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Practice Groups:

Investment Management, Hedge Funds and Alternative Investments

Public Policy and Law

Global Government Solutions

China Eases Access to Interbank Bond Market by Overseas Financial Institutions

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Introduction

According to the Announcement of 2016 No. 3 (the "**Announcement**") promulgated by the People's Bank of China (the "**PBOC**") on February 17, 2016, eligible offshore commercial banks, insurers, securities companies, asset managers, as well as other medium- to long-term institutional investors, such as pension funds and charities, may access the onshore interbank bond market in the People's Republic of China ("**PRC**") without being restricted by quotas or going through any separate application procedures with the PRC regulatory authorities. However, such institutional investors are subject to assessment by an onshore settlement agent (through whom trades in the onshore interbank bond market will be conducted) with respect to their eligibility prior to the onshore settlement agent accepting its appointment.

Along with the PBOC's decision in July 2015 to remove the quota restriction on foreign sovereign wealth funds, central banks, and other official financial institutions to access the Chinese onshore bond market, the Announcement is a significant move towards granting foreign entities free access to China's onshore bond market and represents a continuous effort by the PRC government to loosen currency controls over the Renminbi and integrate with the global financial market, given that most bonds issued by the Chinese government or major Chinese financial institutions trade on the onshore interbank bond market. At the same time, it is line with the PRC government's efforts to curb capital outflows and market speculation in light of last year's volatile Chinese market, particularly as the exclusion of hedge funds as Relevant Entities demonstrates.

Relevant Entities

The Announcement applies to participation in the onshore interbank bond market through or by:

(1) commercial banks, insurance companies, securities companies, fund management companies and other asset management institutions established outside of the PRC ("**Financial Institutions**");

(2) "investment products" legally sold to clients by Financial Institutions - presumably, this refers to the underlying product or contract upon which the interbank bond trade is being conducted, but this has not been clarified; and

(3) other medium- to long-term institutional investors approved by the PBOC, such as pension funds, charity funds and donation funds.

Although it is assumed that the Announcement would apply to all non-PRC institutional investors, the Announcement makes specific reference only to institutional investors from

Hong Kong, Macau, and Taiwan, as well as Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors (each, a "**Relevant Entity**").

Hedge fund managers are not explicitly included on the list. Although arguably hedge fund managers would fall within the ambit of "fund management companies," it is unlikely that they will be accepted as a Relevant Entity, given the PBOC's clear and stated intention (as set out in the Announcement) to attract medium- to long-term investors to the PRC onshore interbank bond market.

Eligibility Requirements

A Relevant Entity must comply with the following eligibility requirements:

(1) it must be incorporated in accordance with the applicable laws of its country or region of origin;

(2) it must have a robust governance structure and internal control system and a business code of conduct and not have been subject to any significant punishment by any regulatory authority due to a breach of laws or regulations in relation to its bond investment business in the past three (3) years;

(3) its source of funds must comply with all laws and regulations; and

(4) it must have the ability to identify and assume the relevant risks and acknowledge and assume risks associated with bond investments,

with the PBOC retaining their usual overriding right to set other requirements as necessary.

A Relevant Entity's eligibility to access the PRC onshore interbank bond market will be assessed and determined by the PRC onshore settlement agent to be appointed by the entity, and such onshore settlement agent may only accept appointment upon a satisfactory assessment by it of the Relevant Entity.

Onshore Settlement Agents

An eligible Relevant Entity must appoint an onshore settlement agent with international settlement business capabilities to conduct trading and settlement in the onshore interbank bond market.

An onshore settlement agent appointed by an eligible Relevant Entity to provide agency trading and settlement services shall fulfill the following criteria:

(1) it must have a specialized business department providing agency services for investments by offshore institutions that is completely separate from its proprietary investment management business in terms of personnel, operating system, institutions, assets and other typical agency business requirements;

(2) it must have a robust system for its agency bond trading and settlement business and must have a comprehensive management system, operational process, risk management system, employee code of conduct and other similar operations systems for its agency bond trading and settlement business;

(3) it must possess the relevant information technology facilities, technical support personnel, information system management and other typical business support necessary to carry out its agency bond trading and settlement business;

(4) the department head, business personnel and other related personnel responsible for its agency bond trading and settlement business must have attended the relevant training courses organized by interbank bond market self-regulatory organizations or intermediary institutions; and

(5) the onshore settlement agent must not have breached any laws or committed significant violations of any regulations in the past three (3) years,

with the PBOC retaining their usual overriding right to set other requirements as necessary.

Upon appointment by an eligible Relevant Entity, the onshore settlement agent must make an investment filing to the Shanghai headquarters of the PBOC on behalf of the Relevant Entity.

The onshore settlement agent will provide the following services:

(1) making investment filings on behalf of the Relevant Entity;

(2) assisting the Relevant Entity in opening, amending and closing the RMB deposit account, bond account, settlement account, bond trading account and other accounts;

(3) conducting trades and settlements on behalf of the Relevant Entity pursuant to instructions from the Relevant Entity; and

(4) assisting the Relevant Entity on matters relating to interest payments and principal payments of bonds.

Furthermore, certain approved onshore settlement agents may also provide asset custody, accounting and valuation, report processing and other custodial-related services to the Relevant Entity.

In addition to assessing the eligibility of the Relevant Entities, the onshore settlement agent will be responsible for, among other duties, (i) providing assistance to the PBOC, the National Association of Financial Market Institutional Investors, the National Interbank Funding Center and institutions responsible for bond registration, custody and settlement in respect of the provision of market analysis data and monitoring, and reporting to the Shanghai headquarters of the PBOC on information relating to the Relevant Entities and the progress of their investment businesses; and (ii) complying with the PBOC requirements on cross-border RMB businesses, monitoring the RMB deposit accounts of the Relevant Entities, and reporting information on the accounts and cross-border RMB transactions into the RMB Cross-border Payment & Receipt Management Information System.

It is noted that the PBOC will announce the detailed implementation rules and the investment reporting template in due course.

Trading and Settlement

An eligible Relevant Entity may access the interbank bond market upon the appointment of the onshore settlement agent. No further applications or approvals would be required.

Trading and settlement by eligible Relevant Entities on the onshore interbank bond market will be conducted by the onshore settlement agent. Under the terms of the Announcement, Relevant Entities may carry out such types of trades as permissible by the PBOC, which, in the first instance, appear to be spot trades of bonds only. It is expected that the PBOC will expand and/or vary the scope of permissible trades by supplemental rules or announcements from time to time.

Termination of Access

A Relevant Entity will be prevented from further access to the onshore interbank bond market upon the occurrence of the following circumstances:

(1) the Relevant Entity is subject to dissolution, winding up, revocation, or bankruptcy;

(2) the relevant "investment product or contract" [sic] has expired – presumably, this refers to the underlying product or contract upon which the interbank bond trade is being conducted but this has not been clarified; or

(3) other circumstances as designated by the PBOC.

Conclusion

After last year's bumpy ride for PRC listed securities, this is certainly a welcome development for foreign investors wanting exposure to PRC assets without the volatility of PRC listed securities. However, due to the lack of clarity and recentness of the Announcement, it will be important for interested readers to keep a close watch on further announcements and developments in this area by the PBOC.

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