deeper market with greater foreign investor participation.

On 17 October 2018, PBOC announced the inauguration of a tri-party repo in the interbank bond market. However, for now, only depository and settlement agents for interbank bonds can act as third parties. However, this is a significant advance since in the future large banks with corresponding capabilities will also be able to provide such services. ASIFMA views the development of tri-party repo as a positive, even if it only uses CCDC as an agent rather than a large custodian bank as is the practice internationally. It will lead to enhanced counterparty risk management and should facilitate increased liquidity. We address specific recommendations for future developments in our summary.

8. Bond futures market

An active, liquid, and well-supervised government bond futures market would allow participants to hedge large positions quickly and reduce risk more effectively, while deepening the underlying bond and derivatives markets. Availability of hedging instruments is key to attracting international investors, our 2016 survey confirmed. Looking at the deepest and most liquid bond markets in the world, bond futures clearly enhance the liquidity of the underlying cash markets as market participants are able to manage risks of their bond inventories more effectively. Additionally, bond futures markets are especially beneficial to market-makers because futures enable them to hedge their positions, thus reducing efficiently their market risk and allowing them to provide more robust liquidity to investors.

China launched 10-year government bond futures on the China Financial Futures Exchange (CFFEX) in March 2015, two years after officially listing five-year government bond futures for trading. A two-year CGB futures contract was launched in 2018, but with modest trading to date. Banks have a real need to hedge their bond positions, especially for one to three-year CGBs, and would like to be allowed to trade CGB futures. However, to date, neither domestic nor foreign banks are allowed to participate directly in the futures market, which they need to be as the major holders of bonds. As Chinese banks own the vast majority of government bonds, this hampers liquidity and therefore undermines the use of futures as a cheap and effective way to hedge.[20]

9. Fixed income derivatives

Interest rate derivatives are effective instruments for CIBM investors to manage interest rate risk and asset/liability mismatches. The interest rate swap curve has been the core pricing component for the entire financial derivatives market. It has been 13 years since the PBOC launched the RMB Interest Rate Swap (IRS) product, and by 2019, the market had a wide range of participants and an efficient electronic trading platform for trade confirmation and settlement.

As the scale of domestic interest rate swap trading grows, factors that restrict IRS market development have gradually appeared. To align with the current international OTC derivatives market standards, CFETS proactively launched the IRS offsetting and electronic trading confirmation business in 2012 based on in-depth research on international experience and required market participants to join the central clearing system as counterparties in 2014. By doing so, CFETS effectively upgraded the standardisation of interbank IRS trading, reduced overall market risk and improved market members' capital efficiency and credit management efficiency. This represented significant progress in the development of the interbank market infrastructure, benefiting onshore investors at the time.

The onshore IRS market trades with two underlying benchmark interest rates used to calculate the floating-rate leg of the swap – FR007 (which is the seven-day repo rate) and SHIBOR with tenors up to five years. These benchmarks are quite market-oriented and prices for standard tenors can be readily obtained from money broking firms and from the pages they post with various providers such as Bloomberg and Reuters. Generally speaking, market liquidity for IRS on FR007 is good and the market has become more active with diversified investors, securities companies in particular.

One challenge to overcome in the longer-run is the fact that funding costs of most corporates is usually based on neither FR007 nor SHIBOR, but on the benchmark lending and deposit rates issued by the PBOC. Products priced off the underlying deposit and loan rates published by the PBOC are not widely accepted by the market, leaving a significant part of corporate assets and liabilities un-hedged. Only bond market makers can do benchmark lending and deposit rates IRS with corporate clients, which limits the market liquidity of these IRS curves. As corporate hedging demand for their loans is always one-sided. Hence, these IRS positions can be very concentrated among certain banks, making it difficult for these market makers to provide aggressive pricing for clients. Overall, it remains a fact that this mismatch in the liabilities of corporates and what is actually traded in market practise is not ideal, in order to encourage increased interest rate hedging by corporates.

Going forward, the volume of offshore financial institutions participating in onshore IRS markets would be greatly increased if ISDA documentation were accepted for trading in interest rate swaps. Many foreign institutions remain reluctant to fully accept NAFMI documentation for swaps trading.

There has also been some small progress in hedging credit risks. In September 2016, NAFMII issued guidelines pertaining to the introduction of Credit-Default Swaps (CDS), Credit-Linked Notes, Credit Risk Mitigation Agreements and Credit Risk Mitigation Warrants. Institutions are able to participate in the credit derivatives market if they are members of NAFMII. NAFMII is a repository of credit derivatives trade data under these new guidelines as all relevant trades must be filed with NAFMII. There are also disclosure requirements in the newly introduced CDS framework.

As of now, there are two categories of market participants under the NAFMII framework: "Core Participants", who can trade with all other market participants and "Normal Participants," who can trade only with the "Core Participants." Financial institutions and Credit enhancement institutions are considered to be "Core Participants".

The introduction of onshore CDS was well timed as Chinese entities, including one SOE and a number of corporates, defaulted on their debt obligations in 2016. As CDSs allow market participants to "insure" against default risk, they can become a useful hedging instrument. More, however, needs to be done to develop the CDS market, which we discuss in our summary recommendations.

10. Price discovery, trading and clearing and settlement

High-quality and cost-effective price discovery is a crucial component of a liquid secondary bond market. Additional components include electronic trading, clearing and settlement platforms, which based on IOSCO best practices, must be clearly demarcated. While there has been progress in developing these components, much more can be done. Price and credit information is available onshore through providers such as Wind[21] but much of the pricing is indicative only and deviates quite substantially from the real price when market participants wish to trade. When trades do happen, they all need to be registered on CFETS, which is a small additional administrative and cost burden. By far the largest share of Chinese bond market transactions are traded OTC in the interbank bond market and registered on CFETS. These instruments include government bonds, central bank bills, policy bank bonds, and negotiable CDs which are the most actively traded, as well as financial bonds, enterprise bonds, corporate bonds, CP and MTNs which are available to trade but are not very liquid.

Focusing on the interbank bond market, which is the dominant bond trading venue, the CFETS trading system is relatively expensive in terms of actual trading costs, at least by international standards, and is not generally considered to be user-friendly, given the lack of an English language user-interface. With respect to actual trade execution, much of the liquidity is actually sourced pre-trade via chat rooms or with direct broker relationships. In essence, the CFETS system is an 'everyone to everyone' market structure – as opposed to a customer/investor facing dealer/market maker arrangement. As a consequence, dealers are sometimes asked to provide liquidity to another party with whom they do not necessarily have a strong relationship. In some instances this makes them reluctant to provide liquidity. Market makers generally only quote two-way prices for on-the-run bonds, and off-the-run bonds have more limited liquidity. Although there is a Request for Quotation (RFQ) feature on the CFETS trading system, we understand that market makers often do not make prices when requests are sent to them, unless it is with an existing relationship.

In recent times, steps have been taken to incentivise dealer behaviour through advertised rankings and other means of recognition to encourage market makers to be active. This has led to market makers starting to provide liquidity to end-users in blocks and increments that are less than the traditional size (RMB 10 million), especially through Bond Connect. This has led to greater price transparency for clients as they now can request tradeable quotes from dealers. In the exchange bond market, investors can trade bonds on the SSE and SZSE. These markets are generally not liquid and likely will remain relatively illiquid, given that exchange trading has not been the dominant venue for bond trading anywhere in the world.

Finally, the clearing and settlement systems are expensive and manually intensive. CCDC and SHCH both provide bond registration, depository and settlement services for the interbank bond market. For bonds listed on the exchange-traded market, the CSRC directly supervises China Securities Depository and Clearing Corporation (CSDCC), which acts as the clearing company of the SSE and SZSE. Depositary and custodial services for the exchange-traded market are also provided by the CSDCC.

In addition, these clearing and settlement market infrastructures impose different practices, communication protocols and sometimes data standards making them even more costly and risky for the market participants. For instance, internationally, clearing members and settlement members or depository participants are segregated and different entities can perform the functions as specialists. In China, only Type A members can perform these roles.

Taken together, all these costs, administrative burdens and asymmetric information undermine liquidity as it is difficult to gauge the true cost of trading and settlement. In summary, it seems a relatively safe assumption to make that measures taken to lower trading and associated costs will also greatly help develop China's fixed Income markets.

With respect to settlement, while a T+0/T+1 settlement cycle can work in a domestic market for domestic investors; it is too short for global investors who are based in a different time zone and operate on a cross-border basis. Allowing for longer settlement on trades would be beneficial in terms of bringing increased foreign investor participation.

11. Investor base

A large and diversified investor base ensures a strong and stable demand for a growing bond market. The investor base should include domestic and foreign participants from a variety of institutions – ranging from commercial banks to insurance companies, pension funds, hedge funds and mutual funds, as well as individual investors. A diverse investor base will naturally create demand for a wide range of time horizons, risk preferences and trading motives, which are vital for stimulating active two-way flow and deep liquidity. In turn, these developments will enable the government, corporates and financials to execute funding strategies under a wide range of market conditions.

China has made significant progress broadening its foreign and domestic investor bases. However, there is still a relatively limited number of pension funds, insurance companies and hedge funds active in the domestic market. An increase in participation of institutional investors enhances market resilience and stability. In addition, restrictions on foreign firms' market participation continues to hinder the broader development of China's capital markets, although the opening of the CIBM to international asset managers, the advent of Bond Connect, anticipated merger of QFII and RQFII, and recent policy developments gradually lifting constraints on foreign ownership of financial institutions are all steps in a positive direction.

Now that regulators contemplate the end of foreign ownership restrictions, ASIFMA believes they should be lifted immediately rather than being phased in; foreign firms would be able to provide necessary liquidity, market skills and investments if they were able to participate. In addition, the inclusion of Chinese domestic bonds in global bond indices from May 2019 will help increase in the weighting of Chinese bonds in debt portfolios around the world.

Currently, institutional investors hold just over 2.4% (early 2019) of Chinese domestic bonds. The inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate Index will serve as a key milestone. SWFs and central banks have been the driving force so far behind non-Chinese buyers of Chinese bonds, with more non-sovereign (private sector) asset managers becoming involved. Estimates of potential inflows from inclusion in Bloomberg Barclays range from US$100 billion to US$1 trillion (Goldman Sachs, by end 2022). The exact amount of incremental buying is tough to determine, but one can be certain that inflows will be significant over the foreseeable future, especially pending further developments with respect to the FTSE World Government Bond Index and the JP Morgan Index

Lastly, it is worth noting that late in 2018, CGBs saw one of the strongest government bond rallies in the world, and as of the end of 2018, the yield on 10-year sovereign notes had fallen 63 basis points over the course of the calendar year.[22] The high risk-adjusted returns of the China fixed income market and low correlation with other major bond markets will continue to encourage increased inflows from private sector money managers and sovereign wealth/central banks.

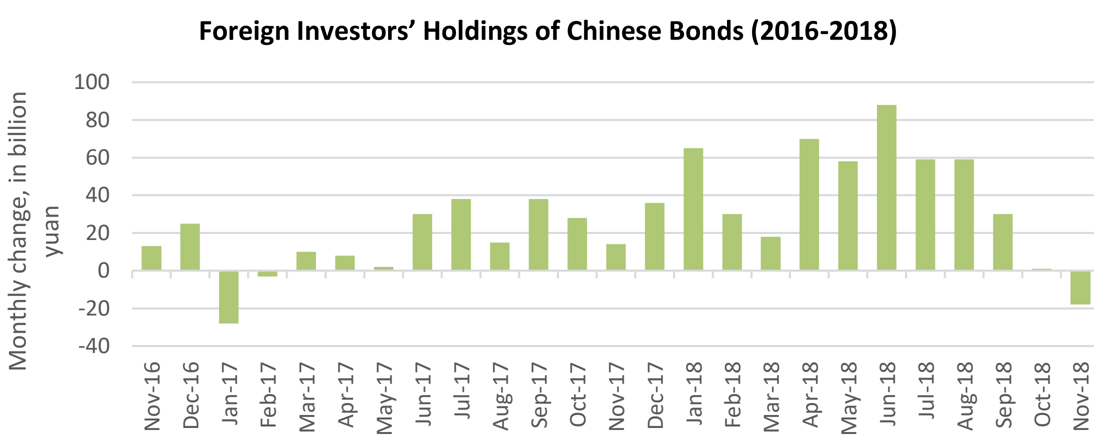

Fig. 11: Foreign holdings of Chinese bonds, monthly change in yuan
Source: ChinaBond, Bloomberg

10-Year China Government Bond Yield (2014-2019)

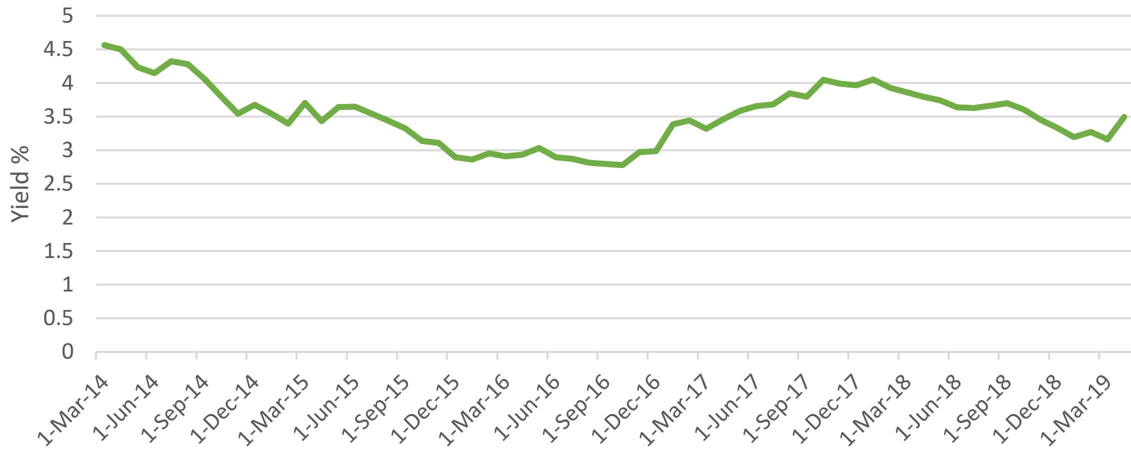

Fig. 12: 10-Year China Government Bond Yield (2014-2019)
Source: WIND Financial Information

12. Green bonds

China is playing a pivotal role in 'green' finance, and Bank of China Hong Kong has recently announced it would issue China's first international sustainability bond.[23] In green bonds, China is the second largest market after the US, with US$42.8 billion in issuance in 2018, representing 25% of global green bond issuance in 2018 (notwithstanding US$10.5 billion that did not align with international definitions) according to FTSE Russell. [24] In January 2019, FTSE Russell launched a new index series tracking Chinese green bonds, including 126 bonds covering 75% of all on-shore labelled green bonds issued by China's government, agencies and corporations. In launching its new green bond index, FTSE Russell noted that since 2015, China's domestic green bond market has grown at a 65% compound annual growth rate.[25]

The 2018 review by Climate Bonds Initiative, in its third report on China's green bond market, noted that the proportion of green bonds that are in line with international green bond definitions increased. International standards exclude coal and other fossil fuel-based technologies and limit the proceeds for working capital used for "non-green" projects or assets to 5%. In 2017, 38% of Chinese issuance did not meet international standards, while in 2018 the figure fell to 26%. China's green bonds have also become more transparent, especially on the domestic market, and both the number of deals and the volume issued increased in 2018. The largest overseas deal was by Industrial and Commercial Bank of China (ICBC), a US$1.58 billion Certified Climate Bond arranged by its London branch, to finance onshore wind and solar farms in China, Pakistan and Scotland. [26]

Like FTSE Russell, the Climate Bonds Initiative distinguishes between total 2018 issuance (US$42.8 billion, or RMB 282.6 billion) and internationally-aligned green bonds (US$31.2 billion, or RMB 210.3 billion, consisting of US$30.9 billion or RMB 208.2 billion issued on domestic and overseas markets by Chinese issuers, and US$208 million or RMB 1.4 billion in green panda bonds issued by Hong Kong issuers). The internationally-aligned green bonds represented 18% of global issuance and a 33% increase from 2017.

In addition, the report cites an RMB 122 million (US$17.7 million) green loan aligned to the LMA/APLMA Green Loan Principles and identifies "a broader universe" of bonds that are climate aligned but have not been classified as green. From this perspective, China is the largest climate aligned bond market globally. In addition to green bonds, there was US$289 billion outstanding in bonds from China-domiciled climate-aligned issuers as of mid-2018, and a further US$4.3 billion from Hong Kong issuers.

Top 15 Countries in Cumulative Green Bond Issuance (2019)

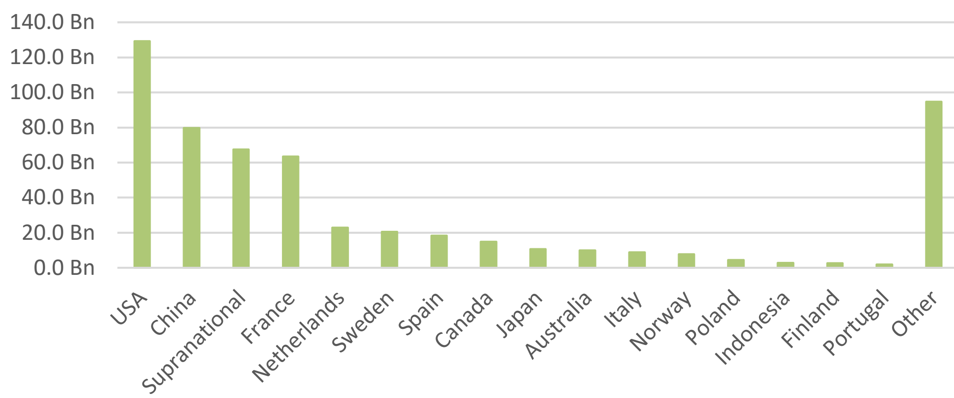

Fig. 13: Top 15 Countries in Cumulative Green Bond Issuance (2019)
Source: Climate Bonds Initiative, 2019

Green bonds have the same financial characteristics as standard bonds (senior unsecured, covered, ABS, etc.) with the added feature that their proceeds are earmarked for eligible green projects with explicit environmental benefits. Funds raised by green bond issuance are allocated to explicitly indicated environmental projects or activities either under project by project or portfolio basis, including an environmental objective, such as renewable energy, energy efficiency, public transportation, efficient buildings, energy networks adaptation, waste and water management, or preservation of biodiversity.

Green bonds provide an attractive solution to one key challenge of current times: how to match issuers' needs for investments in clean energy with socially responsible investors' expectations regarding the use of the proceeds. The bond documentation clearly defines the use of proceeds, with a definition of projects or of the eligibility criteria to select projects or assets to be financed by the green bond proceeds. One more important element is the regular reporting after issuance of the bond on the use of proceeds and actual environmental impact of the projects the funds have been invested in. This is also true for Environmental, Social and Governance (ESG) bonds and reporting, with a number of exchanges, indices, and international organisations providing reporting guidelines, such as the Global Reporting Initiative, an industry group that began formulating guidelines to do more for the environment as early as 1998.

Beyond green bonds, institutional investors are developing an appetite for ESG bonds, social bonds, and sustainability bonds, reflecting a broader interest in environmental, social, and governance investment, and ESG data and ratings are now available for most listed investment-grade borrowers and even for listed high-yield issuers. Green, social and sustainability bonds tied to the United Nations' Sustainable Development Goals are now quite frequently included in the issuers' green, social, sustainability bond frameworks, for which demand is growing by the investors. According to research firm Cerulli Associates, 85% of investors apply ESG criteria to investment grade bonds and 21% apply ESG screening to sovereign bonds.[27] The new Bank of China Hong Kong Sustainability Bond issue represents a welcome market entry.

As a growing number of investors and asset managers, including in Asia Pacific, have started to integrate sustainability factors in their investment decision-making process, rating agencies have followed suit, with S&P, Moody's Investor Service and Fitch Ratings developing ESG sections in their credit rating reports in recent months.

Transparency is key to the green finance market. Green bonds are a thematic financing tool, and attract investors seeking positive environmental impact through their investments. In Europe, the regulators have been pushing to create a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity by the end of this year. In China, regulators have been a step ahead. PBOC and the Green Finance Committee of the China Society of Finance and Banking published the 'Green Bond Guidelines' and the 'Green Bond Endorsed Project Catalogue' in 2015. These set out clear definitions for green projects. Since then the Chinese green bond market has experienced significant growth.

We are positive that the Chinese regulators (including NDRC and PBOC) will continue to stimulate the development of the green finance market. In 2019, the Green Industry Catalogue 2019 was published, which provides a granular overview of the eligible green projects, with the intention of harmonizing green industries, investors and consumers. It updated the December 2015 Green bond Endorsed Project Catalogue, with its six categories (energy saving, pollution prevention and control, resource conservation and recycling, clean transportation, clean energy, and ecological protection and climate change adaptation).

In our view, the 2019 Catalogue is largely aligned with the international green bond market but it also includes some new categories such as manufacturing of equipment related to renewable energy and resource recycling, as well as green-related service industries (providing definitions beyond the current eligible categories according to International Capital Market Association's (ICMA's) Green Bond Principles). However, the topic of clean coal remains controversial. Coal is a significant energy source for the Chinese economy, even while many international investors and financiers have publicly announced plans to reduce their coal portfolio.

The warm acceptance by China's capital market practitioners of socially responsible concepts is a positive development for not only the domestic market but also global investors who can now participate to the financing of the energy transition in the second largest economy in the world. China's definitions of eligible projects are clearly documented with the Catalogue, and it is advisable to ensure that both international standards such as the ICMA-endorsed Green Bond Principle and Chinese Green Bond Guidelines continue become more closely aligned.

13. Municipal bond market

China's planned urbanisation initiative will require local governments to further enhance infrastructure. To overcome domestic financing challenges and allay concerns about shadow banking in local government lending or favourable treatment by regional banks, China has recently started to develop a municipal bond market.

A municipal bond is a long-term (long tenor) bond, issued directly by a local government (municipality) or local government-owned enterprise, typically to finance an infrastructure project. Eligible projects may include construction or maintenance of roadways, bridges and other public institutions, such as schools and hospitals. The creation of such a market would allow a combination of domestic and foreign private capital to finance infrastructure projects, easing the dependence on local banks. In addition, a municipal bond market would increase the amount of longer-term capital available for large-scale infrastructure development. Care should be taken not to simply replace regional bank lenders with those same regional banks buying those bonds at prices that do not reflect the true risk. Hence, the importance of tapping a new investor base for this asset class cannot be overstated.

The potential advantages of municipal bond issuance are well documented and most clearly exemplified by the US municipal bond market. The low cost of capital raised in the municipal market is its most attractive feature. In a well-developed municipal market, issuers are able to keep interest rates low due to attractive tax incentives, which China would need to develop to drive investor appetite. Due to the tax incentives of municipal bonds, the market attracts a variety of participants – including underwriters and bond trustees – that compete, which keeps issuance costs relatively low. The cost of issuing a municipal bond is further reduced by its long maturity, which allows local government to amortise the cost of construction over periods of time that approach the long lifespan of the infrastructure asset being built, providing a better asset-liability match for the issuer.[28]

The Chinese government turned a pilot municipal bond programme into a larger scale one in 2015, allowing 36 high-tier municipal governments to issue bonds directly, as part of an effort to make bonds the main form of local government financing.[29] In 2014, when the NDRC announced the programme, banks and trust companies accounted for some 56% of the local government debt investor base, and regulators hoped to increase transparency and reduce risks by making bonds the main form of local government borrowing, with potential to create a US$1.5 trillion market.[30] This has led to a proliferation of sources of local government funding and local governments are now tapping both the onshore and international bond markets, with some issues rated by international rating agencies.

Municipal bond issuers in China are referred to as Local Government Financing Vehicle, or LGFVs. They have traditionally relied on shadow banking markets to raise financing, but more recently have started issuing bonds in both the onshore yuan-denominated market and offshore bond markets, but this has still some way to go. Since the first LGFV bond issues in 2014, through early 2019, LGFVs have sold US$36 billion in US dollar debt, mostly in Hong Kong, and RMB 8.2 trillion domestically. About US$10 billion of the offshore LGFV debt is maturing in 2019, according to S&P Global. According to Wind Financial Services, RMB 1.5 trillion of the onshore debt is set to mature by March 2020. The size of these maturities has clearly worried regulators, and the failure in August 2018 by the Sixth Agricultural State-owned Assets Management Co. to pay principal and interest on a RMB 500 million (US$73 million) bond was seen as a possible forerunner of a series of LGFV defaults, even though technically Sixth Agricultural was not an LGFV, and bond holders were paid in full after two days.

The scale of issuance of local government bonds has increased rapidly in recent years, as regulators attempted to rein in shadow banking and bring greater transparency to local government financing activities. A debt swap programme initiated in 2014 was a major driver behind the rapid growth of local government bonds, which by 2017 made up 20% of the fixed income market and exceeds the sovereign debt market. In March 2018, local governments were also given a quota of RMB 1.25 trillion (US$197 billion) in issuance of "special purpose" bonds for the year, to pay for infrastructure, with a reminder from the Ministry of Finance in August 2018 to use up the quota. These infrastructure bonds were to be covered by returns from the projects funded, and limited to land and toll road projects. Regulators hope that such "special purpose" bonds could reduce and eventually eliminate reliance on LGVFs for financing infrastructure and capital investment, and have added policy incentives such as eliminating a 20% limit on the share of local government bond sales that bank underwriters could purchase for their own balance sheets.

Fig. 14: China quasi-fiscal entities monthly net bond sales, Q1 2016-Q1 2019
Source: WIND Financial Information, Financial Times

China's growth slowdown constrains the government's policy flexibility in terms of constraining such off-balance sheet debt, and banks and non-bank lenders are being encouraged to offer support to local government bond issues and refinancing. Clearly, much needs to be done in terms of harmonizing tax and regulations, building liquidity, and advancing fiscal reforms to tighten off-budget borrowing and address intergovernmental imbalances. The authors of a September 2018 study argue that the local government bond market is hobbled by severe impediments, including low liquidity weak credit discipline, and structural fiscal deficits in local governments. Some of the LGFVs, like Sixth Agricultural State-owned Assets Management Co., are opaque and the extent to which local government parents are prepared to extend support is unclear. Stating more explicitly the nature of local government guarantees on bond issuances, which is standard for municipal bonds in many jurisdictions, is an important first step to attract more liquidity to the market, as well as international investors.

14. Corporate bonds

Bond issuance to date in China's US$12.5 trillion bond market has generally been dominated by government and public sector bonds issued by government affiliated companies, which account for about 46% of the total bonds outstanding.[31]

The corporate bond market consists of the following types of instruments:

- Enterprise bonds, typically those of SOEs, which are issued on the interbank bond market
- Commercial paper issued by domestic companies and regulated by NAFMII
- Corporate bonds which are issued by a whole range of private sector issuers and are listed on either the SSE or SZSE (regulated by the CSRC)

Five sectors, according to the Fitch rating agency, accounted for half of total onshore corporate issuance in 2018 – construction and engineering, industrial conglomerates, electric utilities, highways and multi-sector holdings. A more detailed breakdown is below:[32]

China's Onshore Bond Issuance by Sector, Q4 2018 (in $millions)

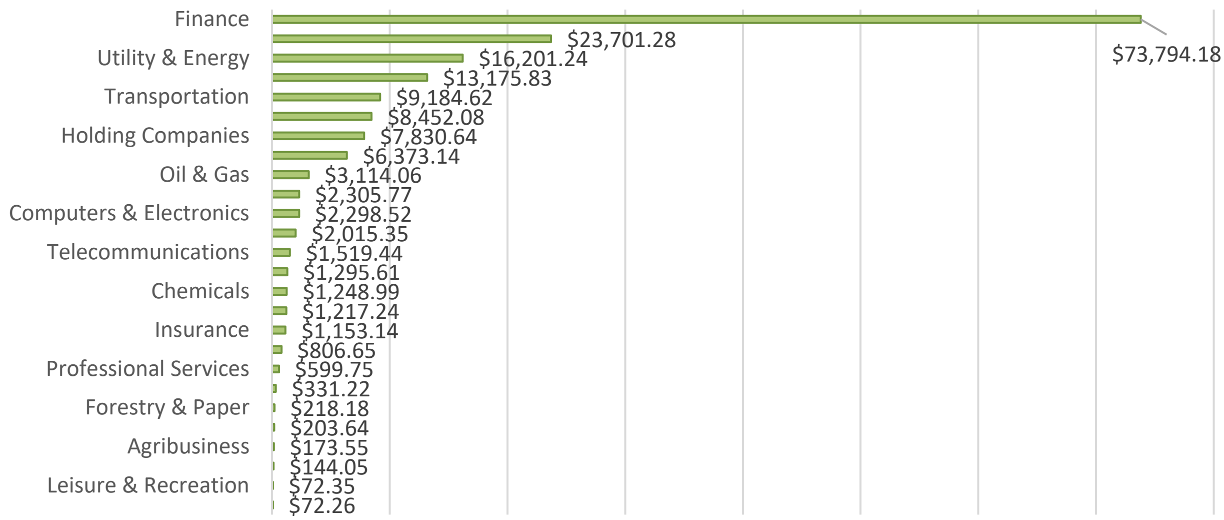

Fig. 15: China's Onshore Bond Issuance by Sector, Q4 2018 (in $millions)
Source: Dealogic, ASIFMA Asia Credit Report Fourth Quarter 2018

China's Onshore Bond Issuance Total Outstanding Bonds by Sector, Q3 2018

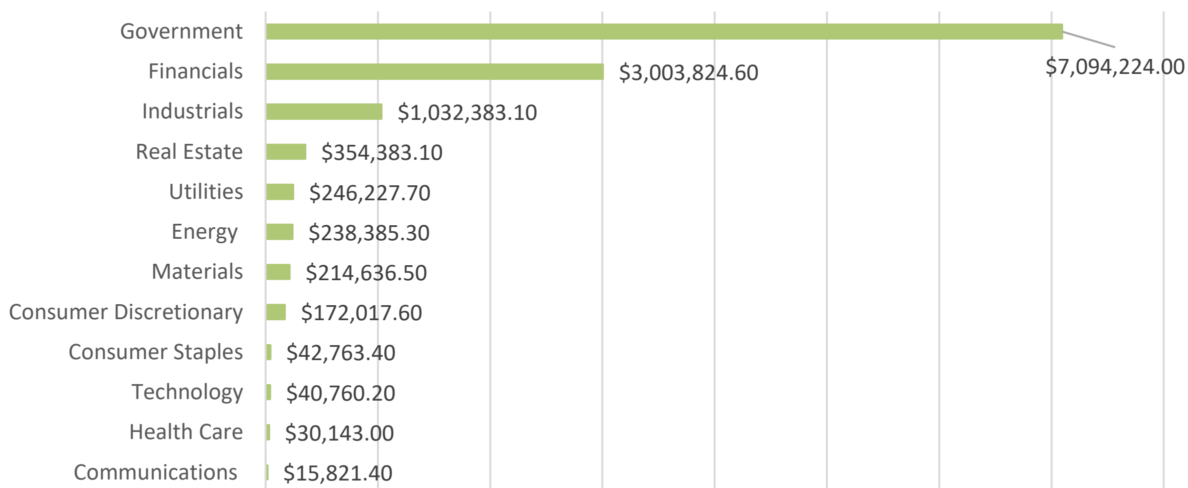

Fig. 16: China's Onshore Bond Issuance Total Outstanding Bonds by Sector, Q3 2018
Source: Bloomberg, ASIFMA Asia Credit Report Fourth Quarter 2018

Meanwhile, 2018 was a record year overall for bond defaults, with RMB 151 billion (US$22.3 billion) reflecting the slowdown in economic growth. The corporate sector was hit disproportionately hard, with 45 Chinese corporates defaulting on 117 bonds with a principal amount of RMB 110.5 billion (US$16.3 billion), according to Fitch statistics. Private, non-SOE enterprises represented 86.7% of the defaults by issuer count and 90% by principal amounts.

According to some analysts, the defaults themselves are a positive sign that the bond market is maturing, with the government no longer prepared to automatically provide bailouts. The first corporate bond default in 2014 was welcomed as a sign that regulators were ready to accept risk of failure and no longer subscribe to the morally hazardous policy of guaranteeing debt from failure as part of the shift from bank lending to bond financing. But the large number of issues with maturities coming due in 2019, together with a reduced appetite for risk and tightened credit conditions for the private sector, raise the threat of a new wave of bond defaults in the RMB 1.5 trillion pool of low-rated bonds that lack government backing. These include securities from LGFV issuers, which have been the beneficiaries both of monetary loosening and stimulus measures such as the RMB 1.25 trillion (US$197 billion) quota for “special-purpose” infrastructure bonds approved by the National People’s Congress, in March 2018.

China Onshore Corporate Bond Issuance and Defaults, 2018

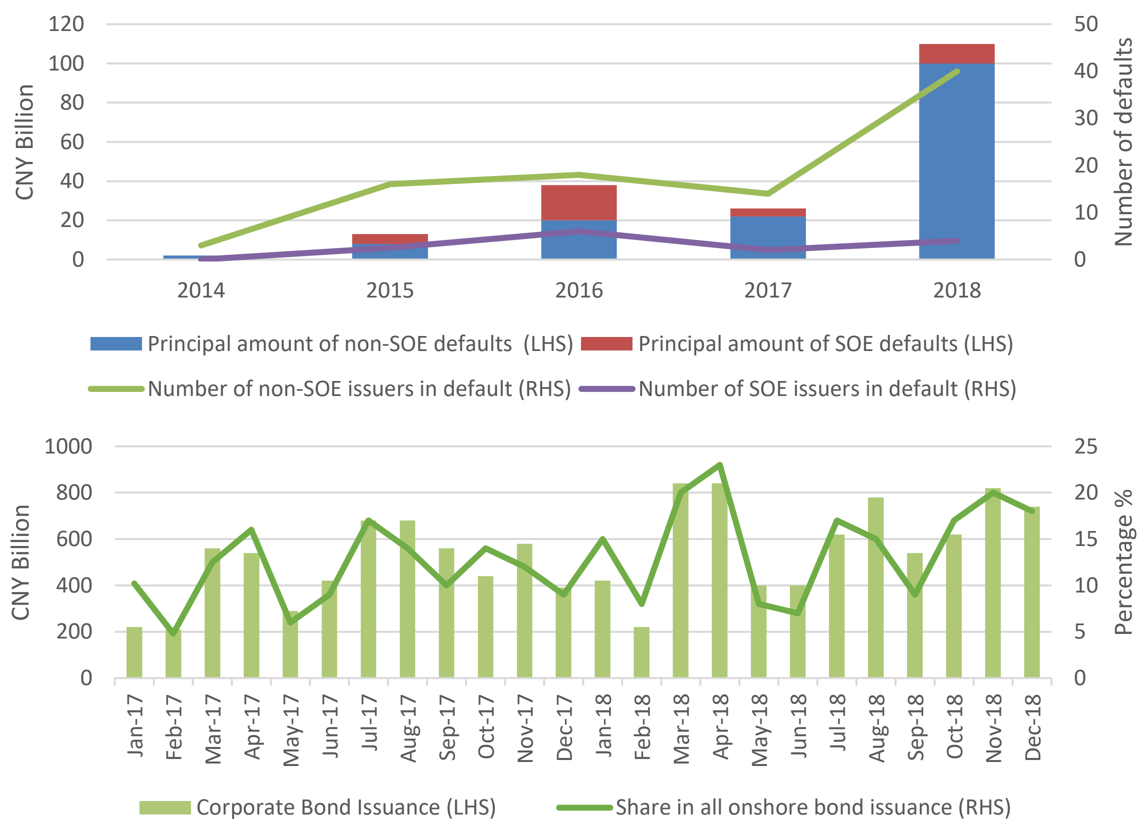

Fig. 17: China Onshore Corporate Bond Issuance and Defaults, 2018
Source: Fitch Ratings, WIND Financial Information, Financial Times

Despite some fears of a weaker economic outlook in 2019, the corporate bond market, which consists of several fast-growing sectors, has been a key growth driver of the Chinese bond market. This trend is expected to continue because of:

- Increasing depth and sophistication of China's capital markets, which will reduce the demand for bank lending
- Growth in Non-Performing Loans (NPLs), more stringent capital requirements, the growth of a "credit culture", and a more accurate assessment of credit risk
- Chinese authorities increasing their scrutiny of "shadow banking" activity, wealth management products and other unofficial banking channels

There are different classes of investors in each of these markets – the OTC interbank bond market largely comprises institutional investors while the exchange markets are aimed largely at retail investors. Some international investors, however, do access the domestic corporate bond market through the exchange markets as well.

An issue that merits urgent attention is the need to improve the strength of covenant packages in the Chinese domestic bond market. Generally speaking, domestic Chinese bonds typically do not have significant financial covenants, regardless of their credit quality. Such covenants are standard in the international credit markets and are critical to providing confidence to all holders (both domestic and foreign bondholders) of Chinese domestic corporate paper. Introducing financial covenants will help improve investor protection, particularly in the context of the opening of the CIBM and Bond Connect to foreign investors. Corporate bond issuers should monitor all covenants in their bond indenture and credit facilities to ensure compliance and should disclose equally and promptly to all market participants any breaches of such covenants.

The permission granted to the Beijing unit of S&P Global Ratings Service to register for bond ratings service in China's interbank market, announced in January 2019, marks the first time an international credit rating agency has been able to rate Chinese bonds and may lead to improved accuracy of credit analysis, particularly if there is convergence between the typically high credit values granted by domestic ratings firms and international agencies. Moody's Investors Service and Fitch Ratings were not mentioned in the 28 January 2019 announcement by PBOC.

In China, 97% of 1,741 non-financial corporate bonds had ratings of AA or above, according to a November 6, 2018 statement by NAFMII. About 39% of Chinese bonds get the highest AAA rating, compared to less than 2% in the US. The Chinese scale has discouraged international investors, who are accustomed to a ratings scale that runs from a high of AAA to a low of C. The Chinese bond rating agencies themselves complain that this is an effect of a fragmentary and overlapping system of regulation, with the PBOC taking oversight of the interbank bond market, CSRC supervising exchange trade bonds, and CBIRC having the authority to approve ratings agencies, and NDRC approving bond issuances. CBIRC requires that banks and insurers invest only in bonds rated AA and above, so that the domestic ratings agencies have had no incentive to provide lower ratings.

15.Securitisation

China's securitisation industry has seen explosive growth in recent years. As of November 2018, according to the CCDC the volume of domestic asset-backed/securities-mortgage backed securities (ABS) issuances in the interbank bond market and exchange market was RMB 777.1 billion (US$115.8 billion), 30% above the annual figure of RMB 602 billion in 2015 (US$89.7 billion) and nearly 45 times the RMB 27 billion (US$4 billion) in ABS issued in 2005, when the market was first established.[33] According to the ABS Development Annual Report of 2018 issued by CCDC and Golden Credit Rating International Co., Ltd., the total volume of domestic ABS issuances in the interbank bond market and exchange market for the year of 2018 was RMB 2.01 trillion (US$299.5 billion), 36% above the total issuance volume in 2017.[34]

For the calendar year 2018, residential mortgage-backed securities (RMBS) accounted for 63% of total credit ABS, with RMB 584.3 billion (US$86.5 billion) in issues, up 242% from 2017. ABS backed by other consumer loans also grew quickly, up 75% from 2017, according to CCDC, but accounted for a much smaller 3% share of total credit ABS issuances. If the credit asset securitisation (CAS) scheme, asset backed specific plan (ABSP), and asset backed notes (ABN) are included under the category of ABS, the volume in 2017 of new issuances was RMB 1.495 trillion, making China the world's second largest securitisation market in terms of new issuance volume, and up 64.7% from the volume in 2016.[35] In the first six months of 2018, China's securitisation issuance saw 42% year over year growth, a remarkable change for the tentative performance of the early 2000s.[36] For all of 2018, corporate ABS accounted for 47% of the issuance volume in the People's Republic of China (PRC). The underlying assets for corporate ABS are usually corporate debts and account receivables. The major underlying assets for credit ABS consisted of RMBS, auto loan ABS and collateralized loan obligations (CLOs).

Securitisation was first introduced by the MOF, PBOC, and CBIRC in China through the CAS pilot programme in 2005 but was suspended in 2008 following the onset of the global financial crisis amid concerns relating to securitised assets. The CAS framework, normally used by bank and non-bank financial institutions, was restarted in 2012, with an initial quota of RMB 50 billion. This was increased to RMB 500 billion, pursuant to an announcement by the State Council on 13 May 2015. Since then, the market has increased in issuance volumes, growth in asset classes and structures combined with greater offshore interest in onshore ABS.

China's Asset Securitisation Markets

	Credit Asset Securitization Scheme	Asset Backed Specific Plan	Asset Backed Note	Asset Backed Plan
Regulators	PBOC and CBIRC	CSRC	NAFMII	CBIRC
Originators	Financial Institutions	All types of institutions	Non-financial institutions	All types of institutions
Issuance Market	Interbank Bond Market	Securities Exchange Markets	Interbank Bond Market	Insurance asset trading playforms
SPV	Trust institutions	Security companies/their fund subsidiaries	SPT/SPC/Originators	Insurance asset management companies
Underlying assets	Credit Assets	Assets not listed on "Negative List"	Receivables, leasing credits, trust beneficiary rights, infrastructure toll rights, real estate, etc.	Not specifically defined
Number of projects	442	1184	67	n.a.
Bond issued (CNY Billion)	1778.01	1657.39	98.07	n.a.

Fig. 18: China's Asset Securitisation Markets
Source: CBIRC, CSRC, NAFMII, CNABS, Pengyuan Structured Finance

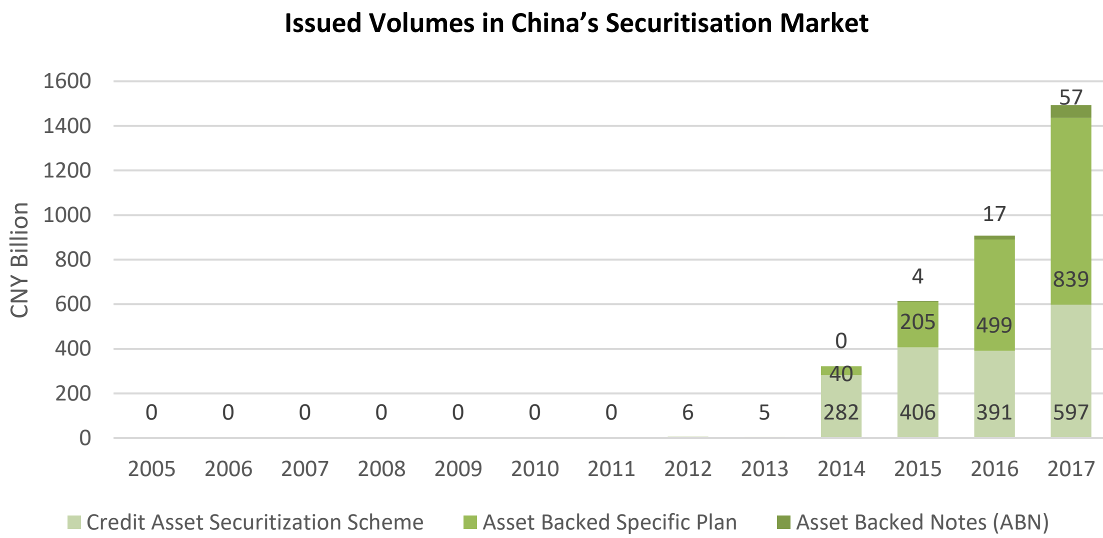

Fig. 19 Growth of China's securitisation market, 2005-2017
Source: China Securitisation Analytics (CN-ABS), Pengyuan Structured Finance

Several innovations have been seen in recent years in the Chinese securitisation markets. These include a programme of NPL securitisation and trust structure ABNs issued by corporates in the interbank market; this is similar to the special purpose trust (SPT) structure under the CAS framework and gives corporate issuers access to the more liquid interbank market. Also, CLO issuance by banks have accounted for an increasingly smaller share of ABS issuance, relative to other forms of securitisation. On the other hand, existing regulations do not permit direct foreign investment into an onshore trust holding securitised assets. In addition, existing routes for foreign investors to access domestic ABS issuances are quite restrictive.

Due to concerns over huge local government debt, the PRC government has in recent years encouraged the adoption of public-private partnership (PPP), a collaborative investment model between government and private companies in infrastructure projects. To attract more private capital and speed up return to investors, the NDRC and CSRC issued a joint statement in December 2016 encouraging PPPs to raise funds by issuing ABS products.

In February 2016, a pilot NPL securitisation programme was established in the PRC, which allowed six large PRC banks to issue a maximum of RMB 50 billion worth of NPL ABS. The six PRC banks were Agricultural Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Bank of Communications and China Merchants Bank. The RMB 301 million worth of NPL ABS issued by Bank of China in May 2016 was the first NPL securitisation in the PRC since 2008.

Since 2016, "Trust Structure Asset Backed Notes (ABNs)" have allowed corporates to access the more liquid China Interbank securitisation market. Assets backing the notes are entrusted to a newly established special purpose trust (SPT) under the Trust Law of the People's Republic of China. Specifically, the ring-fencing protection provided by the trust structure ABN is similar to that provided under the Credit Assets Securitisation (CAS) scheme which is regulated by the PBOC and CBIRC and which until recently was accessible only to bank and non-bank financial institutions. In addition, elsewhere in the China domestic securitisation market, over the 2017-18 period, the securitisation of NPLs, the development of the Commercial Mortgage-Backed Securities/quasi-Real Estate Investment Trust (CMBS/quasi-REITs) framework, and the supply chain finance ABS, especially in the context of the rapid development of the PRC e-commerce market, are especially noteworthy.

Despite the explosive growth of ABS issuance in China, existing laws permit only a limited class of investors to subscribe to ABS issuances adopting the SPT structure; this closed group mainly consists of domestic banks, insurance companies, securities companies and mutual funds. When credit assets originated by a commercial bank are repackaged into ABS sold to other commercial banks on the interbank bond market there is no true transfer of risk. The situation is more akin to an exchange of risk within the banking industry, with no real offloading of risk to the capital markets.

Currently, non-financial corporations are sponsoring securitisation mainly through ABSP regulated by the CSRC. There have been calls for a streamlined securitisation framework for all companies, which would remove the CAS/ABSP distinction. This would bring uniformity in addressing common legal risks, such as co-mingling and true sale and transfer of security, which are present across domestic securitisation offerings governed by Chinese law.

16.Efficient tax environments

As China's financial markets continue to develop, transactions across repo, futures, interest rate derivatives, and bond trading markets will become more inter-dependent, and the failure of tax rules to keep pace with the industry will create concerns for domestic and foreign-invested banks.

China's VAT system is unique by international standards in applying VAT to most financial services, which includes interest income. In terms of the tax treatment of bond interest, we very much welcome the announcement on 30 August, 2018 by the Standing Committee of the State Council proposing a three-year exemption from Corporate Income Tax (CIT) and VAT on interest income derived by overseas investors from their investment in Chinese bond markets and the MOF and SAT's joint circular in November confirming the exemptions. However, there are issues which have yet to be clarified with both MOF and SAT.[37]

Among these issues, our members would like to seek clarification from SAT that the exemptions will apply to all approved debt instruments, all channels and all types of trades (including cash, repo, bond ending and bond derivatives trades). In addition, the three-year exemption should ideally be renewed at least 6 months prior to the end of the three-year cycle. If there is no renewal of the exemption, 6 months advance notice should be given to foreign investors. This will provide certainty for investors and encourage foreign capital inflows into the China bond market.

It is preferable to opt for a simplified tax scheme such as a withholding tax based on the record date principle (versus holding period principle) and no capital gains tax or VAT on transactions requiring complex computation, which become even harder on a cross border basis. The need to appoint a tax agent is an extra complexity and cost for the investor.

For global institutional investors, it is best to:

- Adopt a simple tax scheme (withholding tax calculated on Record Date) but no tax at transaction level such as capital gain tax and VAT on CIBM assets. This will greatly simplify and clarify the tax process.
- Transfer the responsibility of tax calculation and collection from the issuer to the central securities depositories (CSDs), CDCC and SHCH which can collect tax certificates[38] from the investors (which determine the relevant tax rate) and pay the income proceeds to investors on a net basis (i.e.: taxed at source). A tax reclaim process can be considered for investors who would not have submitted their tax certificates on time. In the context of Panda bonds where issuers are under different tax regimes, it is advisable to leverage custodians who already operate in multiple jurisdictions. They can collect tax certificates from their clients. As an example, American and Japanese issuers will require the collection of specific tax certificates.
- Confirm that under a nominee structure, the ultimate beneficial owner is the tax payer and not the nominee itself.

The tax rate influences investors' appetite and the yield. This explains why many markets around the world have even removed the withholding tax on bonds. The lack of clarity or complexity around tax can discourage some investors to enter the market and also prevent inclusion into leading global bond indexes.

Recommendations for Fixed Income

Developing China's primary markets

1. **Adoption of international best practices with respect to issues such as information disclosure**, which could actually be simplified for institutional investors, who do not need the same level of detail provided to retail investors, both in the prospectus/issuing document at the time of the new issue and on a continuing basis
2. **Strengthening the due diligence process**, in particular the key areas of financial (pertaining to the issuer's financial accounts), legal (issues pertaining to the incorporation of the issuer) and business (pertaining to the present and future outlook/prospects for the issuer's business activities) due diligence
3. **Streamline the book building process** to provide more flexibility in terms of price determination through an iterative process of communication between the issuer/underwriter(s)/bookrunner on the one hand and investors on the other hand, similar to the process used in international offerings
4. **Arrangements should be made to facilitate the registration of SPVs** for foreign investment channels such as Bond Connect, to facilitate ABS origination and distribution to foreign investors.

Developing Secondary Markets, classic repo markets, bond futures, fixed-income derivatives

5. **Auction /Market supply and market liquidity**: Actions to increase the issuance size and providing encouragement to market makers to provide pricing transparency are all important steps to developing a strong China benchmark yield curve. Re-opening of outstanding issues where viable is highly advisable. Buybacks for off-the-run issues (to be replaced by tapping more liquid current issues) is also an option worthy of consideration. Any regulatory action that might encourage more active trading participation/bond turnover from large domestic banks is also desirable. The Buy and hold-to-maturity strategy employed by many domestic banks has clearly inhibited market liquidity to at least some degree. Allowing banks and foreign investors to trade futures would also increase the aggregate level of market liquidity.
6. **Guidelines on CDS market:** Regulators should issue guidelines for offshore investors and other market participants to use the Chinese domestic Credit Default Swap (CDS) market.
7. **Regulators should formalize the central clearing of CDS** and the designation of Central Counterparties (CCPs) to mitigate counterparty risk.
8. **Tri-party repos**: PBOC has announced the inauguration of a tri-party repo in the interbank bond market but for now, only depository and settlement agents for interbank bonds can act as third parties. However, this is a significant advance since in the future large banks with corresponding capabilities will also hopefully be able to provide such services. PBOC should consider expanding the range of third parties as soon as possible.
9. **Repo**: Move towards a title transfer (Classic) repo format, facilitating the use of accepted GMRA documentation for foreign investors. Furthermore, Bond Connect can be a powerful channel for growth in foreign investor participation, namely through the use of tri-party repo, initially involving offshore-to-offshore customers. This is discussed is our Market Access section under Bond Connect.
10. **CNY capability and the ability to face multiple FX banks**: Among the most common issues raised by index tracking funds are CNY capability (some GCs are still not able to offer CNY) and the ability to face multiple FX banks for CNY conversion to achieve and verify best execution.

11. **Need for a longer settlement cycle**: Again, a problem raised by investors is the need for longer settlement cycles (not just T+0, T+1, T+2).

Clearing and settlement issues

12. **The role of the Type A member can be split between trading and settlement functions**, to allow specialist trading and settlement service providers to independently service the client.
13. **Type A members can be members at CFETS for trading/trade matching purposes**, only if the trade is sourced and executed by such members. They can also provide settlement functions, if they chose to. However, the functions need not be bundled.
14. **Broker dealers, asset managers or investors should be allowed to trade and enter CFETS** for trade matching on behalf of investors.
15. **Custodians should be allowed to provide settlement services** at the depositories using their existing license, which is allowed in almost every other market globally. They can also be required to do trade reporting for OTC trades at CFETS so CFETS has the entire trade and execution data, if required.
16. **Trade execution or services that can impact the legality of the trade execution** in the market would not be allowed.
17. **Investors should be allowed to enter trade orders in CFETS overseas** either by themselves or through their broker/global custodian/international central securities depository, using the trading ID of the intermediary or their own. Alternatively they can trade onshore through the onshore settlement agent.
18. **A Central Clearing Counterparty for all OTC trades in the CIBM should be considered** with Clearing Members who participate in the Clearing process to minimise clearing risks (for CCDC settlements).
19. **Type A members and custodian banks should be eligible to become clearing members for bond trading upon application**. This would be on a par with the equities market framework in China and also international best practices.
20. **Investors should settle the trades in the account of the GC or ICSD held with the LC**. The LC would be able to confirm such trade directly with the onshore CSD.

Exemptions from VAT and CIT (November 2018)

21. **The exemptions apply to all approved debt instruments,** all channels and all types of trades (including cash, repo, bond ending and bond derivatives trades).
22. **The 3-year exemption should ideally be renewed at least 6 months prior to the end of the 3-year cycle. I**f there is no renewal of the exemption, 6 months advance notice should be given to foreign investors.

Overall recommendations

23. **Undertake steps to increase secondary market liquidity, as listed above.**
24. **Encourage greater participation of foreign investors in repo markets by moving towards a title transfer (classic) repo market, adoption of accepted documentation used in other market (GMRA)** and other possible measures, as outlined in the Bond Connect / Market Access section.

25. **Adopt best practices based on global standards in information disclosure,** for the prospectus/issuing document at the time of the new issue and on a continuing basis.
26. **Strengthen the financial, legal and business due diligence process in the primary markets**.
27. **Streamline the book building process** to provide flexibility in price determination similar to the process used in international offerings.
28. **Allow all investor types to participate in the bond futures market.**
29. **Issue guidelines for offshore investors and other market participants** on the Chinese domestic CDS market.
30. **Formalise the central clearing of CDS** and the designation of CCPs to mitigate counterparty risk.
31. **Consider the introduction of ESG and social bonds** as well as bonds tied to the UN sustainability goals.
32. **Harmonise the different securitisation regimes** to create a bigger, deeper and more liquid securitisation market.

F. Foreign Exchange

The RMB presence and influence has been growing in recent years as the Chinese economy expands and its external linkages increase. This has been achieved despite the fact that China has approached the internationalisation of the currency from the opposite direction to the perceived norm.

While there is no standard path to internationalisation, the process typically combines sequential and incremental steps involving, firstly, the exchange rate regime by allowing the rate to be determined increasingly by the market, and then convertibility of the capital and current account prior to the full liberalisation of the capital account to ensure the liquidity of, and confidence, in the currency. In the case of China, the internalisation has taken a different trajectory with the increased international usage of the currency taking place without its full transferability and convertibility in a regime where rates are typically managed.

1. Overview

Over the past two decades China has implemented a number of enhancements to its currency regime. Due in part to pressure from its trading partners, in 2005, the PBOC took the first important step when it announced it would adopt a managed floating exchange rate system in which the daily fix for the exchange rate was to be determined by reference to a basket of currencies, instead of only the USD, and allow the currency to gradually appreciate, which it did over the following three years. No details were provided of the composition of the basket. The PBOC announced further changes in August 2015 when the daily fix was to be based on the previous day's market close rather than being determined by the central bank and become more "market oriented".

A 7.0% depreciation of the RMB against the US dollar between January and December 2018 may reflect rising trade tensions with the US and the imposition of punitive tariffs on US$250 billion in imports from China in 2018 as well as issues around GDP growth, the increasing debt burden and a divergent monetary policy.

Average Monthly RMB-US Dollar Reference Rates, 2015-2019

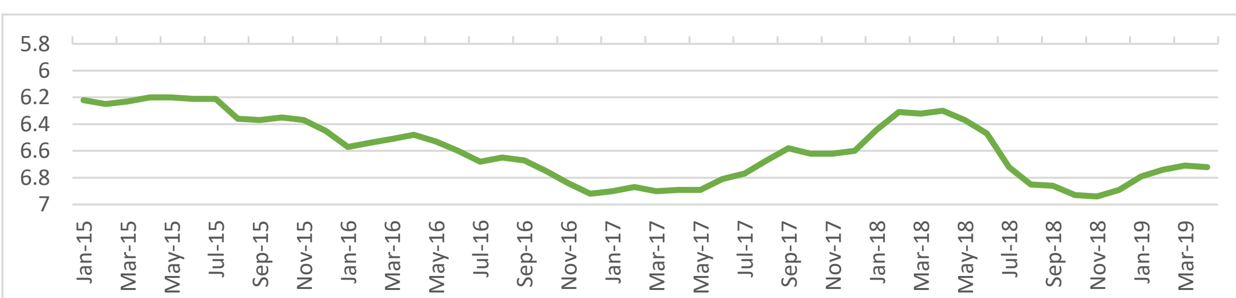

Fig. 20: Average Monthly RMB-Dollar Reference Rates, January 2015-March 2019 (Yuan per Dollar)
Source: WIND Financial Information

In December 2015, CFETS unveiled the CFETS RMB Index to be used to assess exchange rate movements. This was an attempt to shift the market's focus from the RMB against the USD exchange rate to the RMB's performance against a basket of currencies used by its trading partners, reflecting the perspective that the exchange rate should capture the international trade flows of China. The original Index consisted of 13 currencies with weightings based mainly on a trade-weighted average to take into account re-exports, and included all of the world's major reserve currencies, which combined account for more than 80% of the basket. The USD had the largest weighting with 26.4%, while the weightings of the Euro and the Yen components were 21.4% and 14.7% respectively. In December 2016, the CFETS Index was refined with 11 more currencies added to the basket, resulting in reduced weightings for the USD, the Euro and the Yen.

January 2017: Composition of the CFETS RMB Index

Currency	Weight
US Dollar	22.40%
Euro	16.34%
Japanese Yen	11.53%
South Korean Won	10.77%
Australian Dollar	4.40%
Hong Kong Dollar	4.28%
Malaysian Ringgit	3.75%
Singapore Dollar	3.21%
British Pound	3.16%
Thai Baht	2.91%
Russian Ruble	2.63%
Canadian Dollar	2.15%
Saudi Arabian Riyal	1.99%
United Arab Emirates Dirham	1.87%
South African Rand	1.78%
Swiss Franc	1.71%
Mexican Peso	1.69%
Turkish Lira	0.83%
Polish Zloty	0.66%
Swedish Krona	0.52%
New Zealand Dollar	0.44%
Danish Krone	0.40%
Hungarian Forint	0.31%
Norwegian Krone	0.27%

Fig. 21: New currencies added include South African Rand, Korean Won, UAE Dirham, Saudi Riyal, Hungarian Forint, Polish Zloty, Danish Krone, Swedish Krona, Norwegian Krone, Turkish Lira, and Mexican Peso (21.1% of basket)
Source: CFETS

1a. Internationalising the RMB as payment currency

Another significant development in China's currency policy has been the promotion of the external use of RMB to settle current account transactions. Cross-border trade settlement was launched on a trial basis in July 2009. It was initially restricted to selected firms in five regions in mainland China for trading with Hong Kong Special Administrative Region (SAR), Macau SAR and Association of Southeast Asian (ASEAN) countries. The trial scheme ended in 2012 when all mainland firms and current account transactions became eligible for invoicing and settlement in RMB.

In 2018, the RMB was the fifth most active currency for domestic and international payments. In terms of international payments only, and excluding payments within the Eurozone, the RMB ranked eighth in January 2019 with a share of 1.24%.[39]

RMB's Share as a Domestic and International Payments Currency

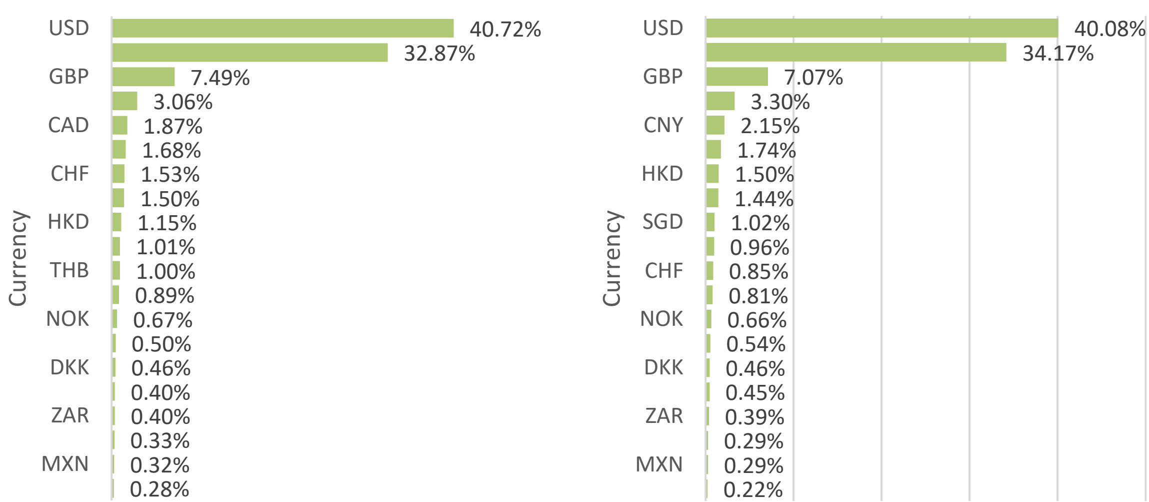

Fig. 22: RMB's share as an international payments currency (Left: January 2017 Right: January 2019)
Source: SWIFT

1b. RMB trading

Despite the on-going reforms, China's CNY (onshore) FX market remains highly regulated. Access to the wholesale market is granted only to domestic banks, SOEs and domestic subsidiaries of foreign banks.

The CNY market is small in relation to China's GDP and its economic links with the rest of the world. In April 2015, China's FX derivative market was only, 0.7% of global derivatives turnover relative to its 2016 US$11.19 trillion GDP (World Bank) lower than India (1.4%) or even recessionary Brazil (1.1%). This compared to an average figure for emerging market economies of 5% and 20% for advanced economies. Furthermore, according to the 2016 Bank for International Settlements (BIS) Triennial Survey, CNY was the eighth most frequently traded currency with a 3.9% share, at US$202 billion of the US$5.088 trillion daily average global FX volume, up from 2.2% in 2013.[40]

Notwithstanding the above, the RMB (which includes (CNH) has become the most actively traded emerging market currency.

FX average daily turnover, EME and developed markets

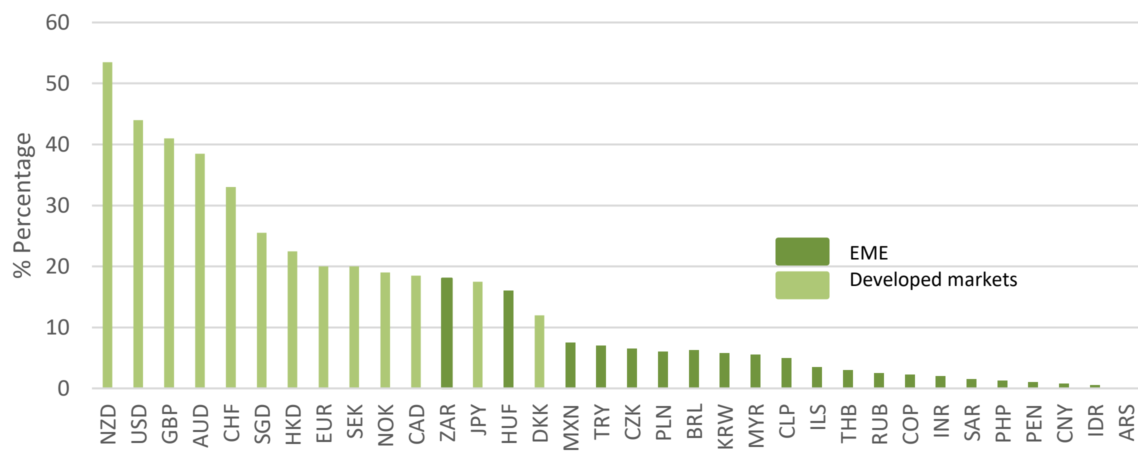

Fig. 23: Comparison of EME and developed markets FX total turnover relative to GDP
Source: BIS Quarterly Review 2016

Renminbi onshore and offshore FX trading in 2016

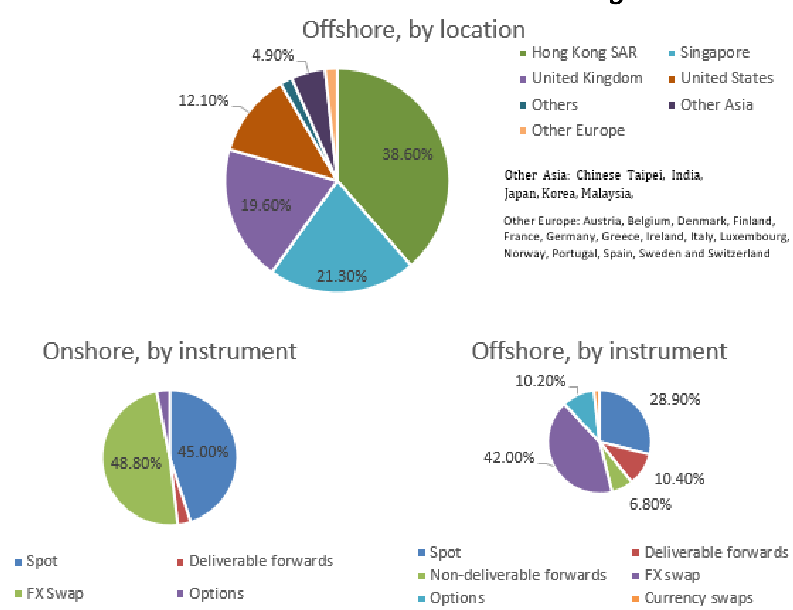

Fig. 24: Renminbi onshore and offshore FX trading in 2016: Share of total turnover volume, in%
Source: BIS Quarterly Review, December 2016

1c. RMB as Special Drawing Rights (SDR) component currency

On 1 October 2016, the RMB was included in the IMF's Special Drawing Rights (SDR) basket of currencies with a weighting of 10.92%, the third largest weighting. This represented recognition on the world stage of China's efforts to internationalise its currency and broaden onshore and offshore access to its capital markets. Despite the expectation that the RMB's inclusion in the SDR would increase investor appetite for RMB-denominated assets and encourage a wider use of RMB in cross-border transactions, the share of the RMB in international payments has remained stagnant along with its position as a reserve currency.

Further currency liberalisation in the short to medium term is unlikely given restrictions on capital outflows continues to be high. The tighter controls over offshore lending by Chinese banks and increased scrutiny of overseas investments by Chinese firms led to a reduction in outbound direct investment in 2017 and 2018, which had been an important driver of renminbi internationalisation. The one bright spot for outbound investment has been Belt and Road Initiative (BRI) deals, which accounted for 13% of total investments in 2018, up 1percentage point from 2017.

Meanwhile, inbound foreign direct investment in China was up by 3% in 2018, according to the UN Conference on Trade and Development, to US$142 billion, reflecting measures to attract foreign capital inflows as China's current account moves from surplus to deficit in coming years.[41]

2. Outlook for RMB in the SDR basket

The RMB has joined the USD, the Euro, the Yen and the British Pound (GBP) as an SDR basket member. In the decades to come, its share is expected to gradually increase. It will be boosted by the rising importance of China in the global economy and the growing reflection of its role in financial markets.

The weight of an SDR currency in the basket is based on a formula. It has the form of an arithmetic average of two indicators, one representing the real economy and one reflecting financial markets. The former equals the share of the country issuing the currency in current account receipts among all SDR-issuing economic areas. The latter corresponds to an arithmetic average of three sub-indicators. The first equals a currency's share in reserve assets; the second in foreign exchange market turnover; and the third its share in the sum of international banking liabilities and international debt securities denominated in the currency.

China's importance according to all of the above criteria is bound to increase from current levels. Upside for its share in current account receipts is more limited given the country's already strong position. On the other hand, China's role in global financial markets is lagging its economic achievements and is bound to expand more significantly. In 2017 it was estimated that at the next IMF review, likely in 2021, the weight of the RMB in the SDR basket could increase to about 15%. The currency's increasing weight will not stop there, and it should eventually approach the role played by the Euro and the US dollar.

The current status of the RMB's role as an SDR currency, and – more importantly -- outlook for its expansion, will be a crucial determinant of its role as an international reserve currency. This is because global central banks have a propensity to allocate their reserves primarily to SDR currencies. In fact, there is a strong correlation between a currency's weight in the SDR basket and its share in global reserve asset allocation.

According to the IMF, holdings of RMB assets by global central banks were US$193.4 billion in the second quarter of 2018, equivalent to 1.84% of all reserve assets. It had the sixth place among reserve currencies, but was still well below the US dollar, at 62.25% of the total; the Euro, with 20.26%; and the yen at 4.97%. Based on conversations with central bankers as well as historical trends, holdings of RMB could be expected to rise to 5% by 2022. This would correspond to 7% of all non-Chinese reserves. In addition, sovereign wealth funds and supra-national agencies will also reallocate part of their assets to the RMB. In US dollar terms, about US$125 billion per year could be invested in the Chinese currency between 2017 and 2022. The process will support the RMB's value and will be a key driver of its internationalisation.

3. Electronic trading

Banks and customers prefer electronic execution due to the efficiencies and cost savings that it brings to execution and transaction processing through higher straight-through processing and much reduced error rates.

The CFETS is the electronic platform for the trading of interbank FX in China. The interbank FX market works on a membership basis and its participants include FX-designated banks, qualified non-banking financial institutions and non-financial enterprises.

Following the launch of the CFETS FX2017 platform in February 2018, which leverages the underlying technology behind NEX Markets' electronic broking service (EBS) platforms, members have the ability to either electronically execute spot via the central limit order book, known as C-trade, on an anonymous basis by accessing a central pool of liquidity, or to execute spot, forwards and swaps through a disclosed, bilateral trading model where price takers can choose from a full range of bank and non-bank liquidity providers. However, because settlement of the transaction continues to involve CFETS, the costs of trading have made it less attractive. In addition, the execution costs of trading on the CFETS platform continue to be a disincentive when compared to the costs of trading major currencies on an interbank platform such as EBS. The trading of FX swaps and options is done on a bilateral basis but all trades have to be registered on the CFETS platform.

Banks are able to offer their onshore customers' electronic execution via single dealer platforms but the onerous documentation requirements to evidence the underlying real economy transaction has limited the efficiency of this method of execution. Consequently, customers execute their FX trades with dealers via the phone. Despite the developments to simplify the documentation requirements, the latest of which took effect in November 2016, the payments process still remains very manual.

4. Product developments

The gradual internationalisation of the RMB has resulted in its growing significance as a settlement currency. One component in achieving this has been the introduction of the offshore pool of deliverable RMB, or the CNH market, in 2010 when banks located in Hong Kong were able to settle RMB with one another.

Prior to the development of the CNH market, the only means available for offshore market participants to hedge their RMB exposure was via the non-deliverable forward (NDF) market. The daily fix for the NDF is the same as the morning fix published by the PBOC. This means that market participants are exposed when the CNY/CNH rates diverge. Despite its contraction, the NDF market continues to be used by corporates that are either concerned about the recent bouts of illiquidity or are yet to develop the infrastructure to enable them to physically settle RMB, or it is used by market participants for speculation. However, the popularity of the CNH market means that it is likely the NDF market will continue to become less liquid although there is likely to be continued demand for the product from some market sectors.

In April 2011, SAFE introduced new rules that permitted locally based banks, financial institutions and corporates to trade vanilla European FX options. At the time, although corporates were only permitted to buy options, it was seen as another step in the internationalisation of the currency and growing the FX market. However, the market did not experience the growth in turnover that it was expecting due in part to the costs incurred in buying options and the lack of sophistication of liquidity providers and users.

The restriction on corporates was lifted in August 2014 when they became able to both buy and sell FX options. This gave corporates the ability to trade simple strategies and the opportunity to reduce their hedging costs.

In 2017, the PBOC and the State Administration of Foreign Exchange (SAFE) allowed central banks to trade FX derivatives directly in the interbank market, which was seen as a key step in encouraging investment in the interbank bond market. The involvement of central banks was further encouraged when they were permitted to negotiate ISDA Master Agreements with their onshore counterparties for FX derivatives. Up until this time, counterparties trading onshore could only negotiate the domestic Master Agreement issued by the NAFMII.

Another significant step taken in 2017 to further open up the capital markets was allowing foreign institutional investors in the CIBM to have access to onshore FX risk hedging arrangements. The lack of onshore hedging capabilities was previously an impediment for foreign investors who had to resort to more expensive offshore FX hedging solutions. As of June 2018, investors via the QFIIs and RQFII channels can directly hedge FX exposures without using their custodians, whereas investors using the CIBM channel are restricted to hedging FX exposures via an onshore agent bank. While there have clearly been positive developments in the FX market since the deliverable CNH currency was introduced in 2010, there continue to be restrictions that limit the size of the onshore market, including:

- Access to the market is limited reducing the number of possible market participants and limiting the natural hedges for liquidity providers
- The lack of close-out netting legislation is more of a limiting factor on the size of the market than liquidity
- The lack of certainty regarding final and irrevocable settlement will continue to limit risk appetite and trading as volumes increase and the currency usage grows
- There is uncertainty as to which long-term institutional investors investing in the CIBM are permitted to hedge their FX exposures
- There is a need to adopt standard international account documentation across all market participants
- There is no PVP risk mitigation infrastructure for the protection from loss of principal. This risk mitigation is important to investors and is available in developed currencies including the most active cross currencies traded with RMB

Furthermore, the anticipated role that the Shanghai foreign Trade Zone (FTZ) would play in the market has not materialised.

End users should not be discouraged from hedging their FX exposures, but the historically high costs of hedging provide disincentives to prudent risk management practices. Introducing simple exotic options, such as barrier and digital options, into the available product suite could provide such incentives. Barrier options were created to provide the hedge of an option but at a lower premium than a conventional vanilla option, thereby reducing the cost and increasing the leverage.

5. Cost of trading CNY

At present, the onshore markets, with the exception of the spot and FX swaps which are highly liquid, are inefficient and costly, making them less attractive to those market participants permitted to trade in them.

The opening up of the option market in 2015 did not result in the expected increase in activity hence the FX derivative market remains disproportionately small relative to the size of the economy and compared to other emerging and developed market economies. A contributing factor to the slow growth has been a lack of familiarity of the onshore participants with the products. However, another cause is the restriction of access to the FX market. In the offshore market, there are numerous non-bank participants that trade both sides of the market, thereby enabling banks to offset the vega risk from selling options and avoid the costs associated with risk warehousing. In the onshore market, where hedging tends to be directional, non-bank participants do not have access to the market. The resulting build-up of risk by the banks incurs costs that need to be recovered through wider spreads which dampens the demand from end users.

Additionally, the current arrangements may negatively impact the bilateral trading and settlement limits in the RMB. While there are alternatives available to the market to increase bilateral trading and settlement limits, these alternatives are not being deployed fully. Absent the implementation of such solutions, such as PVP and DVP settlement, the cost of trading CNY and CNY-denominated assets incorporates the costs of these risks. Additionally, the lack of risk protection of principal in the exchange of currencies without PVP may deter investors.

Further action by the PBOC following its 2% devaluation of the RMB on 11 August 2015 has resulted in higher costs for end users. In September 2015, as part of an initiative to reduce onshore speculation in the FX market, the PBOC required dealers to place a USD-denominated deposit at the Central Bank at 0% interest for one year. The size of the deposit is calculated based on a percentage of the notional value of all outstanding FX contracts where their client is long USD. The percentage is set at 20% for forwards and swaps and 10% for options. Since its introduction the requirement has been reinforced through more frequent calculations and widening of the net of impacted banks. As a result, the costs of holding the reserve at the PBOC are incorporated in the pricing and may have had the unintended consequence of pushing market participants to trade options.

The deposit requirement was lifted in September 2017 but re-imposed with a higher requirement in August 2018. The PBOC announced on 6 August 2018 that the deposit requirement was set at 20% for all products, making options more expensive than under the previous requirement. The move resulted in an increase of about 400 basis points hedging costs and again slows the trend to embrace risk management among Chinese corporates in light of currency market volatility. While the priority of the PBOC remains the stability of the currency the role of the FX market will continue to be suboptimal and market participants will carry more FX risk to avoid the inflated market costs. Deep and liquid FX markets that provide good price discovery are an essential component for investors looking to invest in the onshore equity and debt markets.

Recommendations for FX

1. **Encourage competing platforms to CFETS**: Continue to encourage increased price competition in electronic execution by allowing other platforms to participate to improve efficiency and therefore lower transaction costs.
2. **Continue to identify opportunities to introduce new products** to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.
3. **Clarify whether FX hedge transactions in the interbank FX markets are exempt from VAT**, in line with VAT exemptions in the local currency market.
4. **Minimise the cost of trading FX** in order to encourage market participants to actively hedge their foreign exchange exposures.
5. **Consider digitising the requirement to provide underlying documentation for real economy trades when entering into FX transactions** in order to significantly increase market efficiency and mitigate operational risks and cost.
6. Clarify the FX hedging process for Bond Connect investor
7. Allow investors via CIBM direct channel to hedge FX not only with onshore agent bank, but also other FX market makers onshore.

G. Laws and Regulations

There are significant benefits to China in considering international standards for financial regulation. If policymakers can deliver an appropriate level of similarity, comparability and predictability in regulatory outcomes with other jurisdictions financial institutions, both domestic and international, are better able to invest, operate and offer services cross-border without unnecessary impediment and complexity, freeing investment to flow efficiently to where it is needed most. Companies, investors and retail customers will be able to access services more securely and efficiently with less risk of financial instability. This benefits China's economy, including through the deepening and widening of inbound capital flows, and enabling greater risk diversification and availability of a greater range of financial services to domestic investors. At the same time, integration with international markets can play an important role in stabilising China's domestic market overall.

China will need to address considerable legal, economic and political constraints to achieve the degree of consistency needed to realise these benefits and to reduce the economic costs involved. It is equally important that there be a robust system for the development and implementation of regulation. As in every jurisdiction, a carefully considered balance must be struck between achieving positive outcomes of greater financial stability and allowing for necessary levels of supervisory discretion and sensible local differences. ASIFMA is not advocating for regulation that is identical to that of other jurisdictions, but we think there is opportunity to develop requirements that are more consistent with global legal, regulatory, and commercial standards implemented in other major jurisdictions.

1. Regulatory processes

ASIFMA's global investors' survey in 2016 confirmed that regulatory transparency and consistency, adequate notification for new rules and lead time for implementation, meaningful market consultation including time for public comment and opportunity for adequate dialogue, and openness of processes to foreign market participants including English-language publication of regulatory consultations, circulars, notices, market and technical documentation, etc. are all vital to the development and operation of well-functioning financial markets, and key to attracting international investors. Setting aside the needs of global investors, internally, greater consistency among regulatory agencies in the financial sector is also desirable and greatly needed. A large number of regulatory and quasi-regulatory bodies govern the financial services sector in China (PBOC, SAFE, MOF, SAT, NDRC, CSRC, CBIRC and NAFMII) exist, with the perception that many have their own sets of priorities and processes which may not necessarily align.

Across these regulators, government bodies, and standard-setting agencies, there is no consistent process for engaging with or notifying the industry about regulatory changes. This means that regulatory changes across these institutions can be inconsistent, causing the approval processes for new products or licenses to suffer the absence of a coordinated regulatory approach. Rules themselves are often unclear and reasons for denial or approval are not often disclosed. In some cases, the rules themselves are not readily available publicly. At times, it is unclear which regulator's approval is required and regulators themselves appear to sometimes disagree required relevant processes and procedures. Increasing both coordination among China's regulatory agencies and transparency of their processes will reduce uncertainty and foster foreign investors' confidence in the market as well as that of domestic investors.[42]

In the last few years, there have been an increasing number of consultations with market participants, which ASIFMA views as a very positive development. However, we have found that in some instances, regulations are filed only a few days after the close of the consultation with few or no changes to original drafts. The lack of English-language consultation texts means that foreign market participants are disadvantaged by the extra time required for translation. In order to provide sufficient time for market participants to digest new regulations and provide considered feedback, it would be helpful for regulators to provide more time for such responses, briefings and meaningful dialogue. In most regions, use of English has become an established international practice for financial services consultations. Where possible, ASIFMA would like to see regulatory communications and exchange enquiries handled in English, where such are related to international and offshore account matters. This will lead to more accurate descriptions and prevent miscommunications. Finally, publication of the consultation documents including responses would improve transparency and build confidence in consultation processes and reduce perceptions of regulatory risk within China's markets.

In addition to consulting with market participants, it would be helpful for China's legislature and regulatory bodies to publicly consult on their proposed rules and regulations so that areas, topics, and items of potential concerns can be identified more broadly and explored adequately to ensure successful and efficient implementation of regulations.

Finally, slow and incomplete implementation of Chinese regulatory changes at the working level creates a de facto market access barrier for financial firms seeking to deepen their investment and operations in China. New and amended regulations need to be fully implemented in a timely manner in order to achieve the Chinese government's policy objectives of market stability and access in order to reap benefits for the Chinese economy. Incomplete implementation introduces unnecessary uncertainty and regulatory risk in the eyes of international market participants.

2. Corporate governance

The topic of corporate governance is complex but there are many reasons to expect good corporate governance from Chinese corporates to benefit shareholders, and by extension to the broader society through economic growth, institutional stability, and social development. A Harvard Law School study in 2016 found well-governed companies typically have a higher market valuation. Improving corporate governance, especially in developing markets, typically increases inflows of capital.[43] China's stock markets in particular have been vulnerable to concerns about weak corporate governance, limited transparency, and weak auditing standards and accounting practices. Continued efforts toward improving corporate governance at Chinese public companies will improve investor confidence, lift valuations, and help reduce the cost of capital. This is key to attracting foreign investors, according to our global investor's survey.

In June 2018, CSRC published draft regulations on a new "Code of Corporate Governance for Listed Companies in China", to replace the first Code enacted in 2002. This is an important landmark in China's corporate governance development and has been welcomed by domestic and international investors, listed companies and other market participants. The new Code is better aligned with global standards of corporate governance. It includes many improvements, such as:

- Greater emphasis on institutional investors playing an active role in corporate governance, with encouragement to exercise their voting, inquiry and proposal rights as well as the right to recommend candidates for director or supervisor positions
- Encouragement to institutional investors to publicize their corporate governance principles and objectives, to offer guidance to listed companies on how to improve performance
- Emphasis on the important role played in the governance process by professional intermediaries, including securities companies, law firms and accounting firms when providing sponsorship and underwriting, financial advisory, legal and auditing services for listed companies
- An expanded section on stakeholders that includes a focus on ESG factors, including a reference to incorporating environmental protection into development strategies and corporate governance practices
- The concept of social responsibility has been broadened to include practical issues – assisting communities, especially poor communities, with disaster relief, community welfare and economic development
- Encouragement to listed companies to "actively reward shareholders" and offer specific guidance on cash dividend policies
- The requirement that boards of directors should establish audit committees, reinforcing the addition of an audit committee requirement to stock exchange listing rules in April 2018 – stronger audit committees will improve the integrity of internal and external audits
- Reference to Party organisations (POs), which helps clarify the role of Party organisations in enterprise governance

China's corporate governance has made great strides over the past few decades, according to the Asian Corporate Governance Association (ACGA).[44] In July 2018, it released a report based on a survey of 150 foreign institutional investor perceptions as well as 182 China listed company perceptions, both conducted in the third quarter of 2017. While China introduced "global standards" of corporate governance from the mid-1990s to early 2000s, over the past 10 years the emphasis has been on local governance solutions driven by the state and the Chinese Communist Party, often prescriptive and rules-based. What is emerging now is a hybrid system that puts renewed emphasis on regulatory enforcement and coordination, but also ESG and investor responsibility, in the context of the new Code of Corporate Governance.

Among the unique features of the hybrid system is the leadership role of POs within both SOEs and privately-owned enterprises (POEs) which was reinforced by policy initiatives between 2010 and 2017. POs are above the board of directors in the decision-making chain in SOEs, and are widespread in private enterprises as well, with foreign multinationals in China also coming under increasing pressure to form POs. In private enterprises, the POs provide a focus for Party members, have jurisdiction over the trade union, and offer guidance on regulatory compliance. ACGA describes them as "best understood as an integral part of what the Communist Party of China (CPC) calls the process of 'socialist modernization'" in which the CPC plays the core leadership role over the entire society.[45]Reforms between 2015 and 2017 meant that SOEs had to write them into their articles of association for the first time, causing concern among foreign investors. ACGA's view, however, is that this may help to increase traditionally low transparency of the POs, possibly leading to disclosure reports of the sort that are standard for Chinese listed company boards of directors.

Lack of Clarity Surrounding Party Organisations

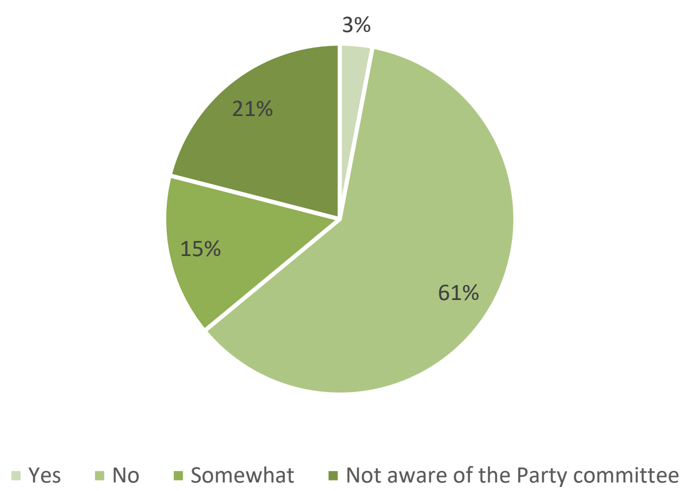

Fig. 26: Foreign perceptions of the clarity/lack of clarity of POs, ACGA survey, Q3 23017
Source: Asia Corporate Governance Association

The ACGA surveys showed that two-thirds of foreign investors and half of the China company respondents see overseas-listed China firms as better governed than A-shares. More of the China participants than foreign investors were in favour of MSCI's inclusion of A-shares in the MSCI Emerging Markets Index (48% of foreign investors were against it, while only 12% of China companies surveyed disapproved), and foreign investors saw relatively little advantage to investing in SOEs versus POEs – only 23% preferred investing in POEs. Only 10% of China respondents saw POEs as better governed than SOEs. Such perceptions point to common governance challenges of POEs and SOEs – concentrated ownership, an insider mindset, policy uncertainty, controlled markets, the need to maintain good government relations, and the requirement to form internal Party organisations.

Differences are largely those that might be expected – the government is seen as far more interventionist in SOEs, and the role of the chairman as less important, since SOE chairman are essentially state employees and are rotated to government agencies and Party organisations or to other SOEs on a regular basis. Since 2015, SOEs have been categorized as “commercial enterprises” or “public enterprises” entailing different objectives, governance requirements, performance metrics, and systems of evaluation, according to ACGA.

Despite improvements, grey areas remain where ACGA has made recommendations to improve corporate governance, which are endorsed by ASIFMA. These include:

- Policy initiatives beginning in 2010 reinforced the role and importance of internal POs in enterprises, both POEs and SOEs, with major statements and Article of Association amendments in 2017. More disclosure is needed on the role of the PO, which should produce a disclosure report comparable to the board of directors and supervisory board reports.
- There is a need to clarify the relationship between the PO and board of directors in Company Law, and enhance board evaluations and committees.
- China’s dual board structure includes a supervisory board (SB) whose functions overlap with those of the board of directors and audit committee. Both Company Law and official guidelines need to clarify the separation of duties between the SB and board of directors. SBs should be encouraged to use their full powers, and private firms should have a choice whether to include SBs in their governance structure.
- The differences in role between board of directors, supervisory boards, and POs need to be clarified since these often overlap in function in practice.
- Nine-person boards with three independent directors are ubiquitous in the China listed ecosystem due to a rule that boards must have at least one-third independent directors. The one-third rules should be revised and companies should engage in director training and abolish attendance by proxy.
- While corporate reporting has improved significantly since 2017 in the view of foreign institutional investors, the audit committees should play a stronger role and internal audit committees should report to them. External auditors also need to be given a stronger voice.
- ESG reporting began in 2006, but there is still much confusion about its relevance to investors. Investors need to play a role in guiding listed companies to better compliance by focusing their attention on large caps, prioritizing their information needs around key issues, encouraging use of third-party and independent data, and experimenting with a “comply or explain” approach.
- After peaking in 2016, the domestic mergers and acquisitions (M&A) market has fallen off slightly, as deregulation has already worked through major sectors of the economy. SOEs account for most of the value of M&As, and are largely driven by policy concerns. Takeover regulations need review together with Company Law on shareholder meetings and voting.

Governance of Overseas-listed Chinese firms versus A-shares

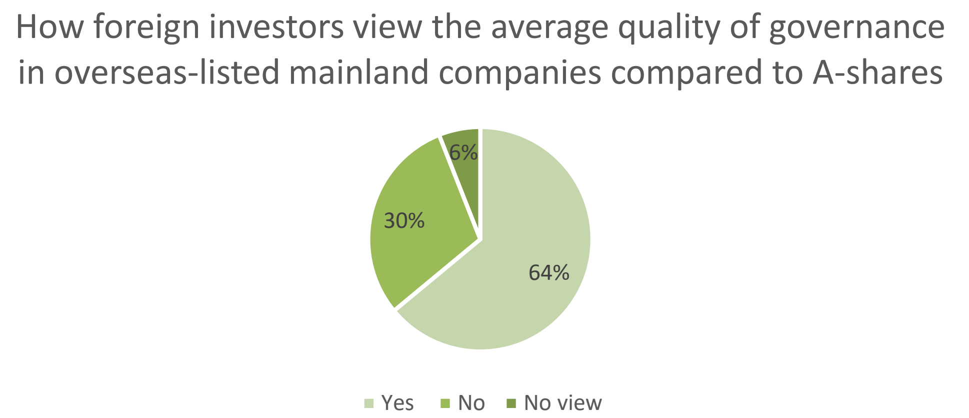

Fig. 27: Do overseas-listed Chinese shares have better CG than A-shares? ACGA survey, Q3 2017
Source: Asian Corporate Governance Association

3. Bankruptcy, insolvency and resolution regimes

Slowing growth has led to an increasing case load of bankruptcies in China's court system, which are spilling over into foreign jurisdictions including the Special Administrative Region of Hong Kong. In 2019, Shenzhen set up a bankruptcy court to handle cross-border cases, aimed at helping officials in Guangdong trace assets of bankrupt businesses in the mainland that have been transferred to Hong Kong. In the first ten months of 2018, according to the Supreme People's Court, 6,647 bankruptcy cases were settled, more cases than the 6,257 bankruptcies in the whole of 2017. As early as 2016, anticipating larger bankruptcy caseloads, a number of provincial-level courts and governments announced plans for measures to help bankruptcy processes move more smoothly, efficiently and transparently. Although their approaches vary, measures being taken include simplifying the proceedings in minor and uncontested cases, establishing a special bankruptcy division within the courts, and setting up information-sharing mechanisms. It remains to be seen how these measures will be implemented in practice, and what their impact will be on bankruptcy and reorganisation practices in China.

In August 2017, CBIRC (then CBRC) told the fifth session of the 12th National People's Congress that it was preparing rules on bankruptcy risk management. The new rules were to push forward legal protection for close-out netting, the primary means of mitigating credit risks associated with OTC derivatives, according to CBIRC, which said it would work with the International Swaps and Derivatives Association to establish a close-out netting arrangement for Chinese commercial banks.

This reform, along with the 2015 introduction of a deposit insurance guarantee scheme, would provide additional clarity about investors' place in the credit structure of Chinese banks, which has been unclear due to the implicit government guarantee. The deposit insurance system guarantee accounts with deposits up to RMB 500,000 (US$74,400). In February 2019, CBIRC released draft rules for industry comment setting clear limits on the business areas in which bad-debt managers could operate, including provincial level bad-debt managers as well as the four dedicated NPL managers set up in 1999. The rules would allow the institutions to acquire, manage, operate, and dispose of NPLs and engage in debt restructuring, debt to equity swaps and bankruptcy management, but prohibit the use of repo agreements which would allow banks to sell bad loans for future repurchase.[46] Given the relative clarity of the new rules for disposition of NPLs, regulators should consider allowing foreign financial firms to purchase NPLs directly from commercial banks.

Commercial banks wrote down or sold off an estimated RMB 1.75 trillion (US$258 billion) in bad debt in 2018, the most in 20 years, as economic slowdown, a regulatory crackdown on shadow banking, which tightened credit conditions and stricter accounting rules on NPLs have led to more debt defaults. The merger of the former China Banking Regulatory Commission (CBRC) and China Insurance Regulatory Commission (CIRC) into CBIRC, announced at the March 2018 meetings of the National People's Congress, should have helped to limit risky lending practices and reduce high corporate debt levels in China's US$42 trillion banking and insurance sectors, with PBOC handing a macro-economic supervisory role and the merged regulators handling operational control. In July 2018, the government created the FSDC, a cabinet-level agency to coordinate financial regulators, whose first meeting, chaired by Vice Premier Liu He, listened to a report by PBOC governor Yi Gang on the government's plans for handling financial risk through 2020.

Despite such positive developments, China has not yet implemented a resolution and recovery regime for financial institutions that is consistent with the Financial Stability Board's (FSB's) Key Attributes of Effective Resolution Regimes for Financial Institutions, which provide global guidance on how to resolve or recover assets related to a financial institution. These were introduced following the 2011 G20 Summit in Cannes, France, and amended in October 2014. The key attributes set a new international standard of 12 essential features that should be included in resolution regimes for all jurisdictions, including the domestically incorporated global systemically important financial institutions (G-SIFIs) that should have a recovery and resolution plan (RRP or “living will”) in place; a named resolution authority with defined powers; limits on statutory or contractual set-off rights; clear rules respecting the creditor hierarchy; funding policies to avoid public bailouts; a legal framework for cross-border cooperation; and specific mechanisms for crisis management, resolvability assessments, recovery and resolution planning, and information sharing.

While China has not set a timetable for building a bank resolution regime consistent with the Key Attributes, we expect the government to expedite its legislation process to establish a bankruptcy procedure for banks that will serve as a basis for a functioning bank resolution regime. This may come in the form of a draft for consultation in the next one or two years, with a consultation paper to follow. The CBIRC agreed to establish a working group on netting during the ninth annual UK-China Economic and Financial Dialogue convened in Beijing in December 2017. The draft of a resolution regime is rumoured to be contingent on netting.

On 1 March 2018, in a broad regulatory update of capital-bond issuance, the PBOC for the first time referred to bonds eligible for Total Loss-Absorbing Capacity (TLAC). Issuance of TLAC bonds would be credit positive for banks’ depositors and senior debt-holders because it would provide a larger cushion to absorb losses and recapitalise a failing bank. The TLAC proposal emerged as one of the final components in the post-crisis effort to address the “too big to fail” problem. The purpose of TLAC is to set a minimum capacity for global systemically important banks (G-SIBs) to absorb losses and recapitalise themselves and to ensure that they have the resources to facilitate an orderly resolution strategy that minimises financial instability and avoids taxpayer-funded bailouts. TLAC bolsters capital and leverage ratios and will apply in addition to capital requirements set out in the Basel III framework.

The official reference to TLAC signals that China is starting to implement its own adaptation of the international resolution framework. On 30 January 2018, regulators disclosed their comment on European Union’s Capital Requirement Directive Article 21b, saying that “currently, Chinese global G-SIBs have all prepared to implement TLAC.” All previous official references to TLAC were in the area of research.

G-SIBs based in an emerging-market economy like China’s will need to comply with the minimum TLAC requirement for risk-weighted assets (RWAs) and for the Basel III leverage ratio’s denominator in two phases: 16% for RWAs and 6% for the leverage ratio’s denominator by 1 January 2025 and then 18% for cross-border aspects of the implementation RWAs and 6.75% for the leverage ratio’s denominator by 1 January 2028. This implementation schedule is six years later than that for G-SIBs in developed markets and applies exclusively to China because it is the only emerging-market economy with G-SIBs.

China is home to four G-SIBs as defined by the FSB and has several large domestic banks with growing international footprints and global aspirations. If China’s resolution regime does not fully reflect globally agreed standards, it may potentially affect international banks. Furthermore, implementing a resolution and recovery regime compliant with the Key Attributes would force investors to consider the credit quality of Chinese banks – by pricing the bonds of the four G-SIBs differently from those of a small provincial lender – when purchasing their bonds or other investment products.

Although more detailed guidelines are forthcoming, the latest policy statement opens the way for much earlier implementation, which helps reduce uncertainty on timely compliance by China's four G-SIBs – the Agricultural Bank of China, Bank of China, China Construction Bank and the Industrial and Commercial Bank of China. Regulators have yet to specify whether any of China's banks other than the G-SIBs will be subject to TLAC requirements. In November 2018, PBOC said that it would expand the list of G-SIBs to include global systemically important financial institutions (G-SIFIs), such as securities companies, insurers and non-commercial policy banks in its new lists. Although PBOC did not disclose the names of G-SIFIs on it list, its statement referenced the FSB and the BCBS as models for Chinese regulators working at the national level. [47]

A key point of interest is that the central bank has given broad guidance that TLAC bond issuance should follow the updated regulation on capital bonds. All capital bonds must contain explicit terms that require either principal write-down or conversion to equity at a specified trigger point, such as the point of non-viability, as determined by the banking regulator. Effectively, TLAC-eligible instruments to be issued will need to have loss-absorption clauses included in their contract. This would suggest that Chinese banks would not be able to meet their TLAC requirements by setting up holding companies to issue structurally subordinated senior debt, the method adopted by Japan, the US and potentially Hong Kong (as proposed in the Hong Kong Monetary Authority consultation paper on Loss Absorbing Capacity rules), to avoid entering into certain financial arrangements that would create obstacles to an orderly resolution.

This may be because China does not have a resolution regime yet that allows for the statutory subordination of a class of liabilities. By subjecting TLAC bonds to contractual write-down or conversion to equity along with other capital instruments, regulators appear to be aiming for TLAC implementation without necessarily having a resolution regime in place. Still, regulators have not formally rejected the option of statutory subordination as one of many ways to implement TLAC.

The introduction of TLAC instruments in China is not likely to reduce the likelihood of a state-funded bail-out. The Chinese government remains the biggest shareholder in the banking sector, while state-owned financial institutions tend to be major investors in bank debt, which renders moot the argument of using bail-in to save taxpayer money. It is therefore likely that Beijing will likely continue viewing a bailout as a preferred option when it comes to bank resolution.

4. Creditors' rights and close-out netting

As repo and other derivatives markets grow, Chinese regulators should consider strengthening rules governing creditors' rights. These reforms are essential for market participants to gain confidence in the enforceability of transactions and contracts, and are of particular importance for derivatives transactions and contracts, which are typically traded under master agreements and secured by collateral.

The enforceability of close-out netting, an established risk-management practice in all advanced financial markets, is a fundamental requirement for efficient markets. China is currently the only major global economy that is not perceived as having enforceable close-out netting protection**.** A lack of legal certainty over netting has caused problems for domestic and international banks that want to trade in China, since they have to set capital against offsetting trades on a gross basis, and Chinese banks report that they could reduce capital held against derivatives counterparty credit risk by as much as 20% if China's netting rules aligned with global standards.[48] Close-out netting enables all exposures to be recognised on a net rather than a gross basis, resulting in improved credit-limit utilisation. It also facilitates the taking of collateral to offset exposures and reduces the level of reserves required under the regulatory capital requirements. Furthermore, these protections allow market participants to increase their bilateral trading and settlement limits.

The lack of certainty regarding enforceability in China means that a bank's exposure to a Chinese counterparty is treated on a gross basis for regulatory capital purposes. Post-crisis regulatory reforms assign much higher capital requirements for non-netted trades, which sharply increases transaction costs. This also makes it extremely difficult for China to develop liquid derivatives and repo markets, both of which are required if their capital markets are to become deep, liquid and accessible to global investors.

For close-out netting to be enforceable it needs to be legally recognised in the jurisdiction of incorporation of the defaulting party, and the insolvency legislation should permit close-out netting in the event of a default or termination event under a master agreement in accordance with the terms of the agreement.

In China there have always been uncertainties surrounding the enforceability of close-out netting. Although the Supreme People's Court interpretation of the PRC Enterprise Bankruptcy Law (II) issued in September 2013 clarified that a non-defaulting party is entitled to calculate the exposure of all the terminated transactions on a net basis within the preview of bankruptcy set-off rules, it is not clear whether the non-defaulting party would be able to terminate all transactions once liquidation proceedings have commenced. The current view is that a non-defaulting party's ability to terminate all outstanding derivative contracts under a master agreement is subject to the administrator's moratorium power under the Bankruptcy Law. Banks, however, are reluctant to use netting agreements without explicit permission from regulators because of the lack of clarity under China's bankruptcy law of how derivatives would be unwound in case of a default.[49]

In order to attempt to safeguard the right to close-out, it would be necessary to apply the modified Automatic Early Termination (AET) provision in the ISDA master agreement. The 2013 Supreme Court Notice clarifies that the courts would review a bankruptcy petition to ensure it conforms to certain statutory requirements prior to registering it. This would appear to prevent a premature triggering of the termination under such a master agreement. However, the validity of this provision has not been tested under the Bankruptcy Law.

Meanwhile, China is one of eight jurisdictions that have implemented the new standardised approach to counterparty credit risk, from January 2019, which makes it even more pressing for China to adopt close-out netting. Without netting, capital requirements under the new methodology may increase, compared with the existing current exposure method. The Standardised Approach Counterparty Credit Risk (SA-CCR) recognises effective netting between designated derivative products grouped into hedging sets. However, the methodology assumes that aggregated trade exposures offset by collateral are also covered by a close-out netting arrangement, and there is no easy way to deal with collateral and margining if netting is not enforceable. China's SA-CCRC rules, published in 2018 by CBIRC, include paragraphs encouraging banks to sign netting agreements with their counterparties, but do not make it mandatory and have not publicly put out statements suggesting ways to manage counterparty credit risk calculations under the new law.

There are several netting initiatives that are understood to be in progress in China:

- A new Futures Law is being drafted and it is hoped that it will include netting provisions applicable to OTC interest rate and FX products. However, the timing of the conclusion of its drafting and implementation is uncertain.
- CBIRC is drafting Financial Institution Resolution and Bankruptcy Guidelines but the timeline is unclear. New bankruptcy guidelines for commercial banks will apparently include netting provisions.[50]

Close-out netting should be incorporated clearly and unambiguously in statute or alternately by clarification of its enforceability by Supreme Court opinion, reflecting internationally accepted practices. In addition, while netting between banks should be a priority, authorities should also work on netting between capital markets participants more generally which could be addressed by the aforementioned Supreme Court opinion.

China and the UK have committed to strengthen information sharing to promote a study on China's close-out netting rules, and have established a UK-China Netting Working Group led by CBIRC and China Banking Association (CBA), along with ASIFMA and ISDA. The latter was set up as a result of the ninth annual UK-China Economic and Financial Dialogue convened in Beijing in December 2017 and we are hopeful that concrete progress on an agreed way forward by all relevant stakeholders will made in 2019 with implementation in 2020.

5. Use of collateral

It is currently not common practice for financial counterparties to exchange collateral to cover domestic OTC derivative exposures. In addition, the Securities Law does not fully support the exchange of variation margin used in the international markets. Existing Chinese law does not incorporate the concept of floating charge over securities. However, the situation has improved. In practice, ASIFMA members have found it possible to provide security in the form of assignments/pledges for exposure related to OTC derivatives or bond repos. The infrastructure of CCDC does support mark to market calculations and collateral calls. In addition, for margin finance of the stock lending business of securities companies, Chinese regulations rely on trust law to ensure that securities companies have sufficient collateral from clients. This mechanism also supports mark to market calculations and collateral calls.

Despite such progress, third-party custodians used to hold initial margin on behalf of the posting counterparty do not currently exist in China. Pending a full liberalisation for foreign investors to hold onshore debt securities under Chinese regulations, there remain certain practical difficulties for a foreign institution to use onshore debt securities as eligible collateral and credit enhancement for its ISDA transactions.

The absence of clear netting rules, a legal framework supporting collateral enforceability and the lack of technical and market infrastructure to support the exchange of collateral is expected to have negative consequences for onshore liquidity following the implementation of the G20 post-crisis regulatory agenda, specifically the requirement to exchange margin on non-centrally cleared OTC derivatives.[51] Collectively, the absence of these institutional pillars that individually and jointly contribute to supporting the smooth and efficient functioning of all financial markets increases the cost of hedging and reduces the efficiency of derivatives as risk mitigation tools. The first deadline to exchange initial and variation under the margin regime was on 1 September 2016 and applied to a limited number of international Phase 1 entities with an uncleared OTC derivatives exposure greater than US$ 3 trillion.

While Chinese onshore entities did not fall within the scope of the September deadline, the requirement to collect and post variation margin with any "covered entity" from 1 March 2017 has had an indirect impact on Chinese entities. In particular, the rules govern exposures with covered entities in non-netting jurisdictions, such as China, impacting the ability of international banks to trade with entities in these jurisdictions, so that, with phased requirements gradually expanding the scope of coverage, ultimately relatively small trades (the final threshold coming into effect in 2020 is US$8 billion) will require compliance.

China joined Argentina, Brazil, Indonesia, Mexico, Russia and Turkey in failing to finalize uncleared margin rules by the initial deadline, and regulators provided a six-month extension through September 2017 to allow full compliance. The phase-in requirements run through September 1, 2020, when the requirements become permanent and a "cliff effect" will occur as Phase 5 of the Basel rules drops the threshold for compliance to entities with just US$8 billion in aggregate average notional amount (AANA) of uncleared derivatives at the group level. The change will bring into scope more than 1,100 counterparties, equivalent to 9,500 trading relationships and 19,000 new custodial relationships that will need to be established, according to an ISDA survey.[52]

However, compliance burdens of the proposed US$8 billion threshold have aroused controversy in the derivatives industry, and the Basel Committee on Banking Supervision and International Organisation of Securities Commissions (BCBS-IOSCO) released a joint notice in March 2019 that said any changes made to legacy derivatives contracts made "solely for the purpose of addressing interest rate benchmark reforms" should not be required to adhere to the margin requirements for non-cleared swaps, with local jurisdictions making their own jurisdictions. The move was viewed as a relaxation of the post-2008 requirements and covers legacy London Interbank Offer Rate (Libor) swaps transactions from before the

US Commodity Futures Trading Commission (US CFTC) first implemented mandatory central clearing in 2012.

6. Anti-Money Laundering Regime (AML)

China Anti-Money Laundering (AML) regulators have been recognising the risk-based approach in AML regulation and law enforcement. The industry, however, still expects more practical use of such an approach to different areas of AML.

In areas of client and its beneficial owner identification and verification, for examples, overseas regulators often give exceptions on the ID copy requirement on beneficial owners for public companies or regulated entities as such ID information is already acquired by exchange or industrial regulators. Senior managers' ID information, as required in Know Your Client (KYC) programmes, can also be waived if such information is already in certain government authority's data repository. Another example is that China KYC regulation requires of ID copy information for authorised traders. Institutional investors, however, have very high turnover rates on such personnel and the China requirement places an unreasonable burden on market players especially when one considers the entity governance structure of such institutional investors.

Some country or regional regulators limit the scope to a small group of authorised persons. For example, in Hong Kong or Singapore, the ID information requirements are mainly on those persons who have the authority to move client assets. These risk-based approaches can help improve the industry efficiency without sacrificing the goal of risk controls. Chinese AML regulation also requires an every six-month review of high-risk client identities, which is much higher than the 12-month frequency commonly seen in other jurisdictions. Such a requirement with a different frequency has created a lot of unnecessary maintenance costs for international firms.

We suggest China AML regulators further explore the application of risk-based approaches to specific rules and enforcement. At the same time, the industry can also have more discretion to implement a risk-based AML programme to comply with Article Nine of China's AML law.

7. Cyber security

The financial sector notes increasing emphasis on cyber security and data in China. In addition to the Cyber security Law (CSL), the Data Security Law and Personal Information Protection Law were included in China's 13th five-year plan (2016-2020) approved by the National People's Congress in March 2016 and date back to a 2010 government white paper. While the industry is supportive of strong protection of personal information and data in general, we strongly encourage China to consult with industry, align with international best practice and avoid unnecessary burdens to industry. Severely restrictions on international firms to transfer data across borders plus unclear, uncertain and sometimes intrusive cyber security requirements will significantly inhibit the functioning of capital flows.

7a. Cyber security Law

The Cyber security Law (CSL) adopted on 7 November 2016 and which took effect in June 2017 has introduced significant requirements for financial services and technology providers to enhance cyber and network security, such as increasing data protection and restricting the mobility of data collected onshore.[53] While it is important for governments to set cyber security standards, this should not be detrimental to financial service providers' abilities to provide legitimate services, conduct legitimate business in China and/or comply with international antimony laundering and KYC rules. The current law makes the business climate in China unpredictable for both foreign and domestic firms.

The current CSL adversely impacts the business and investment climate. The Cyber security Law and any other security legislation should enable sectoral regulators to carve-out functions that are critical to the integrity and stability of the financial system in China, such as those provided by financial services firms. It is hoped China takes a risk-based approach implementing cyber security law, ensures free flow of data, allows firms to adopt best-in-class technology products and services and avoids prescriptive requirements.

- *Regulatory overlap:* ASIFMA is concerned in particular with the overlapping and duplicative nature of cyber security regulations between the Cyberspace Administration of China (CAC), Ministry of Industry and Information Technology (MIIT) and Ministry of Public Security (MPS). We find that CAC and MPS both produce guidelines on protection of personal information which are not coordinated, making compliance more difficult than necessary. Other relevant regulators include CBIRC, CSRC and PBOC.
- *Technical standards:* Since 2010, the National Information Security Standardization Technical Committee (TC 260) has developed more than 300 draft standards related to cyber security under the umbrella of Information Security Technology. Although the standards are meant to provide additional details to provisions outlined in the CSL, but many are published simultaneously – giving industry insufficient time to respond and instead forcing it to pick and choose which standards to provide feedback on. In addition, China has expanded its data protection regime through the introduction of information security technology (IST) technical standards from TC 260's Personal Information Security Specification (GB/T. 35273-2017) and MPS's Guideline for Internet Personal Information Security Protection. A concern is that financial services companies would be designated "Critical Information Infrastructure (CII) Operators" and need to comply with onerous standards, certification and inspection processes, provide cyber security plans, and submit to opaque enforcement regimes. Many of these proposals are similar in scope to the CBIRC's directive on Secure and Controllable Information Technology, which was of concern to the industry earlier in 2015. Overall, ASIFMA would like TC260 to adopt global standards rather than setting up unique requirements.
- *CIIs:* ASIFMA calls for the CAC to fully define a CII and that CIIs will be designated at a system-level and not entity level. The definition should be narrowly scoped and adopt a risk-based management approach to CIIs. The CAC published guidelines for comment in July 2017 on its Rules

for Protection for CIIs and was originally scheduled to be finalised by 1 June 2018. ASIFMA submitted its consultation response on 10 August 2017 but understands that there have been differing views among key drafters regarding the scope of CIIs and competing approaches from sectoral authorities.

- *Data export security reviews*: Given that the obligations on CII operators is significant, the CAC should include a dispute resolution mechanism to allow firms to appeal in instances where it disagrees with the relevant authority's assessment. Additional onerous triggers (domestic whistle blowers and industry associations) for audit reviews in the second draft of the Guidelines for Data Cross-Border Transfer Security Assessment should be removed. Overall, ASIFMA's key concern is the potential prohibition of cross-border data flow when the nature of "important data" is established only after regulatory review. The free flow of data is vital for efficient operation of the financial sector, and the review process constitutes a significant barrier to financial operations in the mainland.

7b Penetration Testing

Industry recognises that penetration testing is important for maintaining robust network security. We are extremely concerned about the possibility of involvement in penetration testing by additional public sector actors as it may unintentionally increase or exacerbate existing risks. We advocate that company-led penetration testing be recognised by regulators as sufficient. We strongly recommend CSRC and other regulators remove penetration testing and system scanning requirements in cyber risk management related articles (among them CSRC Order No. 152) and initiate an open dialogue with industry stakeholders on this topic.

Recommendations for Laws and Regulations

1. **Increase regulatory transparency and consistency** by a more open market consultation process, providing sufficient notifications of new rules and allowing public comments.
2. **Improve transparency and reliability of auditing and accounting standards** to increase confidence by international investors in China's corporate governance.
3. **Improve the corporate resolution and bankruptcy process** to allow investors to predict the impact of defaults by, among other things, ensuring the enforceability of all investor's direct security interest, if any, in a fair, transparent and clear manner in a restructuring or bankruptcy.
4. **Implement a resolution and recovery regime** for financial institutions that is consistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.
5. **Incorporate clearly and unambiguously the enforceability of close-out netting** in statute, reflecting internationally accepted practices.
6. **Amend the Securities Law** to support the exchange of variation margin used in the international markets and reflecting internationally agreed standards.

7. **Anti-money laundering regime.** While the system needs to be robust, it should seek international best practice standards and a risk-based management approach, avoiding unreasonable burdens on market participants.
8. **Cross-entity collaboration:** Enabling various group entities to work closely together to reap efficiency and collaboration gains. Enabling various entities of a group to work closely together would enable efficiency and collaboration gains. Collaboration both within China and across borders, while keeping accountability local, would better reflect today's reality of global matrix organisations. For instance, a management group or committee could run all of a group's businesses in China centrally and across legal entities, while sharing central services through a Business Service Centres. As a reference point, CBIRC has recently approved Allianz Group's plan to establish a fully-owned holding company in Shanghai to carry out insurance, asset management and potentially other financial services under one China group structure.

Corporate governance recommendations

9. **Role of Party organisations:** Policy initiatives beginning in 2010 reinforced the role and importance of internal Party organisations (POs) in enterprises, both POEs and SOEs, with major statements and Article of Association amendments in 2017. More disclosure is needed on the role of the PO, which should produce a disclosure report comparable to the board of directors and supervisory board reports.
10. **There is a need to clarify the relationship between the PO and board of directors** in Company Law, and enhance board evaluations and committees.
11. **Supervisory boards:** China’s dual board structure includes a supervisory board (SB) whose functions overlap with those of the board of directors and audit committee. Both Company Law and official guidelines need to clarify the separation of duties between the SB and board of directors. SBs should be encouraged to use their full powers, and private firms should have a choice whether to include SBs in their governance structure.
12. **Clarification of roles:** The differences in role between board of directors, supervisory boards, and POs need to be clarified since these often overlap in function in practice.
13. **Revise the one-third rule for independent directors:** Nine-person boards with three independent directors are ubiquitous in the China listed ecosystem due to a rule that boards must have at least one-third independent directors. The one-third rules should be revised and companies should engage in director training and abolish attendance by proxy.
14. **Strengthen audit committees:** While corporate reporting has improved significantly since 2017 in the view of foreign institutional investors, the audit committees should play a stronger role and internal audit committees should report to them. External auditors also need to be given a stronger voice.
15. **Encourage investors to play a role in ESG reporting:** ESG reporting began in 2006, but there is still much confusion about its relevance to investors. Investors need to play a role in guiding listed companies to better compliance by focusing their attention on large caps, prioritizing their information needs around key issues, encouraging use of third-party and independent data, and experimenting with a “comply or explain” approach.

16. **Review takeover regulations and Company Law**: After peaking in 2016, the domestic M&A market has fallen off slightly, as deregulation has already worked through major sectors of the economy. SOEs account for most of the value of M&As, and are largely driven by policy concerns. Takeover regulations need review together with Company Law on shareholder meetings and voting.

H. Market Infrastructure

Infrastructure is important and needs to ensure connectivity with the rest of the world. There has been progress made especially with the introduction of the Cross-border Interbank Payment System (CIPS), which allows for payment interface with SWIFT.

1. Centralised clearing of OTC derivatives

The SHCH clears and settles trades, as well as provides registration and depository services for spot and derivative transactions in the interbank market. The centralised clearing service, which includes client clearing, covers certain CNY-denominated interest-rate swaps and USD/CNY FX forwards, swaps and options. While the SHCH is currently the only Central Counter-Party Clearing House (CCP) globally that offers the clearing of physically-settled CNY forwards, swaps and options, Hong Kong Exchange and Clearing Limited launched its USD/CNH cross currency clearing service in August 2016 through its subsidiary, OTC Clearing Hong Kong Limited and now clears deliverable USD/CNH forwards and swaps.

Despite the concerns that exist around the lack of close-out netting in China, the rules of the SHCH's FX clearing service provide for settlement finality and close-out netting. However, for as long as this is not supported by Chinese law, such rulebook language is of limited use. In addition to the requirement that clearing members are required to post-initial and variation margin, the SHCH also operates a guarantee fund and a reserve fund as part of its default management resources and each clearing member is required to contribute to the guarantee fund. Currently, the only eligible collateral for margin is cash.

At present only the clearing of CNY interest rate swaps is mandatory and there is currently no indication from the SHCH or China's regulators that the mandatory regime will be extended to FX products. The introduction of mandatory clearing has brought China in line with its G20 commitments and represents a significant step in developing its derivatives market. However, it does create other issues with regard to the recognition of the SHCH as a qualified CCP (QCCP) in third-country jurisdictions. While PBOC has determined SHCH is a QCCP for Chinese capital purposes, third-country market participants are not always allowed by their own regulators to rely on such determination.

During a default, the SHCH is able to close-out all outstanding positions of a defaulting member and settle on a net basis.[54] In addition, the SHCH has implemented rules that provide for AET.[55] However, as stated above, given an administrator's moratorium power under the Bankruptcy Law and the fact that the validity of the AET provision has not been tested under the Bankruptcy Law, there is a risk to clearing members in the event that exposures of an insolvent clearing member are not terminated by the time a court accepts the bankruptcy petition.

The SHCH's clearing rules and clearing agreement state that settlement for cleared products is irrevocable upon completion. However, China lacks statutory provisions for settlement finality on transactions with a CCP as the Bankruptcy Law supersedes the clearing rules. In its Principles 1 and 8, the PFMI specifically mandate well-founded, clear, transparent, and enforceable legal basis and clear and certain final settlement, respectively. Consequently, if a clearing member becomes insolvent, a Chinese bankruptcy administrator can recover settlement funds paid by that clearing member to the SHCH if the facts show that the clearing member preferred SHCH over other creditors. In addition, and for the same reason, the administrator also has the ability to revoke the application by the SHCH of an insolvent member's guarantee fund contributions, thereby creating potential liabilities for the non-insolvent clearing members.

The ability of a clearing house to use collateral posted by its clearing members is essential to its risk management practices. A clearing house typically takes a security interest in collateral so that its claim in respect of the collateral can benefit from a legally recognised priority. Alternatively, the title to the collateral can be transferred from the clearing member to the clearing house outright.

However, the SHCH does not adopt the normally recognised approach. Instead, under the clearing rules, a clearing member is required to transfer cash into a margin account opened by SHCH with a commercial bank. Cash margin collected from all members is then deposited into the same margin account. Neither the clearing member nor SHCH creates a security interest over cash in the margin account in a way that is recognised by the China's Property Law or Security Law. That said, we note that such an approach has also been used in the Chinese futures market. The Chinese futures market has been established for more than 20 years, during which time the validity of such cash collateral arrangement in the futures market has not been challenged or invalidated by the Chinese courts.

There is currently no legal recognition of the bankruptcy remoteness of collateral posted under central clearing, which means that in case of an insolvency of the CCP, such collateral could become an integral part of the CCP's bankruptcy estate.

There is also a potential concern if the SHCH were to call for clearing members' replenishment payment to cover shortfall in the guarantee fund that such payments could lead to unlimited liabilities. In addition, in the event of multiple members' defaults, there is the concern that such member replenishment requirements could lead to unlimited liability.

2. QCCP status of the SHCH

In the aftermath of the global financial crisis of 2008, the G20 derivatives regulations created significant extraterritorial requirements. In particular, there is a need for CCPs under the rules of those jurisdictions operating mandatory clearing regimes to be recognised as a QCCP. Despite the PBOC recognizing the SHCH as a QCCP, failure to be recognised by other jurisdictions could limit the participation of entities from those jurisdictions in the Chinese OTC derivatives market. The latest publicly available yearbook of SHCH, for calendar year 2018, lists 15 international banks registered as clearing members of the SHCH through their Chinese subsidiaries.

In Europe, the European Commission must assess whether a CCP operating outside of the EU does so under an equivalent regulatory regime. The failure to do so results in a third-country CCP unable to be recognised as a QCCP. Under Article 25 of the European Market Infrastructure Regulation (EMIR), there are rules that prevent European "covered persons" from participating in third-country CCPs that have not received recognition from the European Securities Market Association (ESMA). In addition, under the Revised Capital Directive (CRD IV), European banks clearing through either a branch or a subsidiary will face risk weights of more than 1,250% on their exposure to a CCP that has not been recognised under EMIR.[56] However, when clearing on a QCCP the risk weighting is 2%. This increased capital charge is a significant disincentive for European banks to participate on non-recognised CCPs. The SHCH has yet to be recognised as a QCCP by the European Commission. However, in December 2016, the implementation date of the Capital Requirements Regulation (CRR) was delayed and has yet to be realised.

In the US, there is a requirement under the Dodd Frank Act for third-country CCPs to either apply for recognition as, or exemption from, being a Derivative Clearing Organisation (DCO). Failure to do either will mean that US persons – US banks and their overseas branches but not their overseas incorporated subsidiaries – clearing on a third-country CCP will be in breach of Section 5b of the Commodity Exchange Act as modified by the Dodd Frank Act. In April 2016, the SHCH wrote to the US CFTC requesting a period of no-action relief. The relief was granted in May 2016 for one year, allowing it to temporarily clear swaps subject to the mandatory clearing obligation in China for the proprietary trades of US persons that are clearing members of the SHCH. In July 2018, the US CFTC decided to extend its no-action relief for another three years, raising expectations that it might grant a permanent exemption from formal registration.

In theory, the US CFTC's action should provide US banks with the incentive to start to offer mandatory cleared products onshore. However, with China's legislation on futures law still pending, and no legal basis for netting, settlement finality and bankruptcy remoteness, it remains challenging for US regulated banks to consider SHCH to be a QCCP. Full disclosure by SHCH of its PFMI self-assessment would help US-regulated banks assess its QCCP status, noting that it has achieved a rating of 4 under the latest CPMI-IOSCO list of self-assessments as of January 2018.

Equivalence under EMIR and recognition or exemption as a DCO by the US CFTC is particularly important in the context of the CIBM and Bond Connect opening initiatives currently under way as well as the QFII/RQFII programme. Under these initiatives, international participants in the CIBM and Bond Connect will be allowed to carry out a range of hedges, including CNY interest rate swaps that are subject to mandatory clearing. However, the ability of EU- and US-regulated entities to participate on this market will be hampered if the SHCH has failed to obtain equivalence or exemption status prior to the expiry of the current CRR implementation delay and the current US CFTC no-action relief.

3. Omnibus and segregated account structures

Aggregators, like global custodians (GC), International central securities depositories (ICSDs), prime brokers and private banks typically access markets using an omnibus structure for their end clients. This is already the case for China's H-shares and Stock Connect programmes which allow omnibus structure to trade multiple products. From September 2018, HKEX began implementing BCAN IDs across SPSAs at the fund manager level for northbound investment with minimal issues reported by both members and the exchanges. This has been helpful for average pricing and post-trade allocations but falls short of Omnibus Trading (Super SPSA) via Stock Connect which could further improve trading efficiencies.

However, with the exceptions mentioned above, China generally operates under a segregated account structure model with individual investors opening accounts directly in CSDs, which act as share registrars under Chinese regulation. Historically, this process was intended to protect domestic investors by allowing them to avoid counterparty risk with brokers. This is especially important during the early-stage development of a securities market. The central registry allows investors to reclaim their securities more easily in the event their brokers become insolvent and prevents misuse and misappropriation of investors' assets by unscrupulous brokers.

As a market matures and opens more broadly to foreign institutional investors, the two account structures may co-exist. For example, Singapore requires segregated accounts for domestic retail investors but allows omnibus accounts for sophisticated and foreign investors. This arrangement provides the flexibility to accommodate needs of international investors without impacting domestic retail investors.

Omnibus accounts help sophisticated institutional investors access local markets more quickly and efficiently. These investors are already subject to rigorous home regulations such as Undertakings for Collective Investment in Transferable Securities (UCITS V) in Europe, the Alternative Investment Fund Managers Directive (AIFMD) also in Europe, the Dodd-Frank Act in the US together with Securities Act of 1940 together with the Employee Retirement Income Security Act (ERISA) of 1974 that require them to segregate the assets of their clients, or have those assets held by independent custodians.

The benefits of using omnibus accounts are primarily:

- Simplified market access for investors without necessity of registering and having an onshore service provider
- No account opening and KYC challenges involved for onshore investors
- Standardised services received for bond participation
- Provides RMB internationalisation with offshore RMB trading
- Helps aggregators to facilitate collateral management and in funding for trades

Leveraging these potential benefits, we have the following recommendations that may be considered as an alternative to the segregated account structures currently in place:

- Onshore Local Custodians (LC) can open a special depository and a special cash account in the name of a global custodian (GC) and international central securities depository (ICSD) titled "LC for GC/ICSD" with the depositories and the LC.

- These accounts will be nominee accounts where the onshore nominee, being LC, will hold securities for eligible end investors such as those who access CIBM through the GC/ICSD.
- Where permitted by the Financial Action Task Force (FATF) regulations the LC can rely on the regulated intermediaries – GC and ICSD for KYC and/or AML protection of the investor where it is not opening any account for the investor or require any other documentation about the investor.
- Require the investors and GC/ICSD to furnish any information and such details as specifically required by PBOC. Non-furnishing of such information by investor or by the GC/ICSD within a specified period will make the investor ineligible to trade in China securities. The GC/ICSD may also be penalised or disqualified to provide such services if considered appropriate by PBOC.
- Consider adopting the introduction of a prime broker role for onshore trades, in order to increase infrastructural efficiency and convenience.
- Investors accessing through an ICSD and GC should be permitted to trade with another investor with the same GC or ICSD, possibly, subject to certain conditions like:
    - Only DVP – Receive versus Payment (RVP) trades are permitted (Delivery versus Payment and Receive versus Payment)
    - Repurchase, borrowing and lending trades are permitted for financing and collateral management purposes
    - All such offshore OTC trades must be settled using offshore RMB
    - All such OTC trades must be reported to CFETS by the GC or ICSD through the LC by T+1

The recent opening up of the CIBM has brought a lot of investor interest but the existing account structure still creates some discomfort for foreign investors who are used to operate through intermediaries. While omnibus account and nominee structure are not available through bond settlement agents, some examples of similar structures can be found in China which could be leveraged to facilitate investors' access.

The direct holding structure (that is, segregation) used in China exists in other bonds markets where limited foreign participation is observed. It is also common in the equities world where the trading activity takes place primarily on exchange, requiring market proximity, as prices can fluctuate very fast unlike bonds which are traded OTC and see minimal price difference intraday.

There are numerous debates around the world about the best account structure in the context of clearing and custody. To date no definitive answer has been found as each model has advantages and limitations but some trends are emerging.

In the context of clearing, in order to achieve "portability"[57] central counterparties identified up to 16 different account structures and tend to leave the choice of being direct or indirect to their members. A new concept emerged from their analysis, the "Legally Segregated Operationally Commingled" (LSOC) account structure balancing efficiency and transparency.

In the context of custody, both segregated and omnibus (for example, multi-tiered custodial arrangement) account structures exist and sometimes can be found in the same market. Both structures serve domestic investors well, but the omnibus account structure is preferred by foreign investors who work on a cross border basis.

The absence of omnibus is considered as a market entry barrier by the Group of Experts appointed by the Asia Development Bank for the Asia Bond Market Forum (ABMF) to which China is a member.

The omnibus account structure permits securities to be used as collateral on a cross-border basis. A lot of the offshore liquidity created on the books of Euroclear comes from financing. This offshore liquidity not only offers greater stability of foreign investments but also translates into a greater onshore liquidity. As an example, after Russian bonds became eligible in Euroclear, the domestic CSD reported that the local activity was multiplied by three.

In the context of TARGET-2 Securities (T2S), which is to date the largest project of markets interoperability, all European markets had to introduce the omnibus account concept in their rules and regulations in order to connect to T2S.

Examples of account structures in China which have similarities with the omnibus:

- QFII, RQFII, wealth management products, trust, asset management products issued by securities companies, are all unincorporated entities that open direct accounts in the CSDs, but from an account name perspective, it is not possible to identify the final beneficiary owner, therefore by nature, it should be categorized as multi-tiered custodial structure.
- CCSDCC (Chinaclear) omnibus account with CCDC (Chinabond) for listed bonds. (特殊结算成员 - Tèshū jiésuàn chéngyuán)
- Hong Kong equities and fixed-income market are operated under an omnibus and nominee structure.
- All offshore RMB centres around the world operate under an omnibus account structure.
- Over-the-bank-counter bond business uses multi-tiered custodial arrangement. “Administrative Measures for the Over-the-counter Trading of Book-entry Treasury Bonds at Commercial Banks” (PBOC 2002, No.2) and “Administrative Measures for Commercial Bank Counter Business in the Interbank Bond Market” (PBOC 2016, No.2) all clarified that Commercial Bank Counter uses sub-custodial structure.

The B-shares scheme allows multi-tiered custodial arrangement. Article 22 of the “Regulations of the State Council on Foreign Capital Stocks Listed in China by Joint-Stock Companies” states that investors of B-shares can hold shares under the nominee’s name. More recently, Bond Connect was designed around an omnibus account at CCDC and SHCH level for the Hong Kong market infrastructure but investors do not benefit themselves from the feature.

Several articles relating legal concepts in China with similarities with the nominee concept:

- Article 18 of the Administrative Measures for Registration and Settlement of Securities (Decree No.29 of CSRC) stipulates that "Securities shall be recorded in the accounts of the actual securities holders, unless laws, administrative regulations or CSRC rules otherwise provide that the securities may be recorded in accounts opened in the name of nominee holders. In order to perform its functions in accordance with law, the securities registration and settlement institution may require a nominee holder to provide the relevant information about beneficial owners in its name."
- Also, the first paragraph of Article 16 of the Administrative Measures of Domestic Securities Investment by Qualified Foreign Institutional Investors (Decree No.36 of CSRC), jointly promulgated by CSRC, People's Bank of China and State Administration of Foreign Exchange, stipulates that "A QFII may apply to the securities registration and settlement institution for opening a securities account, in the name of actual holders or nominee holder."

These two clarifications show that the nominee concept is recognised to a certain extent in China, which is in line with international standards and market practices in most mature financial markets. Intermediaries such as custodians or infrastructures: (International) Central Securities Depositories, merely facilitate foreign investments in local markets for international investors and are not the ultimate beneficial owner of the securities. They only act as a nominee to hold the securities on behalf of a group of underlying clients or intermediaries, with whom they have a contractual relationship. Some of these clients may themselves act as intermediaries.

This is for instance set out in CPSS/IOSCO (International Organisation for Securities Commission) Principle 11: "While the title to securities is typically held in a CSD, often the beneficial owner (…) of the securities does not participate directly in the system. Rather, the owner establishes relationships with CSD participants (or other intermediaries) that provide safekeeping and administrative services related to the holding and transfer of securities on behalf of customers."

Our recommendation is to allow custodians to open omnibus accounts in the local CSDs for both securities and cash in order to facilitate the participation of foreign investors in the China capital market. This should preferably be combined with recognition of the nominee concept in order to ensure optimal asset protection for the investors. The omnibus account structure can co-exist with the direct holding structure and can be implemented with no disruption to the existing domestic operating model. The omnibus account addresses the efficiency dimension while the nominee legal structure addresses the beneficial holders' asset protection.

In general, full transparency can be achieved without the segregation at account level but some recent developments demonstrated that there was a possibility to combine a segregated account structure with the benefits of allowing offshore settlement (for example, solution implemented in Malaysia by Euroclear as of 29 April 2019).

4. Delivery Versus Payment (DVP) alignment to global practices

China's equity market is unique in that stocks are settled on the day they are traded, on T+0. Cash, on the other hand, settles the next day, on T+1. This system is admirably efficient and works because China requires all the shares and cash to be fully "prefunded" before the investor could place a buy or sell order. However, for investors this practice requires Free of Payment (FOP) transfers and counterparty risk, in contrast to Delivery vs Payment (DVP) which is the standard in other markets. It also creates "cash drag", a degradation in investment performance since the prefunded cash will earn little or no return. Prefunding also creates trading inefficiencies due to the need for additional pre-trade checking to ensure cash and securities are available before the trade is placed. In most markets, investors have no prefunding requirement; hence trades can be executed immediately. Time-zone differences exacerbate the operational challenges.

Most markets take longer to settle stocks and cash but in these other markets, settlement of stocks and cash occurs simultaneously (DVP) and with sufficient time lag following a trade for counterparties to confirm trades, arrange for delivery of FX as needed, to transfer cash, correct problems, and to settle. Europe moved to a T+2 cycle in 2015, the US followed suit in 2017, and several southeast Asian markets did likewise in 2018 (Thailand, Indonesia, Singapore) as the pace of international alignment towards a harmonized settlement cycle accelerated.

The A share investor selling a security is subject to counterparty risk vis-a-vis his broker for a day. If the broker finances the sale proceeds for the client by delivering the cash on T+0 to eliminate this risk for the client, the broker incurs financing costs and takes on counterparty risk vis-a-vis the exchange clearing house. In addition, standard settlement for the RMB spot market is T+2 in China, as in other FX markets. The difference between FX and stock settlements creates another added cost for foreign investors who have to convert currency on a non-standard cycle of T+1 for equity trades.

There is no doubt that settlement differences in the Chinese system create additional costs and risks for non-Chinese investors and their brokers, especially for large long-only investors who typically have multiple custodians.

There has been a partial solution for this problem in both equities and fixed-income markets. Real time delivery against payment (RDVP) settlement, which is critical for many foreign institutional investors (FIIs), particularly public/retail funds and their investment managers and custodians, was finally achieved for northbound Stock Connect in November 2017. This has allowed foreign fund managers to trade with multiple brokers in Hong Kong instead of trading only with the broker that is connected with the custodian of their funds or clients, usually part of the same group (the integrated model). Prior to having real time DVP, either the broker or the custodian had to advance the cash to the fund manager or client on the trade date (T) when the shares have to be settled as the cash is not settled or received until the day after T (T+1). Owing to the compressed settlement cycle and global time zone issues, RDVP is currently used only for CNH settlements but not yet for clients settling in USD. Therefore, it would be helpful if China stock markets moved to T+1 DVP and central bank payment time was extended till 6 pm. RDVP settlement also became available for not only Chinese corporate bonds but also government bonds under the Bond Connect in August 2018.

5. Payment infrastructure

RMB is cleared domestically through the China National Advanced Payment System (CNAPS), a central bank operated RMB clearing system which provides real-time gross and net settlement. To have direct access to CNAPS a bank is required to have a settlement account at a branch of China's central bank.

One reason behind the disproportionately small use of the RMB as a settlement currency has been the inadequacy of the infrastructure supporting cross-border RMB payments, which were made via a patchwork of clearing hubs and correspondent banks. Payments were hindered by complicated routing procedures, the need to maintain multiple foreign correspondent accounts, liquidity shortages in some offshore RMB clearing centres, different hours of operation between clearing centres and a lack of common standards between international and Chinese domestic payment systems.

Top 15 Offshore RMB Economies by Weight, January 2019

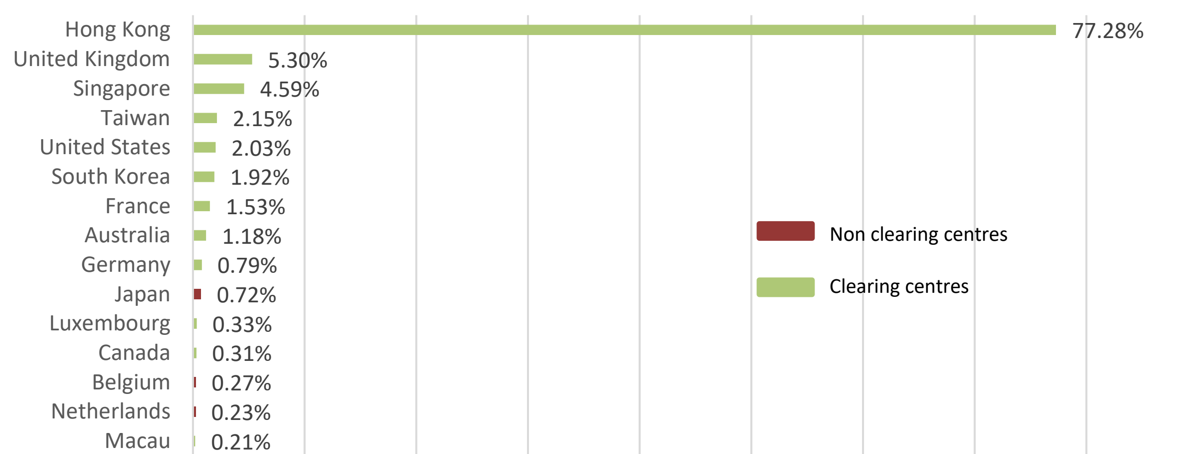

Fig.28: Customer initiated and institutional payments inbound and outbound traffic, based on value, excluding China
Source: SWIFT RMB Tracker February 2019

Currently, there are twenty RMB clearing centres globally. The dominant centre is London, with 36.68% of transactions in January 2019, followed by Hong Kong, with just under 30% of all foreign exchange transactions, according to the Society for World-wide Interbank Communication's (SWIFT's) RMB Tracker. Now all major financial centres and several key Chinese trading centres are serviced by a dedicated RMB clearing bank that facilitates RMB payment and settlement of transactions between market participants. Clearing banks reduce the risk on the RMB side of the transactions, while the non-RMB side can remain exposed to risks.

Top Countries Doing FX Transactions in RMB

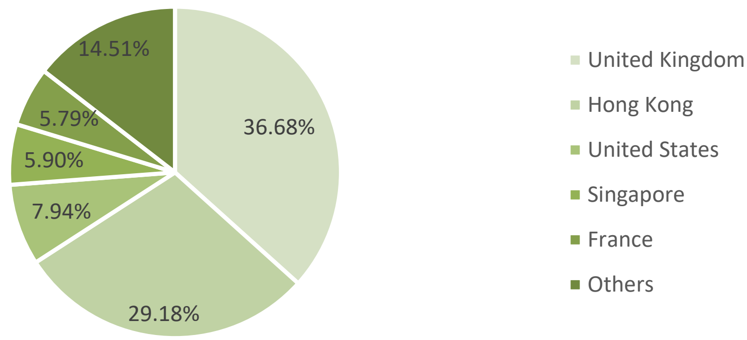

Fig. 29: FX confirmations, including central banks, excluding China, based on value, January 2019
***Source:* SWIFT RMB Tracker February 2019**

In 2015, China launched the Cross-border Interbank Payment System (CIPS), a cross-border RMB payment system based in Shanghai, to address these issues. CIPS is a real-time gross settlement system that provides one-point entry for participants and a central location for clearing RMB payments by allowing direct access to onshore banks and indirect access to onshore and offshore banks.[58] Funding of CIPS accounts is completed via CNAPS. It has reduced the need for banks to navigate complicated payment pathways via offshore clearing hubs or through correspondent banks to facilitate faster payment processing and a reduction in cross-border payment costs; however, quite a few international banks still use SWIFT infrastructure to send payments into China despite the availability of the CIPS interface.

CIPS was an important step to rectify deficiencies in RMB settlement and will play a critical role in its growth as an international payments currency. Because payment messages are now supported in both English and Chinese and it operates the ISO20022 messaging standard and SWIFT bank identifier codes, cross-border payments made through CIPS have been able to achieve higher straight-through processing rates. In addition, the extension of its operating hours from 9:00am to 8:00pm Shanghai-time means the system has made it possible to overlap with business hours in Europe.

However, there are still improvements to be made. The official launch of Phase II was on 2 May 2018, when CIPS began operating 24 hours a day based on the statutory working days of China, with a deferred net settlement (DNS) mode on the basis of real-time gross settlement (RTGS) to offer a liquidity saving hybrid mechanism, support for financial market transactions, with RMB payment for DVP, PVP in RMB and foreign currencies, settlement of centralized clearing of CCP, and RMB settlement of other cross-border transactions. It also allows a wider variety of direct participants, an improved message system, and a CIPS backup system in Wuxi, in Jiangsu province. To further grow the use of the RMB as an international payment currency there needs to be an increase in the number of international banks that are CIPS members even though as of as of 26 April 2019, there are 834 CIPS IPs from 89 countries and regions. There are also 478 CIPS indirect participants (IP) which are located outside of China although these numbers are based on the number of banking entities, not banking group (HSBC has 10 entities globally, which are CIPS IP. They count these as 10 rather than 1).

Although the physical settlement infrastructure of RMB FX instructions has evolved considerably, in some aspects it might not comprehensively reflect and fulfil globally agreed best practice standards:

- Settlement of RMB transactions is completed predominantly on a non-PVP basis. This exposes participants to principal risk (or Herstatt risk), the risk of a loss of the full value of the transactions. In line with the BCBS Supervisory Guidance,[59] where practicable, banks should use financial market infrastructures (FMIs) that provide PVP settlement to eliminate principal risk when settling FX transactions
- Settlement of RMB transactions is not provided in central bank funds in all jurisdictions or in the counter-currencies. The PFMI[60] provide specific guidance as to settlement in central bank money to limit credit and liquidity risks
- Settlement of RMB transactions is usually on a gross or bilaterally-netted basis. Market participants are unable to realise the significant liquidity benefits of multilateral netting that are available to Continuous Linked Settlement (CLS)-eligible currencies settled by CLS

As demand for RMB settlements continues to grow, it will increase pressure on liquidity and counterparty limits and on assuring risk mitigation for the notional amounts to be settled. For internationally active banks, holding separate pools of liquidity in various clearing centres makes it difficult to manage and makes liquidity at times expensive to obtain and unpredictable in terms of time of receipt. RMB is the only top-10 currency ineligible for CLS settlement, as noted by the BIS,[61] which prevents it from becoming a truly international currency.

The adoption of CIPS by the international community has been slower than expected. However, it has the potential to significantly improve the efficiency of cross-border payments by improving settlement times and lowering costs as well as increasing liquidity in the market. To ensure its ongoing observance of international standards, CIPS should regularly complete and publicly disclose its self-assessment based on the CPMI-IOSCO Assessment Methodology of the PFMI.

6. Standardisation in post-trade

Complementing the need for modern trading technology, post-trade infrastructures modernisation should also be considered and not be left behind as has often been the case in economies across the region. The existence of multiple clearing and settlement infrastructures (CCDC, CSDC, CFETS and SHCH) covering different sometimes overlapping products makes the Chinese post-trade environment complex and costly considering the different practices, communication channels and protocols that the market participants have to maintain. A mitigating factor to such an environment is the adoption of international communication standards such as the ISO 20022 universal financial industry message scheme and data standards such as the International Securities Instrument Number (ISIN).

Recommendations for Market Infrastructure

1. **Create statutory provisions for settlement finality on transactions** with CCPs and transactions across financial infrastructures in the Bankruptcy Law reflecting international standards enumerated in the PFMI.
2. **Allow the clearing member to create a security interest over cash in the margin account** which is recognised by China's Property Law or Securities Law.
3. **Prioritise the application of SHCH to be recognised as an equivalent CCP** under EMIR and as an exempt DCO by the CFTC.
4. **Provide foreign investors the option to use omnibus accounts** to allow them to benefit from cost saving and efficiency they currently enjoy from other developed markets. This would allow a simplification in their operating model and improve time-to-market for new products by avoiding the need to open segregated accounts in the entire chain.
5. **Ensure that the domestic market infrastructure is compatible with international standards**, including the PFMI, in order to expand the use of the RMB as an international currency.
6. **Settlement of the RMB on a PVP basis in central bank money accounts** with multilateral netting would support the continued, stable expansion in the global use of the RMB for trade, investment and as a reserve currency, and meet internationally agreed standards.
7. **Allow third party custodians to hold initial margin** on behalf of the posting counterparty.

I. Market Access

1. Investing in China

China has a number of access programmes, each with its own set of criteria and objectives and often subject to specific restrictions (for example, quota, lock-up periods, remittance of capital and repatriation of funds). The access programmes have been designed to complement, rather than replace, each other, and represent China's continuing efforts to facilitate cross-border flows. It is hoped that China will continue to enhance access to its markets over time by addressing some of the issues identified below.

1a. QFII and RQFII

With the proliferation of access channels for non-PRC investors to invest and trade in onshore securities in China, the original two channels, QFII, introduced in 2002 and RQFII in 2011, have been undergoing reforms, culminating in the release by CSRC on 31 January 2019 of draft regulations to combine the two existing schemes and expand the scope of their investments to private funds, derivatives and bond repurchases.[62] This followed an announcement on 8 August 2018 that entry requirements for QFII and RQFII would be "relaxed, standardised and harmonized". The merger reduces the number of access channels in another step towards simplification and integration is welcomed by foreign financial market participants.

Alignment and Integration

As the rules for the QFII/RQFII regimes become more aligned, foreign investors would like to be able to switch easily from one regime to another without having to sell all of their investments under one regime before making investments in another regime especially with respect to CIBM between the QFII/RQFII and CIBM direct channels. The problem with not allowing movement between the channels feely is that it will give rise to unnecessary transaction costs and tax liabilities for the investors who want to keep invested in China and may actually trigger outflows, risking leakage. The merger of the two schemes may eliminate this problem.[63]

Quota changes

As of 31 December 2018, CSRC had awarded 309 foreign institutions US$101.1 billion in investment quotas, out of a total quota of US$150 billion. The RQFII scheme has expanded from Hong Kong to 19 countries and regions, with RMB 646.7 billion granted to 233 RQFIIs, out of a total quota of RMB 1.94 trillion. This compares to the total investment quota allocated to QFIIs and RQFIIs as of 25 January 2017 of US$ 87 billion and RMB 529 billion, respectively; in July 2017, the quota for RQFIIs based in Hong Kong was increased from RMB 270 billion to RMB 500 billion. In 2016, SAFE introduced substantial changes to the quota allocation mechanism for both QFIIs/RQFIIs such that QFIIs and RQFIIs can now determine their own basic quota based on a certain percentage of their asset value or Assets Under Management (AUM

Basic Quota) or that of their group, and a routine filing with SAFE will suffice. If additional quota above their Basic Quota is needed, QFIIs/RQFIIs must then seek SAFE's approval.

The new Basic Quota filing system marked a milestone in the evolution of the QFII/RQFII regimes. It expedited investment by QFIIs/RQFIIs through a more transparent and streamlined process. In addition, capital repatriation for both QFIIs/RQFIIs may now be done on a daily rather than monthly basis and such repatriation will no longer reduce the quota of a QFII/RQFII, which means that the quota may be utilised on a revolving basis. Furthermore, the CSRC has removed the requirements that 50% of the assets of the QFII/RQFII must be invested in stocks and no more than 20% of such assets may be held in cash.

The prospective merger of the QFII and RQFII will encourage higher levels of foreign participation. We would encourage CSRC to allow the quota already granted to a particular entity be allowed to be transferred to another entity under common control of the quota holder and that future quotas be granted to a QFII/RQFII at the holding company level for usage by majority- or wholly-owned subsidiaries of the holding company.

Remittance and repatriation of funds

In addition, the previous six-month fund injection timeline for QFIIs and non-open-ended funds of RQFIIs has been removed, and the capital lock-up period has been shortened from one year to three months for non-open-ended funds starting from the date on which a specific amount (e.g. US$ 20 million for a QFII, and RMB 100 million for an RQFII) has been remitted into China on an aggregate basis.

While in June 2018, the 20% monthly cap on repatriations by QFIIs and the three-month lock-up period for both QFIIs and RQFIIs were removed, ASIFMA's 2016 China onshore bond market survey found that free repatriation of funds was the number one concern of international investors. Although the foregoing has been removed, the draft QFII/RQFII regulations issued in January 2019 provide that the remittance and repatriation of the funds by QFIIs/RQFIIs will be subject to the "macro prudential management" by the PBOC and SAFE based on China's economic and financial conditions, supply and demand on the FX market and the balance of international payments. This creates the kind of uncertainty for foreign investors that have driven many of them to the Stock Connect channel.

Investment scope

While ASIFMA welcomes the expanded investment scope for QFII/RQFII that makes this channel more competitive with the remaining channels, we would like QFII/RQFII investors to be allowed to invest in a private investment fund whose underlying assets fall within the permissible investment scope of QFII/RQFII as well as allowing QFII/RQFII investors to trade OTC derivatives, both stock and futures options, and invest in PE funds, while allowing QFII/RQFII investors to use more than three onshore brokers. On the positive side, QFIIs and RQFIIs have been allowed to engage in FX derivatives transactions onshore with qualified institutions. QFII/RQFII investors can now engage with "multiple" onshore financial institutions for CNY, which is better than the CIBM Direct and Bond Connect schemes.

<u>**Tax clearance**</u>

QFIIs/RQFIIs need to perform a record filing with the local tax bureau and submit the tax record filing forms with local tax bureau's stamp on them to the remitting bank before their proceeds from China can be repatriated. The supporting documents to be filed by the QFII/RQFII with the local tax bureau include a tax certificate or audit report from a local tax consultant, which takes time to prepare. Take the example of a QFII that has a year-end in December, their audit report will not be available until the following March or April which makes any earlier repatriation impossible. In addition, due to resource constraints of some local tax bureaus, they would consider such applications only on a particular day of the week. In view of the announcements on tax exemptions for foreign investors on bonds and equities, we understand that this record filing requirement may be for FX control purposes only and not for tax liability determination. Therefore, we suggest removing the requirement for a tax certificate or audit report from the local tax consultant to improve the repatriation process.

Perhaps the SAT can set up an online data sharing platform with SAFE and/or remitting banks so that the authorities can still have access to the information needed to monitor the foreign exchange situation while QFIIs and RQFIIs are relieved from the record filing process or they can go through a simplified process when repatriating or making outbound payments from China.

<u>**Disclosure of interest**</u>

The proposed regulation distinguishes between the obligation of a qualified investor and that of a foreign investor for whom the former invests when it comes to disclosure of interest. The disclosure of interest obligation rests with the foreign investor who has to report through the qualified investor. However, the qualified investor is also obliged to ensure that the foreign investors under its name strictly comply with relevant information disclosure rules, which is very onerous. Therefore, we would like CSRC to revise the regulation to require a qualified investor to only be held responsible for the investments of a foreign investor that it manages as foreign investors can invest through stock connect or other qualified investors to which it has no control.

1b. Stock Connect[64]

The Stock Connect programme was first conceptualised by China as another channel for opening up China's capital market. In November 2014, mutual market access between the SSE and HKEX was established representing the first time that two stock exchanges have linked up in this way, followed in 2016 by a similar link between HKEX and SZSE. The typical route for investors to buy stocks in another country is through a relationship between the broker in its originating country and a correspondent broker in the target country. Stock Connect, by contrast, is a direct link between exchanges. The link enables brokers who are members of the HKEX to execute orders through a link to the SSE or SZSE, rather than to broker members of the SSE and SZSE.

As China's capital account is restricted, foreign investors are not allowed to open accounts at financial institutions except in specific approved purposes. Stock Connect enables Chinese authorities to allow money to flow in and out of shares through a single controllable conduit. Investors must purchase CNH in Hong Kong or have their broker arrange a purchase on their behalf. When a foreign investor sells shares through Stock Connect, the RMB proceeds are delivered in Hong Kong. Stock Connect creates a "closed loop", segregating the RMB used to buy shares from the rest of the Chinese economy.

Stock Connect allows any investor in the world, institutional or retail, access to A-shares. There are no lock-up periods or repatriation restrictions for Stock Connect. In contrast, QFII and RQFII, which have been steadily liberalised over the years, are restricted to approved institutional investors.

With the success of the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect was launched on 5 December 2016. In contrast to the large SOEs that predominate on the SSE, SZSE listings are tilted towards small and mid-caps, with a significant proportion of companies from cutting-edge industries such as software, high-tech and biotechnology. As a result of the addition of Shenzhen Connect, Stock Connect now provides investors with a much wider menu of equities and considerably increased opportunities for diversification and stock selection.

As we look forward to 2019 when China will experience significant, high-profile index inclusions into the MSCI, FTSI Russell and S&P indices, the three-minute Closing Auction session at the SSE and SZSE will continue to be an important trading window during index inclusion and rebalance days. It will benefit the market to have the international active funds with covered short selling trading to balance against the international passive trading flow. This has been shown to improve price discovery, reduce price volatility and enhance liquidity of Stock Connect eligible securities. Consistent with the earlier recommendations in the Equities Market Structure section on securities lending, key suggestions of offshore Stock Connect modifications include:

- Enhance the existing model to broaden eligibility in the programme to all SBL market participants
- Development of a market microstructure around the action of borrowing and lending securities
- Ensure transparency and visibility of all market activity in SBL and short selling

Quotas

When Shanghai-Hong Kong Stock Connect was launched, an aggregate quota of RMB 300 billion for Northbound and RMB 250 billion for Southbound trades put an upper limit on total investment allowed through this connect in either direction. Its size was limited initially to allow authorities and market participants to evaluate the link. After nearly two years of problem-free operation, the aggregate quotas in both directions were abolished in August 2016, when the Shenzhen Connect Link was announced.

In April 2018, HKEX and CSRC announced the quadrupling of northbound daily trading quotas, and both the PBOC and the HKMA have increased offshore currency resources and swap lines to support the rise in volume. From 1 May 2018, the daily quotas under the Shanghai and Shenzhen Stock Connect schemes were raised to RMB 52 billion (US$8.27 billion) from RMB 13 billion, while daily southbound quotas were raised to RMB 42 billion each from RMB 10.5 billion. Total northbound turnover for 2018 was RMB 4.674 billion, an increase of 106% over 2017, according to HKEX. Southbound turnover was HK$2.834 billion, an increase of 25% over 2017. As of the end of 2018, net capital inflow into the mainland reached RMB 641.7 billion and net capital inflow to Hong Kong was HK$808.9 billion from the time of the launch of Stock Connect.[65]

Quotas are problematic for institutional investors because a quota may unexpectedly prevent the execution of a buy order and throw the portfolio out of alignment of investment mandate. Straying from an investment mandate whatever the reasons creates “tracking error”, the deviation of portfolio performance from its benchmark and a key measure of a fund’s performance. Quotas are an implicit cost and elimination of the aggregate quota gets rid of part of the risk. Though the Northbound daily quota was hit only once, on the day it was launched, Northbound investment should increase substantially, along with the risk of hitting the limit, now that A-shares have been approved for index inclusion for MSCI Emerging Markets. ASIFMA would encourage regulators to consider removing the quota system or improve the current management system, especially with regard to re-allocation of quotas across sub-accounts.

Legal, regulatory and operational implications

The basic principle with Stock Connect is home country rules apply. Hong Kong brokers and investors offering A-share products are subject to the Securities and Futures Ordinance and SFC regulations. In practice it is more nuanced and regulators on both sides of the border cooperate. At the beginning, foreign investors were concerned of their legal claims to A-shares because the shares are held in an HKEX omnibus account, lacking specific customer information. The CSRC, however, issued FAQs in May 2016 which have largely addressed this concern, which the MSCI noted the following month even though it decided not to include A-shares into its index.

The key operational issue in China is that stocks are settled on T+0, but the payment settles on T+1. This is in contrast to the method used in most developed markets, where stock and cash settle on the same day, usually on T+2. Brokers, custodians and HKEX have devised ways which have largely overcome the disconnect in settlements, though some operational and counterparty risk remains. As discussed in this paper’s section on equity markets, we believe a DVP structure for equity settlement would significantly enhance the attractiveness of China’s equity markets to global investors.

The future of Stock Connect

HKEX has announced plans for product additions to Stock Connect, in particular ETFs, IPOs, exchange-traded derivatives, and eventually warrants. ETFs traded in Hong Kong could be of particular interest to Southbound investors, who could use global or regional ETFs easily diversify their portfolios. For some Northbound investors, Chinese ETFs might be attractive given the limited acceptance of A-shares by index managers outside of China. On 9 December 2018, HKEX announced that listed companies with weighted voting rights (WVR) would be included in Southbound Trading of Stock Connect in mid-2019, a welcome development.[66]

HKEX only amended its own rules to allow WVRs in April 2018. These allow control of a company by a small number of shareholders, a structure which is popular with tech firms where the founders want to maintain control over their long-term vision. Dual-class share trading is recognised in many jurisdictions, notably NYSE, and lay behind the loss of Alibaba Group Holdings US$25 billion IPO to New York in 2014.

A suddenly revealed prohibition against Southbound trading caused havoc with the listing of Xiaomi Corp. in June 2018 as the first dual-class listing in Hong Kong. Bourses on both sides of Stock Connect have the power to exclude certain index stocks from trading, so the temporary ban on Southbound trading of dual-class shares was not illegal but disrupted the plans of HKEX to become a hub for new economy trading. ASIFMA concurs with the HKEX argument that WVR listings should be accepted by Stock connect since extraordinary protections already exist in the Hong Kong market. HKEX only accepts such listing from issuers with an expected market capitalisation of HK$40 billion and requires them to establish a corporate governance committee of entirely independent non-executive directors. In order to reach agreement with mainland regulators on WVR listings, it agreed to an initial special stability trading period (SSTP) for Hong Kong-listed WVR companies, after which they could be included in southbound trading. The duration of SSTP is for the time being unclear. ASIFMA believes this requirement should be eliminated as soon as is practicable.[67]

Stock Connect could also embrace exchange-traded derivatives (ETD), such as the CSI 300 contract traded at CFFEX or the Hang Seng Stock Index futures in Hong Kong. The availability of CSI futures will open possibilities for improved portfolio and risk management for offshore China investors. HKEX also trades currency futures and has the world's most active market in warrants and structured products such as callable bull/bear contracts (CBBCs), all of which could become part of the Connect programme eventually. Generally, ASIFMA believes that the ability to open up and cross-sell Hong Kong-listed warrants and CBBCs to certain classes of Chinese investors will create more transparency into such flows, and opportunities for local financial institutions, who will provide access to markets for the offshore issuers of such products. Allowing the creation of similar products using A shares as underlying instruments will contribute to significant northbound flows by product issuers to hedge their exposure.

Chinese authorities have allowed investors to tap the onshore FX market on the back of their Stock Connect investments since the MSCI index inclusion in 2018. However, no banks have figured out how to do it, nor have regulators issued any guidelines. With more equity index inclusions coming in 2019, there is concern whether CNH liquidity can support the inflow requirements. Thus, we would urge regulators and key stakeholders to come up with a framework for CNY conversion and hedging under Stock Connect.

Authorities have announced intentions to eliminate capital controls as early as 2020. If that happens, foreign investors will be able to buy RMB and invest in any Chinese assets more or less without restriction (or subject to the same restrictions as a domestic investor). Given how cross-border investing works in the rest of the world, one might expect Stock Connect to be replaced by the global model. It is also possible that Stock Connect may by then have become a familiar part of the investment process by then. If HKEX maintains a high level of service, Stock Connect could survive. The key to success will be to ensure that Stock Connect provides diverse investors market access efficiently and at a low cost.

Access to Stock Connect by PRC individuals

There is a SAFE restriction for PRC individuals to trade Stock Connect which requires that such individuals should have been resided outside of China for at least one year. We think this should be revised. It is fairly easy for a PRC resident to open brokerage account with Chinese securities houses to invest into Stock Connect. Some houses do not have any qualification criteria to check such clients' source of funding; some houses only require the funding is transferred from a properly licensed Hong Kong commercial bank. In practice, it is hard to verify if an individual has lived outside the PRC for more than a year or not; and at the same time, allowing company to invest provides a way for any individual to bypass the restriction. Thus, such restriction is meaningless to stop any potential non-compliant investment, but encouraging further layering of investor identity, which potentially makes monitoring by regulators more challenging, i.e. it requires further look through to identify the real investor. Such restrictions also prevent A-share from becoming part of the global allocation for PRC resident's overseas fortune; this increases the complexity of product offering. It has largely discouraged global wealth management players' motivation to include A-shares into their global portfolio.

1c. Equity/listed derivative-linked OTC products (onshore and offshore)

ASIFMA encourages the growth of OTC equity-linked derivatives and rules permitting local financial institutions (including affiliates of FFIs) to engage in equity-related derivatives, subject to robust risk managements. Chinese regulatory policy has been somewhat silent and unclear on this topic and has been subject to at least a few shifts based on market movements. In previous years, there was a view that Chinese regulators opposed the use of OTC derivatives by QFIIs and would inquire whether they would allow clients of FFIs to meet investing and hedging needs via OTC formats in Hong Kong or other offshore markets. FFIs are generally required to have client risk management with transparency underpinning principal trading in Chinese equity markets. Therefore, we would like to see Chinese regulators support the growth of these OTC-linked markets outside China, while ensuring that QFIIs comply with the Market Conduct and Trading Rules of the onshore venues.

1d. Mutual Recognition of Funds

CSRC and SFC jointly announced on 22 May 2015 the decision to launch the Mutual Recognition of Funds (MRF) scheme between Hong Kong and China, with an initial quota of RMB 300 billion for Hong Kong and Mainland funds. The MRF was launched on 1 July 2015 with the first batch of three Hong Kong (Northbound) funds approved by the CSRC and four Chinese (Southbound) funds approved by the SFC on

18 December 2015. As of December 2018, a total of 17 Northbound funds compared to a total of 50 Southbound funds had been approved.

Given the large discrepancy in the total number of Northbound and Southbound funds that have been approved, the fund recognition or approval process for Northbound funds can benefit from greater transparency and improvement. Even though only 17 Northbound funds had been approved by December 2018, they collectively raised RMB 9.02 billion as of the end of December 2018 compared with the RMB 0.43 billion raised by the Southbound funds as of the same date.[68] Concern over the depreciation of the RMB and uncertainty about China's economy may be some of the reasons for the lack of investors' interest in the Southbound funds. On the other hand, the same reasons coupled with a desire for diversification may explain Mainland investors' strong demand for the Northbound funds.

As the MRF scheme develops, it is hoped that different types of funds and other products will be included in the scheme so that investors in China and Hong Kong have more choices as currently only the plain-vanilla type of funds is approved. Also, allowing delegation of investment management to offshore entities would expand the eligible product range, and grant exposure to global markets. This would diversify Chinese investors' investments and more importantly, reduce the risks that they face from over-concentration. It is hoped that the requirement that at least 50% of the AUM of a fund must come from the fund's home jurisdiction would be adjusted in the case of a Hong Kong domiciled fund given the small size of the Hong Kong market compared with mainland China. ASIFMA would like to see elimination of the requirement that funds must be registered in Hong Kong for more than three years, and the ability to sign MRF schemes with other major fund domiciles like Luxembourg.

1e. CIBM opening

CIBM is an OTC market launched in June 1997 when the PBOC mandated all commercial banks to move their repo and bond trading out of the stock exchanges and into an interbank market operating through an electronic trading system. The major debt instruments traded in the CIBM are government bonds, central bank bills (essentially treasury bonds under one-year duration but issued by PBOC), financial institution bonds and other debt financing instruments. CIBM has become China's dominant bond market (accounting for more than 90% of China's total outstanding bond volume in custody). Together with bonds traded on China's two stock exchanges, China's bond market is the third largest in the world after the US and Japan.

<u>Liberalisation process</u>

China began opening the CIBM to foreign investors starting in 2005 when the Pan-Asia Fund and Asia Debt China Fund were allowed to invest in the CIBM. The liberalisation truly commenced in 2010 when the "three types of foreign institutions" – the overseas central banks/monetary authorities, the RMB clearing banks in Hong Kong and Macau, and overseas banks engaged in RMB cross-border settlement – were allowed to trade and settle bonds in the CIBM. Further liberalisation followed when Hong Kong-based

RQFIIs were allowed to invest in the CIBM in 2011, then extended to insurance companies in Hong Kong, Singapore and Taiwan in 2012, QFIIs in 2013 and subsequently all RQFIIs.

The pace of the CIBM opening to foreign investors increased significantly when PBOC announced in July 2015 that foreign central banks, monetary authorities, international financial organisations and SWFs (collectively the sovereign institutions) would be allowed to invest in the CIBM without any approval requirements or quota limits and subject only to filing with the PBOC. In February 2016, the PBOC announced that most types of foreign institutional investors would be permitted to invest in the CIBM through the new filing without the need for prior approval or quota allocation ("the Direct Access regime"). These include foreign commercial banks, insurance companies, securities firms, fund management companies, their investment products, pension funds, charity funds and endowment funds, and other medium- and long-term institutional investors recognised by PBOC. Initially, the regulators indicated that the same institution should not use both the Direct Access regime and the QFII/RQFII regime to invest in the CIBM. However, they have clarified that foreign institutions may use both channels for their different clients and/or products.

Medium and long-term investors

The PBOC's rules on the Direct Access regime leave it to the settlement agent banks to determine whether a foreign institution is a medium- or long-term investor for purposes of qualifying for this regime. It would be helpful if the criteria used for such determinations were standardised and not kept to individual settlement agent banks to determine.

Hedging onshore and repo access:

Unlike equity fund investors, it is very common for global bond funds to invest on an onshore currency hedged basis. Therefore, it is crucial for foreign bond investors to be able to easily hedge RMB currency exposure through the onshore FX spot and forwards market. Furthermore, foreign investors would want to engage in interest rate hedging activities including the use of onshore interest rate swaps and bond futures. With respect to repo for foreign investors, it is currently not practical for foreign institutional investors to access the onshore bond repo market. This is primarily due to market format (pledge based repo), market documentation (Local GMRA/NAFMII and not the same documentation as clients would be using in other markets), and lack of access to tri-party repo through the investor's global custodian banking relationship.

Bond-linked products

After overseas institutional investors successfully enter the CIBM, the fact they hold onshore bonds would trigger other considerations. These include questions such as whether investors may issue offshore market access products linked to bonds traded in the CIBM (such as those who do not qualify as eligible investors themselves), and whether offshore credit-linked products are permitted to help foreign investors hedge the risks of potential bond defaults and taking security over onshore bonds. Clarification of the foregoing would help to promote increased offshore interest into CIBM.

1f. Bond Connect

The launch of northbound trading on Bond Connect, Hong Kong's new channel for fixed-income trading, on 3 July 2017 represented a breakthrough, with nearly RMB 130 billion (US$19.72 billion) of foreign flows in its first year. Overseas investors and market participants welcomed this additional access channel, along with the existing access channels through the QFII and RQFII programmes, CIBM direct access and the dedicated access channel for global central banks, sovereign wealth funds and multilateral institutions.

As of year-end 2018, there were 503 registered institutional investors across 24 jurisdictions, according to HKEX. [69] By January 2019, there were 558.[70] Average Daily Turnover (ADT) was RMB 3.6 billion in 2018 and this increased to RMB 6 billion by January 2019, according to HKEX. While overall foreign holdings in China's interbank bond market reached RMB 1.73 trillion by 31 December 2018, double the size of holdings at the time of the launch of Bond Connect in July 2017. [71] Overseas holdings topped RMB 1 trillion for the first time in August 2018, according to CCDC, bringing the share of Chinese bonds held by offshore institutions to 8%. [72]

There have been many positive developments, including RDVP settlement on CCDC, the launch of block trading allocations on Bond Connect and the MOF and STA's joint circular around the temporary 3-year exemption of withholding tax and VAT on bond interest derived by foreign institutional investors. More can be done to make this an even more attractive channel including smoothing out the application process, reducing trading costs by allowing alternative trading platforms and flexibility in appointing multiple FX banks (facilitation of client verification of best execution on FX hedging trades), and introducing additional hedging tools including onshore repo, interest rate swaps and futures. Importantly, the PBOC should allow more FIIs to serve as offshore market makers. This would aid the PBOC in fulfilling its goals of growing Bond Connect and in so doing, diversify sources of funding and further reform China's capital markets in line with international best practices.

One of the most advantageous features of Bond Connect is that it enables FIIs to trade bonds in the CIBM through an international electronic platform (Tradeweb and Bloomberg) outside China and obtain bids and quotes directly (from the 34 designated market makers as of December 2018) without manually having to go through an onshore agent. Bond Connect investors, in general, benefit from a simpler application process, which currently takes a few weeks but can take longer. They can also leverage on their existing offshore custodian without a need to appoint a local settlement agent in China.

Unlike Stock Connect and trading in China equities in general, Bond Connect allows settlement up to T+2. To make Bond Connect more attractive to FIIs, extending the possible settlement cycle to T+3 or longer would be helpful.

Trading fees

Bond Connect participants have to appoint a custodian (CMU Custodian) which must be a member of the Central Moneymarkets Unit (CMU) under the HKMA. The CMU Custodian would appoint the FX settlement bank for the FII. FIIs also have to engage Bond Connect Company Limited (BCCL), a joint venture between CFETS and HKEX, for the application review and other market access guidance and support.

Due to the number of parties involved in the Bond Connect structure, the fees (including CMU custody and trading fees, CFETS trading fee, the trading platform fee and BCCL fee) under the Bond Connect can be higher than those under the CIBM Direct. However, we note that BCCL cut their service fee, with effect from 1 July 2018, to 0.0060% for those traded instruments with a tenor of longer than one year and 0.0025% for all traded instruments with a remaining tenor of less than or equal to one year.

The current billing of the CFETS and BCCL fees and other charges to the trading platform (for example, Tradeweb), which then passes them on to the FIIs on a monthly basis without a trade by trade breakdown poses a significant problem for FIIs that are asset or fund managers who need to be able to pass on those fees and charges to their clients and/or funds. As bonds are typically traded on a principal basis globally where the relevant fees and charges are built into the spread rather than charged separately to the investors, passing any fees and charges to clients may be difficult for some asset/fund managers even if such fees and charges can be broken down on a trade by trade basis.

FIIs would like, at a minimum, to see the fees and charges under Bond Connect charged on a trade-by-trade basis to the custodian for the underlying fund or client account for which the trade was made. It would be even better if the fees and charges related to bond trading can be built into the spread like they are done elsewhere around the world.

Choice of FX counterparties

Many FIIs, especially fund managers, rely on their global custodians to arrange the FX conversion for investment and hedging under the Bond Connect.

Under Bond Connect, these custodians would appoint a CMU Custodian, which must be a member of the CMU under the HKMA. Each CMU custodian is allowed to appoint only one FX settlement bank, which is normally the CMU member itself, or an affiliate of the CMU member. FIIs, whether investing through QFII/RQFII, CIBM Direct or Bond Connect, are also required to use the same FX settlement bank for its inward and corresponding outward remittance, which limit their choice of FX counterparties. Allowing a CMU member to appoint multiple FX settlement banks or a FX settlement bank at the account level would greatly improve the situation. On the broader issue of FX access, it is our understanding that global custodian banks may, in the future, be granted the right to access on-shore FX liquidity, in order to service their clients FX needs. This would be a very promising development for foreign investor ease of access and would facilitate further investment.

Bond Connect repo

A year after the launch of Bond Connect, PBOC announced the possibility of repo for Bond Connect. This is a welcome development for foreign investors and for the Bond Connect. While details have yet to be announced, we believe that the following measure, if introduced for the Bond Connect repo, will be attractive to foreign investors. This is to allow bilateral offshore-to-offshore trading of repo between two registered Bond Connect foreign investors, where the repo is a title transfer repo transaction using GMRA documentation and settled and registered through CMU between two CMU accounts and recorded with CFETS under existing Bond Connect channels. This type of transaction could also be undertaken as a tri-party repo, using a global custodian bank service provider.

Hedging onshore

The ability to hedge interest rate and other risks onshore is equally important to FIIs who wish to invest through the Bond Connect. Allowing Bond Connect participants to engage in bond lending, bond forwards, interest rate swaps and forward rate agreements like the FIIs investing through CIBM Direct is what FIIs want to see most. In addition, opening up China's bond repo market and bond futures to FIIs under Bond Connect would help increase foreign investors' interest in this channel.

However, one of the main concerns of foreign investors is the legal documentation required for them to enter into these hedging agreements. FIIs prefer to use the globally recognised documentation from ISDA, combined with full title transfer under the actual transaction rather than the documentation from NAFMII.

Standardise operational infrastructure and requirements

Currently, Bond Connect only supports manual trade confirmations, which increase the risk of errors and failed trades. In addition, each global custodian has to build their own system to direct instructions from their clients to the relevant market and to the sub-custodian to process a trade and to differentiate the funding channel. As there is no standard for sending instructions under Bond Connect, it varies from custodian to custodian. Some of their requirements are not straight through processes (STP) which could speed up the transaction process. This is incredibly inefficient and costly so standardizing the operational infrastructure for Bond Connect and introducing an automated solution, such as Omgeo Central Trade Manager (CTM), is something that the relevant authorities (PBOC and HKMA) and onshore and offshore depositories (CMU, CCDC and SHCH) should work with the industry to achieve.

The requirement to include the CFETS trade deal number as a criterion to match and settle a trade also makes block trades processing challenging. A more feasible alternative to this requirement is needed.

Another problem is that if FIIs invest through the Bond Connect using CNY, the sale proceeds from bonds purchased with CNY must be re-invested or repatriated within a reasonable time. What is "reasonable" is not specified in the regulation but left to the FX settlement banks to define, which leads to different interpretations from different FX settlement banks. FIIs would like PBOC to clarify what is meant by “reasonable” so that it can be applied consistently and what penalties, if any, are involved if there is a breach of the aforementioned requirement.

Under Bond Connect, the CMU custodian also has a responsibility to ensure that the FII’s currency conversion and hedging transactions are “genuine and reasonable” in light of the settlement and holding information of the FII. If the FX settlement bank appointed by the CMU custodian has a suspicion about the genuineness and reasonableness of such transactions, it may request further clarification and information from the CMU custodian. Due to the lack of a common understanding of what “genuine and reasonable” means, this has led to further confusion among FIIs about what is or is not permitted. FIIs would like the relevant authorities to clarify what they consider to be genuine and reasonable transactions.

Place of Settlement (PSET) can be accepted. Such an automated solution, if adopted throughout the market, would reduce the risk of manual processing.

Reporting failed trades

Like CIBM Direct trades, trades on Bond Connect could fail. When a trade fails, it has to be cancelled in the market and if required, a new trade has to be executed. Both the foreign investor and the onshore counterparty are obliged to file a failed trade report with CFETS and the relevant depository (CCDC for government bonds and SHCH for listed corporate bonds). These reports have to be in Chinese and the process is not standardised and it also depends on whether the trade has been affirmed by CMU. It would be beneficial to standardise the failed trade reporting process by permitting such reports to be done in English and for the fail reason to be reported to the CMU member (similar to the BSA under CIBM Direct) and for the CMU member to file the failed trade report to CFETS and the relevant depository. Having a centralized source of the reasons for failed trade at the CMU member level would improve efficiency in this regard. Perhaps BCCL can be the sole entity responsible for all the failed trades reporting so that they can share the required information in data/file format with CCDC, SHCH and CMU instead of having both the foreign investor for which inputting information in Chinese is a challenge and onshore counterparty file the fail trade reports.

Default arrangements (Tri-Party Repo)

Clarification in the event of default arrangements for tri-party financing transactions is needed as part of the impetus to increase the amount of tri-party repo available to foreign investors. Currently, the international norm, is that in case of counterparty default, the secured party needs Power of Attorney to input the sale of bonds through the relevant trading platform (this is in order to liquidate the collateral and receive the cash). Such arrangements would need to be specified under tri-party trade involving foreign investors, if the hope is to significantly increase foreign participation in repo trade activity.

Block trading

Bond Connect launched the service of block trade allocations on 31 August 2018, which allows asset managers to allocate block trades to multiple client accounts prior to the trades. With the pre-trade allocations function, FIIs can execute a single block trade and allocate specific percentages or amounts of the trade to up to 30 individual accounts . It would be helpful if there is no limit on the number of accounts that can be included in a single block trade. In addition, there are some other requirements, such as the requirement to include CFETS trade deal number as criteria to match and settle the trade, that make the processing of block trades challenging. Like Stock Connect, there needs to be working groups comprising of the relevant Bond Connect parties working with representatives from the industry to find a solution for these types of issues.

1g. Panda bonds

Panda bonds – or RMB-denominated paper issued in mainland China by foreign borrowers – have seen an explosive growth since China resumed strong policy support for the market in 2016. In the first six months of 2018, 23 panda bonds were offered on CIBM with a total amount of RMB 41.26 billion, accounting for 80.13% of total Panda bond issues by value.[73]

We believe that the surge in activity is only the beginning of what should shape up to be Asia's most important new market in the coming decade. Such an optimistic view is based on the attractiveness of panda bonds to issuers as well as investors in addition to strong policy support.

The panda bond market is highly attractive to issuers because it offers unique opportunities. Firstly, for those planning to use the raised funds onshore, panda bonds enable easier utilisation of proceeds than when issuing offshore (where remittance onshore is more complex due to regulatory barriers). Second, panda bonds offer the ability to reach new categories of bond buyers. Thirdly, this product offers a new source of funding, which in some cases will be the cheapest source of funding for the borrower.

The Panda bond market is also attractive to investors, both onshore and offshore, as it offers advantages to each. Panda bonds offer domestic investors access to issuers otherwise unavailable onshore, and free access to issuers available offshore only via special programmes (QDII, RQDII). They provide foreign investors with access to issuers not available in the offshore markets and in the rest of the onshore market, including foreign issuers with international ratings higher than even those of CGBs like the Asian Development Bank (ADB).

Chinese regulators will most likely continue to offer strong support to the panda bond market. However, there are a few unresolved issues. In practice, only a subset of issuers, including sovereign and quasi-sovereign issuers (such as the multilateral agencies like the ADB) can readily access the market. Also, as of early 2019, an issuer needs to have financial statements that follow Chinese accounting standards, Hong Kong accounting standards or IFRS and need to be audited by Chinese- or Hong Kong-qualified auditors. Submissions have been made to Chinese authorities to allow entities in other jurisdictions that follow local Generally Accepted Accounting Principles (GAAP)/US GAAP to be granted equivalence for accounting purposes and for expansion of auditor qualification.

As the rules stand currently, all potential panda bond issuers must present the past three years of financial statements in a format that meets Chinese accounting standards. If this issue is resolved satisfactorily, a greater volume of panda bond issuance from a greater range of issuers (including international corporates) will likely arise. We suggest China consider admitting the place-of-origin accounting principles at least to the extent they are compliant with IFRS or substantially compliant with IFRS. In addition, Chinese regulators exclude US GAAP from their acceptable accounting standards. As a result, US financial institutions and corporations are not able to issue bonds in the interbank bond market. Conversely, however, Chinese accounting systems, being itself a framework of accounting standards that are substantially compliant with IFRS, are accepted by US financial regulators.

The current application scoring mechanism for obtaining the membership of NAFMII disadvantages foreign banks. For example, the process sorts applications by onshore business volume excluding the business of offshore parent companies and compares with domestic banks' onshore parent companies, where Chinese domestic firms have an advantage.

We also believe that bona fide foreign issuers should be allowed to freely repatriate issuance proceeds offshore. Currently, foreign issuers face approval uncertainty as these cross-border remittances require approval of both PBOC and SAFE. It adds both time and cost to follow the current practice in which RBM bonds are issued only to exchange the proceeds to USD or other foreign currencies.

In the medium to longer term, despite the short-term impediments, the seriousness of Chinese authorities on market opening measures gives reason for optimism about the continued growth and development of the panda bond market.

1h. Credit ratings

Credit ratings and research help investors analyse the credit risks associated with Fixed Income securities and other financial obligations. For international investors interested in the Chinese domestic bond markets, credit ratings issued by domestic credit rating agencies (CRA) are helpful in such credit risk analysis. However, many of the international investors would be particularly interested in credit ratings issued by international CRAs.

Over the course of their history, international CRAs have adapted to market needs so that credit rating systems have developed certain key attributes, including:

- Opinions supported by insightful and robust analysis
- Symbols that succinctly communicate opinions
- Public availability of opinions
- Broad coverage across markets and industries that allows for comparability

Credit ratings promote dialogue and debate among market participants, which in turn help further the integrity of the debt markets and understanding of credit risk. The credibility and global comparability of the credit ratings issued by international CRAs are particularly important for international investors.

Foreign credit ratings agencies are now allowed to set up branches in China, rather than operating through local JV partners. Of the three international ratings agencies that have applied, only S&P has been approved as of March 2019, while Moody's Investor Service and Fitch Ratings were still waiting to hear on their applications from PBOC.

Credibility

International CRAs have long histories of issuing credit ratings, and international investors trusted credit ratings issued by these CRAs due to the long-term performance record of such ratings. If ratings of Chinese bonds will be issued by international CRAs, such ratings will be perceived as having predictive value by international investors. They can thus increase awareness of RMB denominated issuance and help international investors better understand Chinese bonds.

At the moment, the top ten Chinese rating agencies award investment grades to 99.5% of all publicly-offered debt.[74] Following legal reforms, ratings agencies will likely be required to reassess assumptions about the likelihood of automatic government bailouts and broaden the range of their ratings.

Cumulative issuer-weighted default rates by annual cohort, 2009-2018

Rating	1	2	3	4	5	10
Aaa	0.000	0.000	0.000	0.000	0.000	0.000
Aaa	0.000	0.002	0.005	0.005	0.008	0.020
Aaa	0.002	0.004	0.007	0.010	0.019	0.023
Baa	0.009	0.009	0.015	0.014	0.015	0.022
Baa	0.018	0.022	0.022	0.035	0.042	0.094
Baa	0.071	0.083	0.099	0.116	0.125	0.240
Caa-C	0.530	0.333	0.365	0.406	0.434	0.556
IG	0.004	0.005	0.008	0.010	0.014	0.021
SG	0.121	0.151	0.167	0.190	0.203	0.291
All	0.050	0.062	0.069	0.078	0.085	0.115
Data in percent						

Fig.30: Cumulative issuer-weighted default rates by annual cohort, 2009-2018

Source: © 2019 Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their affiliates and licensors. All rights reserved. Information is provided subject to the terms and conditions available at the following link: https://www.moodys.com/Pages/globaldisclaimer.aspx.

Comparability

Credit ratings issued by international CRAs establish commonly understood points of reference that enable comparison across markets, industries and geographies. China is a market of increasing importance and interest to international investors. As part of their analytical work, international investors will be looking for the views of international CRAs to help them understand the relevant credit worthiness of a Chinese bond versus other bonds. For example, an investor can look at a debt issuance in Finland with a BB rating and debt issuance in Brazil with a B rating, and easily understand the international CRA's opinion on their relative credit worthiness.

ASIFMA's 2016 global investor's survey on "Accessing Mainland China's Onshore Bond Markets" further illustrates the importance of international CRAs to international investors. According to the survey results, "coverage of issuers by international credit rating agencies" is listed by 60% of the respondents as either the number one or number two concern (out of five) with respect to credit information.

While our discussion focuses on the investor side, participation by international CRAs will also benefit the issuers in the domestic bond market, whether they are domestic or international issuers (in the case of panda bonds).

Altogether, international CRAs can serve as the bridge for capital flow from international investors to the Chinese domestic market if they participate in rating Chinese domestic bonds. We are thus encouraged by the recent proposals by the Chinese government to remove foreign investment restrictions on the CRA sector, and recommend that Chinese regulators welcome the participation of international CRAs by (1) facilitating international CRAs to operate in Chinese market without restrictions, and (2) creating a regulatory environment that is consistent with the international standards set forth in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

1i. Tax certainty

Withholding tax treatment

Lack of clarity on the tax treatment of bond interest received by FIIs had been a major reason why many FIIs have held back investing through the CIBM Direct and the Bond Connect. The State Council finally announced on 30 August 2018 a three-year exemption for withholding tax (WHT) and value VAT on interest income derived by FIIs on China bonds. This was followed by a circular jointly issued by the Ministry of Finance and SAT on 22 November 2018 confirming that the three-year exemption on bond interest WHT and VAT for FIIs will commence on 7 November 2018. However, FIIs are still waiting for further clarity on a number of areas.

Exemption retroactivity

According to the MOF and SAT's joint circular, interest income from bonds purchased by FIIs on or after 7 November 2018 is exempted from WHT and VAT. However, for the period prior to that date, the tax treatment is unclear for foreign investors. As there has been a lack of effective withholding mechanism for the collection of WHT or VAT, it would be difficult if not impossible for FIIs to withhold these taxes prior to that date. FIIs, particularly funds and fund managers, have struggled to decide on whether to make a provision for such taxes on their funds' balance sheet. Any such provision will have a direct impact on the expected return from the funds' bond investment. And, any retroactive collection of such taxes from fund unit holders is impractical if not impossible.

As foreign funds and fund managers need certainty, they would be grateful if the MOF and SAT can provide clarity on whether WHT and VAT are due for the period prior to 7 November 2018 and preferably confirm that they would not seek to change or challenge the past treatment adopted by foreign funds and fund managers regardless of whether tax has or has not been withheld or provided for in the past. Such clarification or confirmation from MOF and SAT would be beneficial to the whole fund industry. Without clarity and certainty as to whether WHT and VAT are payable on bond interest derived prior to 7 November 2018, FIIs would face difficulties and undue delay in the tax clearance process when they decide to repatriate profits. FIIs are concerned that without clear guidance from MOF and STA, different local tax bureau may adopt different stance and practice resulting in inconsistent and undesirable outcomes for FIIs.

Permanency of Exemption

In addition, as the tax exemption is for a three-year period only, FIIs would like sufficient notice in advance, preferably at least 6 months prior to the end of the three-year period. As most jurisdictions such as the United States, Japan and Australia exempt foreign investors from WHT in respect of interest on government bonds and certain corporate bonds, FIIs would welcome a permanent exemption for China bonds. We also note that to the best of our knowledge, China is the only jurisdiction which applies a VAT to non-government bond interest income and other financial products. By eliminating VAT permanently on bond interest income, China would attract more FIIs to invest in its bond markets. Importantly, in the event that the WHT and VAT will not be renewed, there would need to be detailed withholding mechanisms in place to support the tax compliance and payment process, and reasonable notice to foreign investors such that they have sufficient time to implement the proper process and procedures.

Scope of the exemption

The State Council announcement and subsequent MOF and SAT notice referred generally to WHT and VAT exemption for FIIs. We assume that, such exemptions apply to all FIIs regardless of the access channel used by them to purchase bonds in China in the past or in the future. It would be helpful to have this confirmed in a Question and Answer issued by MOF or SAT.

In addition, it would be helpful to clarify that the scope of exemption is not limited to "bonds" but rather that it was intended to apply to all "debt instruments". There are various types of tradeable instruments in the CIBM besides bonds (for example, treasury bonds, local government bonds, central bank bonds, financial and corporate bonds) such as asset backed securities, certificate of deposits, etc. There are also derivatives such as bond lending, bond forward, forward rate agreements and interest rate swaps that FIIs are allowed to invest in or trade under the CIBM Direct. Clarification on which of these debt instruments are covered by the tax exemption would be helpful.

Certainty of tax treatment on their investments is an important consideration for foreign investors and implementation rules on these areas will be most beneficial for further promotion of the bond market.

Foreign Account Tax Compliance Act (FATCA)

China agreed in substance to enter into a Model I Intergovernmental Agreement (IGA) with the US in order to implement FATCA, which became effective 1 July 2014. Almost five years have passed and IGA negotiation is still underway. In July 2016, the US turned up the heat with Announcement 2016-27 requiring jurisdictions which agreed in substance or already signed an IGA but not yet put into force to provide a detail step by step plan and timeline for signing or bringing the IGA into force. The US will review and remove jurisdictions which failed to demonstrate firm resolve to enter or bring an IGA in force beginning January 2017.

If China is being removed from the list, financial institutions in China will be required to comply with FATCA Regulations. Under FATCA Regulations, financial institutions are required to due diligent new and existing accounts, withhold on US source payments to non-participating foreign financial institutions (NPFFIs) and recalcitrant account holders, and report directly to the US Internal Revenue Service (IRS) on reportable accounts. Since existing Chinese laws do not allow financial institutions to withhold and report, Chinese financial institutions could be regarded as NPFFIs. According to FATCA requirements, NPFFIs cannot open US accounts, must identify itself as 'non-participating' to withholding agents, will be subject to 30% withholding on US fixed, determinable, annual or periodical income payments (FDAP) and being reported to the IRS. In addition, it is possible that certain non-US sourced payments attributable to amounts that would be subject to FATCA withholding (referred to as "foreign passthrough payments") may also be subject to FATCA withholding though the definition in the US Treasury regulations is currently pending.

While China is still on the list of countries agreed in substance to enter into an IGA, as of January 2019, the list continues to be monitored for changes by the IRS. In the meantime, financial institutions need to liaise with their regulator and government authorities for the release of the draft guidance and detail to reporting so that the industry can be more prepared to comply. In the meantime, we urge relevant government authorities in China to maintain dialogue with the IRS to ensure China remains on the list and ultimately enter into the IGA.

Common Reporting Standard (CRS)

Common Reporting Standard (CRS) is an Organisation for Economic Co-operation and Development initiative to increase tax transparency by requiring financial institutions in adopting jurisdictions to report account holder information where an account is held by a resident of a partner jurisdiction. More than 100 jurisdictions have committed to adopt CRS by entering into multi-lateral or bilateral Competent Authority Agreement (CAA).

CRS requires financial institutions to identify the tax residency of the financial account holders and report the relevant information to the local tax authority (in the case of China, it is the SAT). Tax residency information will be collected via indicia search and/or self-certification. Financial accounts held by a resident of a jurisdiction which China entered into CAA are to be reported to the STA. Information to be reported includes, but not limited to, personal information, account balance and payments. Since CRS is implemented through enactment of local laws, non-compliance will be penalised under Chinese laws.

China signed the multilateral CAA on 17 December 2015 confirming its commitment to implement CRS by 1 January 2017 and exchange of information by September 2018. China released legislation and FAQ in May 2017.

1j. Harmonizing market channels

China presently offers a multitude of access channels to its markets, but their differing requirements can be confusing for foreign investors. Not only is it challenging for market participants to build efficient implementation processes, but it limits the flexibility to use the various programmes in a complementary way and increases the risks to the market arising from operational errors. Additionally, as China develops new and less restrictive channels, it often has the unintended and perverse consequence of putting earlier investors utilizing older channels at a disadvantage. China should attempt to harmonize and align the various access channels, and rather than offering new channels China can consolidate, evolve or liberalise those already in place. If a new access channel is necessary, then it should provide for seamless and costless transfer of asset positions/holdings from old to new channels, or at least provide for a forward-looking transitional mechanism for investors to transition from old to new channels.

For example, while repatriation limits and lock-up periods have been removed for QFIIs/RQFIIs, there are still quotas that many foreign investors would like to see eliminated. In addition, as foreign investors are allowed to invest in new types of assets in China (for example commodities), QFIIs/RQFIIs, which were the earliest public markets accessible to foreign investors in China, should have their investment scope expanded accordingly and this should include hedging instruments and other transactions that other foreign investors are allowed to engage in. The combination of the two channels may present opportunities to accomplish some of these goals which would lead to greater efficiency and flexibility.

2. Operating in China

2a. Foreign ownership limitations

Foreign ownership has long been restricted to 49% for many financial services companies in China while China's own companies have benefitted from easy access, sound legal frameworks and lower restrictions on their own mergers and acquisitions in the US and EU.

The State Council's Information Office announced in November 2017 that direct or indirect foreign ownership of securities investment companies, fund management companies and futures companies will be relaxed to 51% and after three years, the foreign ownership limit will be lifted. On 23 August 2018, the CBIRC announced that foreign banks can now acquire 100% of Chinese banks and asset managers. And in March 2019, a new foreign investment law was approved by the National People's Congress, to come into effect on 1 January 2020, replacing the three legacy foreign capital laws that have guided China's reform and opening up – the Law on Sino-Foreign Equity Joint Ventures, the Law on Sino-Foreign Contractual Joint Ventures, and the Law on Foreign-Capital Enterprises.

The specific rules in the draft law are vague, however. FIIs would like to see 100% ownership as soon as possible, ahead of the 2021 deadline. Even though the 51% foreign ownership rule has been superseded, there remain hidden impediments that may prevent foreign firms from availing themselves of the rules, and which will prevent the Chinese economy from fully benefitting from the opening up. Experience with the new ownership rules so far indicates that licensing may remain problematic.

Many of these barriers involve licensing procedures, with some FIIs waiting more than a year for decisions on the current 51% ownership limit. As the new rules come into effect for 100% ownership, application procedures, terms and conditions for approval, and timetables for submission of documents and review should be made transparent.

On 9 March 2018, the CSRC also issued a consultation on the Draft Measures on Equity Interest in Securities Companies. Although the measures would apply to both domestic and international shareholders of Chinese Securities Companies, there were many requirements that are troubling specifically to foreign firms including:

- New qualification requirements: an RMB 100 billion net asset requirement for controlling shareholders and disclosure obligations which apply to shareholders of securities companies, some of which are stringent and may be difficult to comply with in practice.
- The introduction of new caps on ownership of securities companies by non-financial institutions, which may affect foreign investors disproportionately and could require the restructuring of many existing shareholdings in securities companies.
- The lack of specific provisions in the Draft Measures as to whether the existing shareholders of securities companies, who acquired their shares before the new rules come into effect, will be

exempt from complying with the qualification and other requirements of the Draft Measures or have the benefit of a sufficient grace period to enable them to meet the requirements.
- The failure of the Draft Measures to expressly take into account the parent entities of direct shareholders when assessing compliance with the qualification requirements.

Allowing foreign financial firms to establish wholly foreign-owned subsidiaries will benefit China's economy. Weak competition in the industry and constrained participation of international firms exacerbate challenges in the securities market such as inefficient capital allocation, excessive speculation of A-shares, lacklustre product development and innovation, and the inability of mergers and acquisitions deals to get beyond the initial stages. Allowing foreign firms to establish subsidiaries would attract more human capital, stimulate technology developed, improve risk management practices, and galvanise financial innovation. Foreign companies would bring more products onshore and/or relocate their subsidiaries from other parts of Asia to China. This would enhance Shanghai and other Chinese cities' positions as international financial hubs. It would also lead to more jobs and increased tax revenues.

Even if subsidiaries are permitted, however, competitive barriers would remain. Foreign brokers would continue to face challenges gaining market share as they lack the branch network needed to compete with domestic brokers in retail services. Hence foreign firms will focus on institutional clients. Notwithstanding their advantages, and perhaps in part because of them, the domestic securities sector is behind the banking sector in opening up to foreign investment. For this reason, despite the on-going treaty negotiations between China and the US and EU, we recommend China begin liberalising its securities sector as it does not now satisfy conditions for the necessary development of China's capital market.

Many hidden barriers remain in rules governing 51% foreign ownership, including financial and other eligibility requirements for foreign owners, for example, the RMB100 billion NAV requirement, and different licensing rules for existing JVs versus new JVs. Existing JVs can only apply for 2 new licenses every 6 months, while new JVs can apply for 4 new licenses in one tranche. The application process for higher levels of ownership is opaque in practice, which also contributes to an unlevel playing field. The uneven playing field is one reason why there are few foreign Bond Connect market makers.

2b. Wholly Foreign Owned Private Fund Managers

Recently, there have been encouraging signs, with China allowing foreign financial institutions to set up Wholly Foreign Owned Enterprises (WFOEs) to engage in the private investment fund management business in China, raising funds and making investments in China. The Asset Management Association of China (AMAC) registered the first such WFOE as a "private securities investment fund manager" in January 2017 under the so called "WFOE Private Fund Management (PFM) policy" and more such WFOEs are expected to be registered in the near future.

Since foreign investors were allowed to set up WFOE PFMs in June 2016, there has been quite a lot of interest. However, foreign shareholders or controllers of PFMs must meet the following eligibility requirements: (a) they must be a financial institution licensed by a financial regulatory authority in their home jurisdiction, (b) the securities regulatory authority in their home jurisdiction must have entered into a memorandum of understanding on securities regulatory cooperation with the CSRC or other institutions recognised by the CSRC, and (c) they must not have been subject to any material penalty by a regulatory or judicial department in the past three years.

For PFMs to be able to provide investment management or advisory services in relation to securities and futures investments, they must first be registered with the Asset Management Association of China (AMAC). As of December 2018, 16 PFM WFOEs have been registered with AMAC. As a PFM, they can raise funds in China from up to 200 eligible investors through private placement and invest in stocks, bonds and related derivatives (including commodity derivatives) in the secondary market.

PFMs must launch their first fund within six months of its registration. The fund must have at least two investors with the minimum subscription of each investor being RMB 1 million. As of December 2018, 16 PFM WFOEs had launched a total of 25 private funds onshore. 17 of those funds are equity funds while five of them are fixed income funds, one is a futures fund and two are mixed funds.

Actually, quite a large number of investment management WFOEs have been set up by foreign investors, mostly in Shanghai but also in Beijing and Shenzhen. Many have not yet registered as a PFM WFOE with AMAC because of the requirement that within six months of such registration the PFM WFOE must launch its first fund. But, as soon as they are ready to launch their first fund, we expect many of these WFOEs to register with AMAC.

Seeding

It is common practice for overseas fund managers to provide initial investment for their funds. However, PFMs are not allowed to invest in their own fund using their registered capital due to SAFE rules but they can do so with their profits or any legitimate revenue that they have. PFM WFOEs can also get their onshore affiliates to invest in their fund provided that those affiliates are permitted to invest in private funds.

As PFM WFOEs are all start-ups yet to build a name or brand in China, many, especially those with no onshore affiliates, experience difficulty raising monies for their first fund. Since QFIIs/RQFIIs are permitted to invest in securities investment funds, allowing them to invest not only in retail mutual funds but also private securities investment funds would provide a ready source of seeding monies for PFM WFOEs' first fund. Having QFIIs/RQFIIs as an initial investor of a PFM WFOE's fund would enhance confidence of mainland investors in the fund and also help kick off the PFM's fundraising and track record building process in China. Therefore, we strongly suggest that QFIIs/RQFIIs be included in the list of qualified investors of PFM funds.

We understand that CSRC has already allowed some QFIIs/RQFIIs to invest in some specific customer asset management products of Fund Management Companies (FMCs) and collective investment products of securities companies that are similar to private securities investment products. FIIs look forward to the issuance of a clear policy from the CSRC on QFIIs/RQFIIs' investment into these products, including the products of PFM WFOEs.

Investor base

Chinese insurance companies are currently allowed to invest in private equity investment funds. PFM WFOEs would like to see insurance companies being allowed to also invest in private securities investment funds so that they can be another source of capital for PFM WFOEs' funds. Similarly, expanding the type of investors for private securities investment funds to include the national social security fund and enterprise annuities would also be helpful to PFM WFOEs.

Although Chinese commercial banks cannot invest their proprietary funds into stocks or products issued by financial institutions (noting that PFMs are currently not considered financial institutions), wealth management products issued by the banks' wealth management subsidiary can invest into private funds whose manager meets CBIRC's requirements.

Distribution challenges

PFM WFOEs are allowed to sell their funds directly to qualified institutional and individual investors. They can also sell their funds through a distributor with a fund distribution license. Typically, this is done through an investment in the PFM WFOE's fund by an asset management product (AMP) issued by the distributing entity which has already raised capital from qualified institutional and individual investors (Wrapper Product).

However, a number of issues arose with lies with the issuance of the *Guiding Opinions regulating Financial Institutions' Asset Management Businesses* on 27 April 2018 by PBOC, CSRC, CBIRC and SAFE (the Guiding Opinions) and the subsequent implementing measures issued by CSRC and CBIRC. The Guiding Opinions were introduced to provide a uniform regulatory framework for regulating financial institutions' asset management business and their AMPs. Financial institutions are defined as bank, trust, fund, futures and insurance asset management companies.

In CSRC's implementing measures, there are some new requirements on investment concentration which are particularly problematic for PFM WFOEs. Those requirements provide that (a) an asset management product issued by FMCs, securities companies, futures companies and their respective subsidiaries not invest more than 25% of its Net Asset Value (NAV) in the same asset and (b) the investment of all asset management products managed by the same securities and futures companies in the same asset not exceed 25% of the asset's NAV (referred to as the "double 25%" requirement). There are exceptions, however, including (i) if the AMP is a closed-ended collective scheme with professional investors only, and each investor's minimum subscription is RMB 10 million; (ii) if the AMP is a securities investment collective scheme that strictly follows an index; or (iii) if they are other collective schemes recognised by CSRC as not subject to the asset allocation limit.

The double 25% requirement effectively means that a Wrapper Product needs to invest in at least four unrelated private funds or a private fund needs to have at least four unrelated Wrapper Products as investors, which make product design and operation of the Wrapper Product extremely complicated and difficult to implement. As a result, fundraising by private funds has become even more challenging than it currently is. While we understand the objective of the Guiding Opinions is to prevent multi-layer product investments, it does have an impact on PFM WFOEs' and Qualified Domestic Investment Partnership (QDLP) managers' ability to raise funds from fund-of-fund products, which already have two layers of funds. It also restricts the capability of implementing a multi-asset investment strategy to onboard any AMP as the multi-asset strategy needs to leverage the underlying equity and fixed income private funds as building blocks.

The Guiding Opinions and relevant implementation rules also effectively closed the bank distribution channel for PFMs (including PFM WFOEs and QDLPs) because bank wealth management products can only invest in AMPs managed by "financial institutions holding professional licenses and under supervision by PRC financial regulators or other institutions recognised by CBIRC", which PFMs are not. PFMs can only invest in AMPs of bank wealth management subsidiaries which are being set up only recently by banks. The result of which is that many private funds can only leverage the securities and futures operating institutions (including securities companies, fund management companies, futures companies and their subsidiaries engaging in private asset management business) and wealth management platforms to help them raise capital for their private funds.

We do not believe that it is the intention to apply the investment concentration limit to Wrapper Products as these types of products are very common overseas. The double 25% requirement would severely limit the ability of PFM WFOEs to raise capital for their funds and to bring more investment strategies to the China market that would meet Mainland investors' needs. We suggest that there be a relaxation of the multi-layer investment restriction and the double 25% requirement if there is a legitimate reason or strategy for having more than two layers of investment (for example, asset allocation) and not because of nesting and being a channel. Otherwise, these requirements will make it difficult for newly-established PFM WFOEs and QDLP managers with few onshore clients to raise capital for their funds from the onshore market and may decrease the interest of some potential foreign investors from setting up a PFM WFOE or a QDLP manager in China.

15 QDLPs have been registered with AMAC as of the end of 2018. Given the master-feeder structure of QDLP funds, which are targeted to invest into offshore master funds, FIIs would like the CSRC to confirm in writing that the two-layer limitation under the Guiding Opinions and the investment concentration limit under the CSRC implementing measures do not apply to offshore investments of QDLP products.

Many global asset managers expressed interest in applying for the WFOEs PFM registration with commitments to allocate resources to support their China business expansion plan. But, foreign firms may have to overcome various "technical difficulties", such as how to first obtain an appropriate corporate name and business scope registration for "investment-type" enterprises, because these repatriations were temporarily suspended in early 2017. It is still unclear when the local authorities will reinstate generally such repatriations.

Prior to AMAC's registration of PFM WFOEs, Shanghai, Shenzhen and some other cities in China had launched pilot programmes to allow foreign fund managers to set up WFOEs to raise funds within China but for investments offshore only. The best known of these programmes, Qualified Domestic Investment Enterprises (QDLP) and Qualified Domestic Institutional Investors (QDIE) were aimed at opening another channel outside of QDII to facilitate outbound investment. Given that these were all pilot programmes launched by local governments, it is not surprising that local governments require, among other things, that the WFOE be set up in their city as the pilot programme would be using the outbound investment quota of that city. As the business scope of foreign fund managers expands or changes, they may have to set up different WFOEs in another or multiple locations, which is not an efficient use of capital and other resources for these (or any) firms.

Foreign firms appreciate such initiatives from the local governments but also recognise the trial basis of such pilot programmes and the uncertainty over how and when such programmes will morph into a nationwide policy. Along with the unfolding of the WFOE PFM policy, it is hoped that, at some point, the authorities may allow a QDLP or QDIE WFOE to be converted to a PFM WFOE allowing a PFM WFOE to apply for various pilot programmes in different cities so that WFOEs can conduct business in different jurisdictions through one entity instead of multiple entities. We believe such integration of various policies, if achieved, would promote greater efficiencies, facilitate growth and more free flow of capital in the long run which are particularly important for the fund management industry where economies of scale, for example, would reduce not only the costs of doing business for fund managers but also the cost to the ultimate investors or purchasers of funds.

2c. Bond underwriting and settlement licenses

Foreign financial institutions continue to face barriers despite opening-up measures. Since 2017, only five international banks have won sub-underwriting licenses in China, including JP Morgan, Citi, BNP Paribas, and Deutsche Bank with three additional foreign banks receiving co-manager licenses in October 2017. Moreover, capital requirements for underwriters in China are higher than elsewhere. In October 2017, HSBC became the first foreign bank approved as a joint lead underwriter for Panda issuances by offshore non-financial corporates in China's interbank bond market.[75]

International banks and financial institutions currently still have difficulty acquiring underwriting and settlement licenses despite significant expertise in this area. To get an underwriting license, for example, foreign banks must first receive approval from the underwriters already active in the market. Requiring a firm's competitors to approve its participation in the market is a significant obstacle for foreign banks. In addition, the current application-scoring mechanism disadvantages foreign banks by considering only onshore business volume and ignoring the foreign applicant's offshore business.

As such, no foreign banks have obtained a full license that gives them a leading role in domestic bond deals and in December 2018, at least two US banks were denied a license for lead underwriting status, which permits firms to co-lead and co-arrange bond issuance on behalf of clients in the interbank bond market. The denial was opaque and subjective, citing lack of a sufficient risk control framework and insufficient syndication volume in 2017. Without a lead underwriting license, foreign firms are subordinate to their Chinese competitors and relegated to a supporting role in the underwriting process, which substantially limits profitability and growth potential in China's booming bond market. Moreover, it serves as a hurdle to achieving the volume levels that regulators cited as deficient when they denied underwriting licenses to the two US firms.

International financial institutions should be able to acquire bond underwriting and settlement licenses on a fair and transparent basis.

3. Raising Funds in China

3a. QDII and RQDII

The QDII regime, launched in 2006, is a near mirror image of the QFII regime. It enables domestic Mainland Chinese institutional investors with a QDII license and quota approved by the China's regulatory authority to invest in offshore markets. Each QDII is granted a specific quota by SAFE.

Overview of the QDII Regime

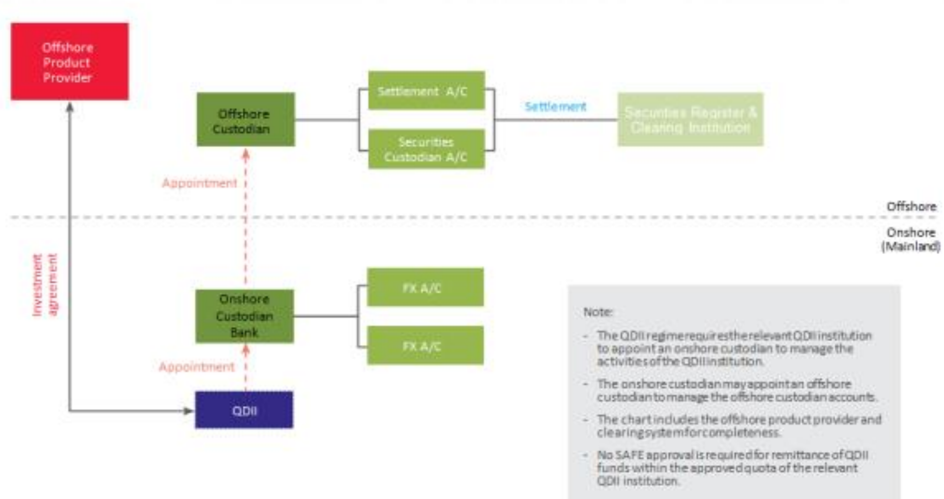

Fig.31: Overview of a QDII
Source: ASIFMA

Under China's Securities Law, a QDII institution (other than a QDII insurance company) is required to repackage an offshore investment product as its own QDII product for sale to its domestic investors.

Chinese 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
- The investment criteria that onshore investors must satisfy
- The investment restrictions that QDII institutions shall observe

As a result of the different QDII regulatory regimes, different categories of QDII institutions are subject to different types of permissible offshore investments. There are also various types of investment restrictions applicable to different offshore investment products invested in by different types of QDII institutions.[76]

The Renminbi Qualified Domestic Institutional Investor (RQDII) regime, which was launched in 2014, permits RQDIIs to invest in overseas RMB denominated products using their own RMB funds or RMB funds raised from China's institutional or individual investors.

Unlike the QDII regime, RQDIIs do not need to be granted a quota by SAFE. Qualified RQDIIs may invest as much RMB funds as they are able to raise from domestic investors, provided that the amount of funds is within the maximum amount reported to or approved by the regulatory authorities.

However, China stopped approving quotas for QDIIs/RQDIIs as of December 2015 out of concerns over capital outflows. New quotas were granted in April-June 2018, and SAFE announced on April 11, 2018 that it will enhance the QDII programme and study how the programme should be improved for the next steps.

As QDII/RQDII is another important access channel for foreign asset managers, we would like to see these regimes opened again in the near future. ASIFMA believes that more quotas should be granted to QDIIs, ideally with a schedule for the timing of the release of further QDII quota. We would also like to see the limits increased of the high yield exposure of banks' QDII products from 20% of the NAV of the products to 30% to 40%.

Recommendations for Market Access

1. **Channel harmonization:** Harmonise the requirements of similar access programmes with a view towards future consolidation and/or alignment to improve efficiencies. Where viable, consider the positive impact of fungibility of different investment channels, given the end objective of stimulating great foreign investment into China.
2. **Level playing field:** It is key to ensure that foreign-owned securities JVs can operate and compete in China on equal terms as domestic firms, by swiftly approving applications for 51% foreign ownership and for all necessary licenses.
3. **Bond underwriting:** A level playing field should be provided by allowing international banks and financial institutions to acquire bond and ABS underwriting licenses on a fair and transparent basis. International banks and institutions face difficult and often discriminatory procedures to acquire underwriting licenses. The system of approval includes a panel of existing underwriters that effectively requires new entrants to the market to be approved by their competitors.

4. **Reconsider qualification requirements:** The industry is still awaiting feedback from the CSRC on the *Draft Administrative Measures on Equity Interest in Securities Companies.* Although the Draft Measures would apply to both foreign and domestic players, they introduce new qualification requirements (e.g. RMB100 billion net assets for the controlling JV shareholders) that are difficult to comply with for foreign firms.
5. **Licensing conditions between existing and new foreign-owned securities firms should be equalized** by allowing existing JVs to receive the same number of licenses in one tranche as new JVs. At present old JVs can apply for 2 new licenses every 6 months while new JVs can only apply for 4 new licenses in one trance.
6. **Grandfathering of existing JVs**: The enhanced qualification requirements in the CSRC Administrative Measures of Foreign Invested Securities Companies should apply equally to new securities JVs and existing securities JVs. Existing JVs should be grandfathered into the new requirements as they are already reviewed and approved at the time of the establishment of the securities JV.
7. **Streamline application process for license applications:** ASIFMA recommends that China establish an equivalent, transparent, and streamlined approval process for foreign financial services companies applying for local operating licenses, such as lead bond and ABS underwriting, futures, settlement, and others. In terms of the continuing limits on ownership by foreign financial institutions, ASIFMA members would like to see immediate realization of 100% ownership as opposed to the phased-in removal of limits over three years.
8. **Quotas:** Remove all repatriation limits (e.g. QFII) and quotas (e.g. daily quota under Stock Connect) across all access programmes.
9. **QFII/RQFII restrictions:** Allow QFII/RQFII to be able to invest in private funds in China.
10. **Approvals for Northbound funds:** Improve the transparency and efficiency of the Northbound fund approval process under the MRF.
11. **Increase range of issuers:** Increase the range of issuers for panda bonds, facilitate international credit rating agencies to rate panda bonds and allow greater flexibility in accounting rules in line with global standards (particularly for US GAAP).
12. **Improvements to Bond Connect:** Further enhance the Bond Connect scheme, including streamlining the registration process, accelerating the approval of more trading platforms, lowering the costs of onboarding and trading, the introduction of Bond Connect repo scheme (through introduction of tri-party repo, using established global custody providers). Lastly, expanding the range of approved dealers to include regulated offshore parties.
13. **Foreign participation in onshore trust holdings:** Allow foreign investments into an onshore trust holding for securitized assets.
14. **Cyber security Law:** Adopt a regulatory approach that is flexible and risk-based, embracing global standards and best practice.
15. **Investor education:** Promote investor education programmes that teach key principles of investment such as an understanding of risk, the role of diversification, and the importance of building a portfolio with an appropriate investment horizon. Remove the foreign ownership cap for securities, trusts, asset management, and credit ratings entities.

16. **Qualification requirements for controlling shareholders:** We hope that the qualification requirements for controlling shareholders in domestic securities companies can be lowered or that at least the parent/group can be taken into account instead of the immediate parent. We also ask that existing JVs be grandfathered
17. **10% limit on individual foreign investors:** In addition, clarity is needed on how the 10% limit for individual foreign investors should be calculated, especially if the investor is an asset manager acting on behalf of multiple clients or funds.
18. **PRC investor eligibility to trade Stock Connect:** SAFE should revisit the "resident outside PRC for >1 year" requirement for Stock Connect participants.

J. List of All Recommendations

Recommendations for Equities
Developing the Chinese Equity Markets 1. **Calculate Short Swing Profit Rule on an Individual Client/Fund basis**, rather than at the Fund Manager level, given the large number of funds and clients that many Fund Managers often invest on behalf of (funds currently aggregated as deemed to be "acting in concert"). Large fund managers run the risk of triggering the 5% threshold which may cap their ability to further grow the size of their managed portfolios in China, especially as the weighting increases. 2. **Further enhance the robustness of the Closing Auction Session (CAS):** Volumes remain low in both SSE's and SZSE's CAS owing to structural and operational frictions, which need to be addressed. Clear and consistent messaging from Market Surveillance on how brokers may or may not trade during the CAS, allowing for order cancellations during the CAS, and permitting more order types (for example, Market on Close or MOC) will help encourage increased broker participation in the CAS. Securities lending and borrowing can also help facilitate increased participation during the close, where large sell and buy orders can be better matched against each other while minimizing price impact. 3. **Alignment to the international settlement cycle where cash and stock settle simultaneously:** Given a global client base and the operational challenges of the current T+0 settlement cycle, allowing DVP to better protect investors, as well as a move to T+2 or T+1 to better harmonize with global practice can help to reduce settlement risk. We recognise this may be a longer-term solution but note that securities lending and borrowing may help to address some of these operational challenges in the interim (for fails settlement). 4. **Direct Market Access (DMA) Qualification Criteria** – Proposed relaxation of the Third Party Connection rule for Institutional Clients to trade directly via Broker Trading Systems is most welcome, but the current draft rules require that the local securities brokers, possibly including JVs, offering DMA to have an A grade rating or above in the past 2 years out of 3. This requirement may create a barrier of entry for existing or new securities JVs challenged to meet the profitability level to qualify for an A grade rating. DMA offerings to clients have become a significant contributor to profitability and it may be difficult to achieve such without DMA as a service offering. We are not aware of profitability prerequisites in other markets for expanding the business scope of securities firms. This rating requirement may be a deal-breaker for foreign players wanting to develop their business in China, deterring them from injecting capital into China and not advantageous to the promotion of investment interest in China. 5. **DMA Broker QFII Due Diligence Requirement** – Draft guidelines require that DMA brokers obtain information from clients on trading system structure, functional design, product structure, product management model and risk management control and for such information to be submitted by the local broker, possibly including JVs, to CSRC. Such information is currently already

readily accessible by CSRC upon request to QFIIs; hence, concerns have been raised about sharing such confidential information which is considered intellectual property with the local broker. While securities brokers onshore are responsible for upholding the integrity of the market, and for monitoring the exchange trading activities of their QFII clients, the due diligence focus should be on risk management controls rather than on verifying their QFII clients' product offerings and other matters ordinarily considered confidential business information.

6. **Reduce restrictions on derivatives:** Futures contracts and other derivatives are crucial tools for investors to hedge their positions.
7. **Allow Off Market Trading to facilitate Best Execution**, including alternatives to exchanges such as Multilateral Trading Facilities (MTFs) and Alternative Trading Systems (ATSs).
8. **Access channel fungibility and harmonization:** Offer investors the ability to easily switch from one access channel to another for the same beneficial owner without having to liquidate and repatriate investments, with a view towards eventual future consolidation and/or alignment of such channels to improve efficiencies.
9. **Allow investments in the QFII/RQFII and Stock Connect Channels to be settled in CNY**.

Stock Connect (Shanghai and Shenzhen)

10. **Omnibus Trading at the Fund Manager Level:** The ability to trade at the omnibus level remains a key characteristic of mature markets. Although BCANs at the Fund Manager level allow for fair and equitable average pricing and allocations to underlying funds on a post-trade basis, Omnibus Trading at the Fund Manager Level would further improve trading efficiencies and better facilitate Best Execution for clients. Such capability would also help facilitate MOC as mentioned above.
11. **Block Trading:** Although a China block trading window is available for QFII/RQFII investors, such a facility is currently not available to participants of Stock Connect. Brokers need access to block trading to better source liquidity to match large trades, especially during rebalance days.
12. **Efficient Stock Borrow Loan (SBL) environment:** As portfolios grow in size over time and with additional weighting increases, investors will need securities lending and short selling to better hedge their market exposure. An effective SBL mechanism can also help support failed settlement coverage and Guaranteed Volume Weighted Average Pricing (GVWAP) for best execution.
13. **Holiday Trading: As China and Hong Kong observe different holiday schedules, Stock Connect is currently unavailable for use during Hong Kong holidays as well as on the day prior. Investors should be able to trade through Stock Connect when the Chinese stock markets are open for trading.**
14. **Stock Connect Stability and Risk Reduction**: Continue to work with HKEX to improve Broker-Dealer order throughput capacity via Throttle on Demand, which would provide added flexibility for algorithms, additional volumes in the CAS, and improvements to Best Execution for clients.
15. **Streamline the Real-time Delivery Versus Payment (RDVP) process for USD** to facilitate more global investor participation in the A share market via Stock Connect, as current cutoff windows are too tight (RDVP for CNH works well).

16. **Enhance Special Segregated Account (SPSA) Client Onboarding forms and processes** to streamline and facilitate more efficient SPSA account openings.
17. **Expand or remove the Stock Connect Daily Quota**: Although the quadrupling of the previous daily quotas for northbound and southbound trades in April 2018 was a welcome measure, the Daily Quotas should eventually be removed or expanded to ultimately facilitate a 100% inclusion factor.

QFII/RQFII

18. **Removing the restriction to only sell through the same broker through which the shares were originally purchased.** The lack of choice for investors in Hong Kong through Stock Connect has the potential of impairing best execution.
19. **Block Trading:** Although block trading is currently permitted from 3 to 3:30pm, the manual nature of this facility makes it operationally challenging to use effectively, especially for fund managers trading hundreds of underlying funds. ASIFMA suggests a host to host interface to automate the block trading process.
20. **Improve QFII/RQFII Quota Management:** Account managers should be able to manage, transfer, and re-allocate quotas between different sub-accounts on an ongoing basis without significant administrative inhibitors, given the dynamic needs of clients and the nature of the market.
21. **Elimination of the quota scheme (the total QFII quota was recently increased to US$300 billion):** Although the January 2019 doubling of the QFII quota is a welcome change, elimination of the quota scheme is the natural course as China's capital markets embrace globalization.
22. **Removal of minimum settlement reserve funds to mitigate settlement risks:** Currently QFII/RQFII are obliged to contribute reserve funds to the central depositories in Shenzhen and Shanghai. The contribution is based on prescribed percentages of the investment quota. The funds cannot be used for trading nor repatriation. This should be replaced by an intra-day facility in line with international practice.
23. **Efficient Stock Borrow Loan (SBL) environment:** As portfolios grow in size over time and with additional weighting increases, investors will need securities lending and short selling to better hedge their market exposure. An effective SBL mechanism can also help support failed settlement coverage and GVWAP for best execution.

Recommendations for Fixed Income

Developing China's primary markets

24. **Adoption of international best practices with respect to issues such as information disclosure**, which could actually be simplified for institutional investors, who do not need the same level of detail provided to retail investors, both in the prospectus/issuing document at the time of the new issue and on a continuing basis
25. **Strengthening the due diligence process**, in particular the key areas of financial (pertaining to the issuer's financial accounts), legal (issues pertaining to the incorporation of the issuer) and business (pertaining to the present and future outlook/prospects for the issuer's business activities) due diligence

26. **Streamline the book building process** to provide more flexibility in terms of price determination through an iterative process of communication between the issuer/underwriter(s)/bookrunner on the one hand and investors on the other hand, similar to the process used in international offerings
27. **Arrangements should be made to facilitate the registration of SPVs** for foreign investment channels such as Bond Connect, to facilitate ABS origination and distribution to foreign investors.

Developing Secondary Markets, classic repo markets, bond futures, fixed-income derivatives

28. **Auction /Market supply and market liquidity**: Actions to increase the issuance size and providing encouragement to market makers to provide pricing transparency are all important steps to developing a strong China benchmark yield curve. Re-opening of outstanding issues where viable is highly advisable. Buybacks for off-the-run issues (to be replaced by tapping more liquid current issues) is also an option worthy of consideration. Any regulatory action that might encourage more active trading participation/bond turnover from large domestic banks is also desirable. The Buy and hold-to-maturity strategy employed by many domestic banks has clearly inhibited market liquidity to at least some degree. Allowing banks and foreign investors to trade futures would also increase the aggregate level of market liquidity.
29. **Guidelines on CDS market:** Regulators should issue guidelines for offshore investors and other market participants to use the Chinese domestic Credit Default Swap (CDS) market.
30. **Regulators should formalize the central clearing of CDS** and the designation of Central Counterparties (CCPs) to mitigate counterparty risk.
31. **Tri-party repos**: PBOC has announced the inauguration of a tri-party repo in the interbank bond market but for now, only depository and settlement agents for interbank bonds can act as third parties. However, this is a significant advance since in the future large banks with corresponding capabilities will also hopefully be able to provide such services. PBOC should consider expanding the range of third parties as soon as possible.
32. **Repo**: Move towards a title transfer (Classic) repo format, facilitating the use of accepted GMRA documentation for foreign investors. Furthermore, Bond Connect can be a powerful channel for growth in foreign investor participation, namely through the use of tri-party repo, initially involving offshore-to-offshore customers. This is discussed is our Market Access section under Bond Connect.
33. **CNY capability and the ability to face multiple FX banks**: Among the most common issues raised by index tracking funds are CNY capability (some GCs are still not able to offer CNY) and the ability to face multiple FX banks for CNY conversion to achieve and verify best execution.
34. **Need for a longer settlement cycle**: Again, a problem raised by investors is the need for longer settlement cycles (not just T+0, T+1, T+2).

Clearing and settlement issues

35. **The role of the Type A member can be split between trading and settlement functions**, to allow specialist trading and settlement service providers to independently service the client.
36. **Type A members can be members at CFETS for trading/trade matching purposes**, only if the trade is sourced and executed by such members. They can also provide settlement functions, if they chose to. However, the functions need not be bundled.
37. **Broker dealers, asset managers or investors should be allowed to trade and enter CFETS** for trade matching on behalf of investors.

38. **Custodians should be allowed to provide settlement services** at the depositories using their existing license, which is allowed in almost every other market globally. They can also be required to do trade reporting for OTC trades at CFETS so CFETS has the entire trade and execution data, if required.
39. **Trade execution or services that can impact the legality of the trade execution** in the market would not be allowed.
40. **Investors should be allowed to enter trade orders in CFETS overseas** either by themselves or through their broker/global custodian/international central securities depository, using the trading ID of the intermediary or their own. Alternatively they can trade onshore through the onshore settlement agent.
41. **A Central Clearing Counterparty for all OTC trades in the CIBM should be considered** with Clearing Members who participate in the Clearing process to minimise clearing risks (for CCDC settlements).
42. **Type A members and custodian banks should be eligible to become clearing members for bond trading upon application**. This would be on a par with the equities market framework in China and also international best practices.
43. **Investors should settle the trades in the account of the GC or ICSD held with the LC**. The LC would be able to confirm such trade directly with the onshore CSD.

Exemptions from VAT and CIT (November 2018)

44. **The exemptions apply to all approved debt instruments,** all channels and all types of trades (including cash, repo, bond ending and bond derivatives trades).
45. **The 3-year exemption should ideally be renewed at least 6 months prior to the end of the 3-year cycle. I**f there is no renewal of the exemption, 6 months advance notice should be given to foreign investors.

Overall recommendations

46. **Undertake steps to increase secondary market liquidity, as listed above.**
47. **Encourage greater participation of foreign investors in repo markets by moving towards a title transfer (classic) repo market, adoption of accepted documentation used in other market (GMRA)** and other possible measures, as outlined in the Bond Connect / Market Access section.
48. **Adopt best practices based on global standards in information disclosure,** for the prospectus/issuing document at the time of the new issue and on a continuing basis.
49. **Strengthen the financial, legal and business due diligence process in the primary markets**.
50. **Streamline the book building process** to provide flexibility in price determination similar to the process used in international offerings.
51. **Allow all investor types to participate in the bond futures market.**
52. **Issue guidelines for offshore investors and other market participants** on the Chinese domestic CDS market.
53. **Formalise the central clearing of CDS** and the designation of CCPs to mitigate counterparty risk.
54. **Consider the introduction of ESG and social bonds** as well as bonds tied to the UN sustainability goals.

55. **Harmonise the different securitisation regimes** to create a bigger, deeper and more liquid securitisation market.

Recommendations for FX

56. **Encourage competing platforms to CFETS:** Continue to encourage increased price competition in electronic execution by allowing other platforms to participate to improve efficiency and therefore lower transaction costs
57. **Continue to identify opportunities to introduce new products** to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.
58. **Clarify whether FX hedge transactions in the interbank FX markets are exempt from VAT**, in line with VAT exemptions in the local currency market.
59. **Minimise the cost of trading FX** in order to encourage market participants to actively hedge their foreign exchange exposures.
60. **Consider digitising the requirement to provide underlying documentation for real economy trades when entering into FX transactions** in order to significantly increase market efficiency and mitigate operational risks and cost.
61. Clarify the FX hedging process for Bond Connect investor
62. Allow investors via CIBM direct channel to hedge FX not only with onshore agent bank, but also other FX market makers onshore.

Recommendations for Laws and Regulations

63. **Increase regulatory transparency and consistency** by a more open market consultation process, providing sufficient notifications of new rules and allowing public comments.
64. **Improve transparency and reliability of auditing and accounting standards** to increase confidence by international investors in China's corporate governance.
65. **Improve the corporate resolution and bankruptcy process** to allow investors to predict the impact of defaults by, among other things, ensuring the enforceability of all investor's direct security interest, if any, in a fair, transparent and clear manner in a restructuring or bankruptcy.
66. **Implement a resolution and recovery regime** for financial institutions that is consistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.
67. **Incorporate clearly and unambiguously the enforceability of close-out netting** in statute, reflecting internationally accepted practices.
68. **Amend the Securities Law** to support the exchange of variation margin used in the international markets and reflecting internationally agreed standards.
69. **Anti-money laundering regime.** While the system needs to be robust, it should seek international best practice standards and a risk-based management approach, avoiding unreasonable burdens on market participants.
70. **Cross-entity collaboration:** Enabling various group entities to work closely together to reap efficiency and collaboration gains. Enabling various entities of a group to work closely together would enable efficiency and collaboration gains. Collaboration both within China and across

borders, while keeping accountability local, would better reflect today's reality of global matrix organisations. For instance, a management group or committee could run all of a group's businesses in China centrally and across legal entities, while sharing central services through a Business Service Centres. As a reference point, CBIRC has recently approved Allianz Group's plan to establish a fully-owned holding company in Shanghai to carry out insurance, asset management and potentially other financial services under one China group structure.

Corporate governance recommendations

71. **Role of Party organisations:** Policy initiatives beginning in 2010 reinforced the role and importance of internal Party organisations (POs) in enterprises, both POEs and SOEs, with major statements and Article of Association amendments in 2017. More disclosure is needed on the role of the PO, which should produce a disclosure report comparable to the board of directors and supervisory board reports.
72. **There is a need to clarify the relationship between the PO and board of directors** in Company Law, and enhance board evaluations and committees.
73. **Supervisory boards:** China’s dual board structure includes a supervisory board (SB) whose functions overlap with those of the board of directors and audit committee. Both Company Law and official guidelines need to clarify the separation of duties between the SB and board of directors. SBs should be encouraged to use their full powers, and private firms should have a choice whether to include SBs in their governance structure.
74. **Clarification of roles:** The differences in role between board of directors, supervisory boards, and POs need to be clarified since these often overlap in function in practice.
75. **Revise the one-third rule for independent directors:** Nine-person boards with three independent directors are ubiquitous in the China listed ecosystem due to a rule that boards must have at least one-third independent directors. The one-third rules should be revised and companies should engage in director training and abolish attendance by proxy.
76. **Strengthen audit committees:** While corporate reporting has improved significantly since 2017 in the view of foreign institutional investors, the audit committees should play a stronger role and internal audit committees should report to them. External auditors also need to be given a stronger voice.
77. **Encourage investors to play a role in ESG reporting:** ESG reporting began in 2006, but there is still much confusion about its relevance to investors. Investors need to play a role in guiding listed companies to better compliance by focusing their attention on large caps, prioritizing their information needs around key issues, encouraging use of third-party and independent data, and experimenting with a “comply or explain” approach.
78. **Review takeover regulations and Company Law**: After peaking in 2016, the domestic M&A market has fallen off slightly, as deregulation has already worked through major sectors of the economy. SOEs account for most of the value of M&As, and are largely driven by policy concerns. Takeover regulations need review together with Company Law on shareholder meetings and voting.

Recommendations for Market Infrastructure

79. **Create statutory provisions for settlement finality on transactions** with CCPs and transactions across financial infrastructures in the Bankruptcy Law reflecting international standards enumerated in the PFMI.
80. **Allow the clearing member to create a security interest over cash in the margin account** which is recognised by China's Property Law or Securities Law.
81. **Prioritise the application of SHCH to be recognised as an equivalent CCP** under EMIR and as an exempt DCO by the CFTC.
82. **Provide foreign investors the option to use omnibus accounts** to allow them to benefit from cost saving and efficiency they currently enjoy from other developed markets. This would allow a simplification in their operating model and improve time-to-market for new products by avoiding the need to open segregated accounts in the entire chain.
83. **Ensure that the domestic market infrastructure is compatible with international standards**, including the PFMI, in order to expand the use of the RMB as an international currency.
84. **Settlement of the RMB on a PVP basis in central bank money accounts** with multilateral netting would support the continued, stable expansion in the global use of the RMB for trade, investment and as a reserve currency, and meet internationally agreed standards.
85. **Allow third party custodians to hold initial margin** on behalf of the posting counterparty.

Recommendations for Market Access

86. **Channel harmonization:** Harmonise the requirements of similar access programmes with a view towards future consolidation and/or alignment to improve efficiencies. Where viable, consider the positive impact of fungibility of different investment channels, given the end objective of stimulating great foreign investment into China.
87. **Level playing field:** It is key to ensure that foreign-owned securities JVs can operate and compete in China on equal terms as domestic firms, by swiftly approving applications for 51% foreign ownership and for all necessary licenses.
88. **Bond underwriting:** A level playing field should be provided by allowing international banks and financial institutions to acquire bond and ABS underwriting licenses on a fair and transparent basis. International banks and institutions face difficult and often discriminatory procedures to acquire underwriting licenses. The system of approval includes a panel of existing underwriters that effectively requires new entrants to the market to be approved by their competitors.
89. **Reconsider qualification requirements:** The industry is still awaiting feedback from the CSRC on the *Draft Administrative Measures on Equity Interest in Securities Companies.* Although the Draft Measures would apply to both foreign and domestic players, they introduce new qualification requirements (e.g. RMB100 billion net assets for the controlling JV shareholders) that are difficult to comply with for foreign firms.
90. **Licensing conditions between existing and new foreign-owned securities firms should be equalized** by allowing existing JVs to receive the same number of licenses in one tranche as new JVs. At present old JVs can apply for 2 new licenses every 6 months while new JVs can only apply for 4 new licenses in one trance.

91. **Grandfathering of existing JVs**: The enhanced qualification requirements in the CSRC Administrative Measures of Foreign Invested Securities Companies should apply equally to new securities JVs and existing securities JVs. Existing JVs should be grandfathered into the new requirements as they are already reviewed and approved at the time of the establishment of the securities JV.
92. **Streamline application process for license applications:** ASIFMA recommends that China establish an equivalent, transparent, and streamlined approval process for foreign financial services companies applying for local operating licenses, such as lead bond and ABS underwriting, futures, settlement, and others. In terms of the continuing limits on ownership by foreign financial institutions, ASIFMA members would like to see immediate realization of 100% ownership as opposed to the phased-in removal of limits over three years.
93. **Quotas:** Remove all repatriation limits (e.g. QFII) and quotas (e.g. daily quota under Stock Connect) across all access programmes.
94. **QFII/RQFII restrictions:** Allow QFII/RQFII to be able to invest in private funds in China.
95. **Approvals for Northbound funds:** Improve the transparency and efficiency of the Northbound fund approval process under the MRF.
96. **Increase range of issuers:** Increase the range of issuers for panda bonds, facilitate international credit rating agencies to rate panda bonds and allow greater flexibility in accounting rules in line with global standards (particularly for US GAAP).
97. **Improvements to Bond Connect:** Further enhance the Bond Connect scheme, including streamlining the registration process, accelerating the approval of more trading platforms, lowering the costs of onboarding and trading, the introduction of Bond Connect repo scheme (through introduction of tri-party repo, using established global custody providers). Lastly, expanding the range of approved dealers to include regulated offshore parties.
98. **Foreign participation in onshore trust holdings:** Allow foreign investments into an onshore trust holding for securitized assets.
99. **Cyber security Law:** Adopt a regulatory approach that is flexible and risk-based, embracing global standards and best practice.
100. **Investor education:** Promote investor education programmes that teach key principles of investment such as an understanding of risk, the role of diversification, and the importance of building a portfolio with an appropriate investment horizon. Remove the foreign ownership cap for securities, trusts, asset management, and credit ratings entities.
101. **Qualification requirements for controlling shareholders:** We hope that the qualification requirements for controlling shareholders in domestic securities companies can be lowered or that at least the parent/group can be taken into account instead of the immediate parent. We also ask that existing JVs be grandfathered
102. **10% limit on individual foreign investors:** In addition, clarity is needed on how the 10% limit for individual foreign investors should be calculated, especially if the investor is an asset manager acting on behalf of multiple clients or funds.
103. **PRC investor eligibility to trade Stock Connect:** SAFE should revisit the "resident outside PRC for >1 year" requirement for Stock Connect participants.

K. Glossary

Word or Acronym	Expanded version
AANA	Aggregate Average Notional Amount
ABMF	Asia Bond Market Forum (Asian Development Bank)
ABN	Asset-Backed Note
ABS	Asset Backed Security
ABSP	Asset-Backed Specific Plan
ACGA	Asian Corporate Governance Association
ADB	Asian Development Bank
ADT	Average Daily Turnover
AET	Automatic Early Termination
AIFMD	Alternative Investment Fund Managers Directive
AMAC	Asset Management Association of China
AML	Anti-Money Laundering
AMP	Asset Management Product
APLMA	Asia Pacific Loan Market Association
ASEAN	Association of Southeast Asian Nations
ASIFMA	Asia Securities Industry and Financial Markets Association
ATS	Alternative trading system
AUM	Assets Under Management
BCAN	Broker-to-Client Assigned Number
BCBS	Basel Committee on Banking Supervision

BCBS-IOSCO	Basel Committee on Banking Supervision and International Organisation of Securities Commissions
BCCL	Bond Connect Company Limited (JV of CFETS and HKEX)
BRI	Belt and Road Initiative
CAA	Competent Authority Agreement
CAC	Cyberspace Administration of China
CAS	Credit Asset Securitisation
CAS	Closing Auction Session
CBA	China Banking Association
CBBC	Callable Bull-Bear Contract
CBIRC	China Banking and Insurance Regulatory Commission
CBRC	China Banking Regulatory Commission (obsolete)
CCDC	China Central Depository & Clearing Co., Ltd
CCP	Central Counter-Party Clearing House
CDS	Credit Default Swap
CEM	Current Exposure Method
CFFEX	China Financial Futures Exchange
CGB	Chinese Government Bond
CIBM	China Inter-Bank Bond Market
CII	Critical Information Infrastructure
CIPS	Cross-border Interbank Payment System (China)
CIRC	China Insurance Regulatory Commission (obsolete)
CIT	Corporate Income Tax
CLO	Collateralised loan obligation

CLS	CLS Bank (Bank for International Settlements)
CMBS	Commercial mortgage-backed securities
CMU	Central Moneymarkets Unit
COMI	Committee on Payments and Markets Infrastructure (FSB-IOSCO)
CNAPS	China National Advanced Payment System
CNH	Chinese Yuan (or Renminbi) in the offshore market
CNY	Chinese Yuan or Renminbi funded in the onshore market
CP	Commercial Paper
CPC	Communist Party of China
CPMI	Committee on Payments and Market Infrastructures
CPSS	Committee on Payment and Settlement Systems (Bank of International Settlements)
CRA	Credit Rating Agency
CRD IV	Revised Capital Directive (under EMIR)
CRR	Capital Requirements Regulation
CRS	Common Reporting Standard
CSD	Central securities depository
CSDCC or Chinaclear	China Securities Depository and Clearing Corporation
CSFC	China Securities Financing Corporation
CSL	Cybersecurity Law
CSRC	China Securities Regulatory Commission
CTM	Central Trade Manager
DCO	Derivatives Clearing Organisation (under the US Dodd-Frank Wall Street Reform and consumer Protection Act of 2010)

DMA	Direct Market Access
DNS	Deferred Net Settlement
Dodd Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (US)
DVP	Delivery versus Payment
EBS	Electronic broking service
EMIR	European Market Infrastructure Regulation
ESG	Environmental, Social and Governance
ERISA	Employment Retirement Income Security Act of 1974 (US)
ESMA	European Securities Market Association
ETD	Exchange-Traded Derivatives
ETF	Exchange-Traded Fund
Fed	US Federal Reserve Board
EU	European Union
FATCA	Foreign Account Tax Compliance Act (US)
FATF	Financial Action Task Force
FII	Foreign Institutional Investor
FMC	Fund Management Company
FMI	Financial Market Infrastructure
FOP	Free of Payment
FSB	Financial Stability Board
FSDC	Financial Stability and Development Committee (China)
FTSE Russell	Financial Times Stock Exchange International Ltd., a British provider of stock market indices and data services
FTZ	Foreign Trade Zone

FX	Foreign Exchange
G20	Group of 20
GAAP	Generally Accepted Accounting Principles
GBP	British Pound
GC	Global custodian
GC	General collateral
GDP	Gross Domestic Product
GMRA	Global Master Repurchase Agreement
G-SIB	Globally Systemically Important Bank
G-SFII	Globally Systemically Important Financial Institution
HKEX	Stock Exchange of Hong Kong
HKICL	Hong Kong Interbank Clearing Ltd
HKMA	Hong Kong Monetary Authority
ICBC	Industrial and Commercial Bank of China
ICSD	International central securities depository
ID	Identification
IGA	Inter-governmental Agreement
IMF	International Monetary Fund
IMM	Internal Model Method
IOSCO	International Organisation of Securities Commissions
IP	Indirect Participant
IPO	Initial Public Offering
IRS	Interest Rate Swap

IRS	Internal Revenue Service (US)
ISDA	International Swaps and Derivatives Association
IST	Information Security Technology
JV	Joint venture
KYC	Know Your Client
LC	Local custodian
LGFV	Local Government Financing Vehicle
LIBOR	London Inter-Bank Offered Rate
LMA	Loan Market Association
LSOC	Legally Separated Operationally Commingled
M&A	Mergers and acquisitions
MIIT	Ministry of Industry and Information Technology (China)
MOC	Market on Close
MOF	Ministry of Finance (China)
MPS	Ministry of Public Security (China)
MRF	Mutual Recognition of Funds
MSCI	Morgan Stanley Capital International, the first global market indices created in 1968
MTF	Multilateral trading facilities
MTN	Medium-term note
NAFMII	National Association of Financial Market Institutional Investors (China)
NAV	Net Asset Value
NCD	Negotiable certificate of deposit
NDF	Non-deliverable forward

NDRC	National Development and Reform Commission
NEX Group	NEX Group plc, formerly known as ICAP plc, a UK-based business focused on electronic markets and post-trade business; listed on the London Stock Exchange
NPFFI	Non-participating Foreign Financial Institutions (under FATCA)
NPL	Non-performing loan
OPB	Offshore Participating Bank
OTC	Over-the-Counter
PBOC	People's Bank of China
PE	Private equity
PFM	Private Fund Management
PFMI	Principles for Financial Market Infrastructures
PO	Party organisation (China)
POE	Privately Owned Enterprise (China)
PPP	Public Private Partnership
PRC	People's Republic of China
PSET	Place of Settlement
PVP	Payment-versus-payment
QCCP	Qualified Central Counter-Party Clearing House
QDLP	Qualified Domestic Investment Partnership
QDIE	Qualified Domestic Investment Enterprise
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
REIT	Real Estate Investment Trust

RFQ	Request for Quotation
RMB	Renminbi, or Chinese Yuan, a unit of currency
RMBS	Residential Mortgage-Backed Securities
ROII	Relevant Overseas Institutional Investors
RQDII	Renminbi Qualified Domestic Institutional Investor
RQFII	Renminbi Qualified Foreign Institutional Investor
RDVP	Real-time Delivery versus Payment
RRP	Recovery and Resolution Plan
RTGS	Real-time Gross Settlement
RVP	Receive versus Payment
RWA	Risk Weighted Assets
S&P	Standard & Poor's Financial Services
SA-CCR	Standardised Approach Counterparty Credit Risk
SAFE	State Administration of Foreign Exchange
SAR	Special Administrative Region (China)
SASAC	State-owned Assets Supervision and Administration Commission (China)
SAT	State Administration of Taxation (china)
SB	Supervisory Board (China)
SBL	Stock Borrow Loan
SCHC	Shanghai Clearing House
SCP	Super and Short-term Commercial Paper
SDR	Special Drawing Rights (IMF)
SHIBOR	Shanghai Inter-Bank Offer Rate

SOE	State Owned Enterprise
SME	Small and Medium Enterprise
SPSA	Special Segregated Accounts
SPT	Special Purpose Trust
SSE	Shanghai Stock Exchange
SSE Science and Technology Board	New science and technology board on the Shanghai Stock Exchange
SSTP	Special Stability Trading Period
STP	Straight-Through Process
SWIFT	Society for World-wide Interbank Financial Communication
T2S	TARGET-2 Securities
TC260	National Information Security Standardization Technical Committee
TLAC	Total Loss-Absorbing Capacity
TWAP	Time-Weighted Average Price
UK	United Kingdom
US	United States
US CFTC	US Commodity Futures Trading Commission
USD	US Dollar
UCITS V	Undertakings for Collective Investment in Transferable Securities
VAT	Value Added Tax
VWAP	Volume-Weighted Average Price
WFE	World Federation of Exchanges
WFOE	Wholly Foreign-Owned Enterprises
WHT	Withholding Tax

WTO	World Trade Organisation
WVR	Weighted Voting Rights

L. Endnotes

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