Summary

The China Securities Regulatory Commission (CSRC) published its Measures for the Administration of Foreign-funded Securities Companies (the “Exposure Draft”) on 9 March 2018 as a step towards implementing the central government’s call for “substantially liberalizing market access and further opening up the financial services sector.”

It follows the announcement by China’s Vice Finance Minister Zhu Guangyao of nationwide plans to remove caps on foreign ownership in Chinese financial institutions at a press briefing immediately after the November 2017 Sino-US summit.

This Exposure Draft marks the second announcement by a domestic regulator towards further financial market liberalization, following the 24 February 2018 issuance of the Decision on Amending the Implementation Rules of the China Banking Regulatory Commission on Administrative Licensing for Foreign Banks. It is a clear welcome sign from the CSRC to foreign financial institutions seeking to actively participate in China’s financial market. Once in effect, foreign investors are allowed, singly or in concert, to hold up to 51% of shareholding in securities companies directly or indirectly, and subsequently the cap would be removed completely within three years.

Throughout the 19th National Party Congress, the National People’s Congress and the People’s Political Consultative Conference, national leaders emphasized that China would accelerate the pace of opening up to the outside world, heightening expectations for further opening-up of policies in China’s financial sector.

Comparative Analysis

The Exposure Draft serves as a revision to the existing Rules for the Establishment of Foreign-invested Securities Companies (the “Former Rules”), reflecting the policy-making principles of continuity, gradualism and forward-looking perspective, moving towards the objective of opening up China’s securities industry by streamlining requirements for establishing joint ventures and expanding their business scope.

The Exposure Draft comprises 26 articles which altogether introduce one new rule and remove four old ones, while introducing substantive changes to seven original rules and text-level revisions to another 17. The revisions can be summarized into the following five areas, echoing the written descriptions provided by the CSRC:

► Allow foreign investors to gain control of joint venture securities companies; provide a legal basis for foreign investors to increase their proportionate holdings to take a controlling stake
► Phase out business scope restrictions for joint venture securities companies
► Improve the rules for foreign shareholding in listed securities companies
► Clarify the policies over the legal status of a domestic securities company following change in the actual controller of a domestic shareholder
► Improve the eligibility criteria applicable to foreign shareholders.
1. Allow foreign investors to gain control of joint venture securities companies; provide a legal basis for foreign investors to increase their proportionate holdings to take a controlling stake

The main amendments in this part are as follows.

Firstly, the requirement for foreign investors to seek a domestic securities firm counterpart to establish a joint venture securities firm was removed. Secondly, the foreign shareholding proportional restriction clause in the Former Rules was removed, which marks the most fundamental change introduced in the Exposure Draft and also serves as the regulatory basis for allowing foreign-controlled joint venture securities companies.

Together with lifting caps on the shareholding proportion, the CSRC has also made certain restrictions on the currency denomination of capital contributions as well as the lower limit of the shareholding proportion by foreign shareholders. Article 7 requires that foreign shareholders invest with freely exchangeable currency. A floor of 25% for the foreign shareholding proportion (including direct and indirect ownership) in foreign-funded securities companies will become generally applicable, except for domestic securities companies converted by action of law.

2. Phase out business scope restrictions for joint venture securities companies

The Exposure Draft allows newly-established joint venture securities companies to initially apply for four types of businesses (as defined by Article 125 of the Securities Law and the Provisional Regulations on the Approval of the Business Scope of Securities Companies) in line with their own circumstances. Further expansion into up to two additional business types per application will be considered from the second year. The business types and associated minimum registered capital mandated by the Securities Law are as follows:

<table>
<thead>
<tr>
<th>Business Type</th>
<th>Registered Capital Requirement (CNY)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Securities broking</td>
<td>Minimum 50 million</td>
</tr>
<tr>
<td>(2) Securities investment consulting</td>
<td>Minimum 50 million</td>
</tr>
<tr>
<td>(3) Financial advisory related to securities trading and investment activities</td>
<td>Minimum 50 million</td>
</tr>
<tr>
<td>(4) Securities underwriting and sponsoring</td>
<td>Minimum 100 million</td>
</tr>
<tr>
<td>(5) Securities proprietary business</td>
<td>Minimum 100 million</td>
</tr>
<tr>
<td>(6) Securities asset management</td>
<td>Minimum 100 million</td>
</tr>
<tr>
<td>(7) Other securities-related business</td>
<td>Minimum 100 million</td>
</tr>
</tbody>
</table>

*For a company with more than two businesses from item four to seven, the minimum amount of registered capital is CNY 500 million. The registered capital of a securities company should be contributed paid-in capital.

This phase out of business scope restrictions for joint venture securities companies stands alongside the relaxation of shareholding caps as the two key changes introduced by the Exposure Draft. The Exposure Draft removes the various business scope restrictions applicable to joint venture securities companies. More detailed rules are expected in the final version, as the current draft still lacks explicit provisions regarding the specific business areas open to foreign-funded securities companies by application.

To prevent a haphazard rush to grab up securities business licenses, the CSRC has included a provision in the Exposure Draft (new rule (3) to Article 5) that keeps the initial business scope for a foreign-funded securities company within the bounds established by the industry experience of the controlling shareholder and the largest shareholder.

3. Improve the rules of foreign shareholding in listed securities companies

The Exposure Draft removes the 25% shareholding cap for collective foreign investors. Article 22 specifies that collective foreign shareholdings (including direct and indirect ownership) in listed domestic securities companies shall be raised to a ratio “not exceeding commitments made towards opening up China's securities industry”, which is aligned with the upper limit of foreign shareholding applied to unlisted firms.

The Exposure Draft also raises the foreign single-investor shareholding cap for listed securities companies. Article 22 specifies that “the proportion of shares in a listed securities company held by a single offshore investor through purchase over a stock exchange or by acquisition agreement, or jointly held via agreement or other arrangement with other parties, shall not exceed 30%”, marking a moderate increase on the 20% cap in the former rules. The changes in foreign shareholding percentages which will be introduced if the Exposure Draft becomes effective are summarized in the following table:

<table>
<thead>
<tr>
<th>Requirements on foreign shareholding proportion</th>
<th>Former Rules</th>
<th>Exposure Draft</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unlisted firms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single foreign investor</td>
<td>No more than 20%</td>
<td>No more than 30%</td>
</tr>
<tr>
<td>All foreign investors</td>
<td>No more than 25%</td>
<td>Not exceeding commitments made towards opening up China's securities industry</td>
</tr>
<tr>
<td><strong>Listed firms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single foreign investor</td>
<td>No more than 49%</td>
<td>Not exceeding commitments made towards opening up China's securities industry</td>
</tr>
</tbody>
</table>

*The 25% foreign shareholding floor is waived for domestic securities companies acquiring foreign-funded status by force of law.
Comparative analysis of policy changes

4. Clarify the policies over the legal status of a domestic securities company following change in the actual controller of a domestic shareholder

This requirement addresses the emergence of “the indirect holding of shares by foreign investors in certain domestic securities companies due to the change in the national status of the actual controlling (from Chinese to foreign ownership)” brought forth by the new regulations. The Exposure Draft has included the above case within the scope of foreign-invested securities companies and clarified the requirements. Such overseas investors are given a time limit to meet the requirements applied to foreign shareholders.

Article 14 of the Exposure Draft specifies the requirements applicable to domestic securities companies applying for conversion to foreign-invested status. It denotes that when foreign investors step into the roles of controlling shareholder or ultimate controller of a domestic securities company, those overseas investors must meet the conditions stipulated in Article 6. The shareholding proportion in their indirectly-controlled securities company must also conform to the provisions in Article 7. If the requirements are not met at inception, a time limit will be set for required remediation. Article 6 and Article 7 are set to address the qualification requirements and investment requirements on foreign investors, respectively. Article 16 clarifies the requirements on the application documents for the change to the shareholding nature.

5. Improve the eligibility criteria applicable to foreign shareholders

The amendments to eligibility criteria for foreign shareholders aim to bring high-quality foreign shareholders and advanced overseas management experience into China. The Exposure Draft requires all foreign shareholders to be “financial institutions”, a change from the more limited previous requirement to include “at least one financial institution”. It also adds the following specific qualification requirements to the former rules demand for “good reputations and business performance”:

- Good international reputation
- Good business performance
- High global ranking in business scale, revenues and profits for the preceding 3 years
- Maintenance of high long-term credit ratings for the preceding 3 years
- Not subject to official investigation for serious violation of laws or regulations

Documents to support these requirements must be submitted to the CSRC when a joint venture securities firm shifts to shareholding by overseas investors.

These amendments aim to ensure that foreign shareholders comprise high-quality companies with extensive experience in financial activities. More explicit rules are likely to be introduced in the final version to replace the broad and non-quantified criteria - such as “good” and “high global ranking” - found in the current version.

<table>
<thead>
<tr>
<th>No.</th>
<th>Name</th>
<th>Register Time</th>
<th>Foreign Shareholder(s)</th>
<th>Shareholding Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>China International Capital Corporation</td>
<td>31 July 1995</td>
<td>GIC Private Limited and others</td>
<td>16.80%</td>
</tr>
<tr>
<td>2</td>
<td>BOC International</td>
<td>28 February 2002</td>
<td>BOC International Holdings Limited</td>
<td>37.14%</td>
</tr>
<tr>
<td>3</td>
<td>Goldman Sachs Gaohua</td>
<td>13 December 2004</td>
<td>Goldman Sachs Asia Limited</td>
<td>33%</td>
</tr>
<tr>
<td>4</td>
<td>UBS</td>
<td>11 December 2006</td>
<td>UBS Limited</td>
<td>24.99%</td>
</tr>
<tr>
<td>5</td>
<td>Credit Suisse Founder Securities</td>
<td>24 October 2008</td>
<td>CREDIT SUISSE AG</td>
<td>33.3%</td>
</tr>
<tr>
<td>6</td>
<td>Zhong De Securities</td>
<td>10 April 2009</td>
<td>Deutsche Bank</td>
<td>33.3%</td>
</tr>
<tr>
<td>7</td>
<td>Morgan Stanley Huaxin</td>
<td>4 May 2011</td>
<td>Morgan Stanley Asia Limited</td>
<td>49%</td>
</tr>
<tr>
<td>8</td>
<td>Citi Orient Securities</td>
<td>4 June 2012</td>
<td>Citigroup Global Markets Asia Limited</td>
<td>33.33%</td>
</tr>
<tr>
<td>9</td>
<td>Shengang Securities</td>
<td>8 April 2016</td>
<td>Willie International Holding Limited /Freeman Securities Limited</td>
<td>30%</td>
</tr>
<tr>
<td>10</td>
<td>Huajing Securities</td>
<td>19 August 2016</td>
<td>Maxson Securities Limited</td>
<td>49%</td>
</tr>
<tr>
<td>11</td>
<td>BEA Qianhai</td>
<td>9 August 2017</td>
<td>The Bank of East Asia, Limited</td>
<td>49%</td>
</tr>
<tr>
<td>12</td>
<td>HSBC Qianhai</td>
<td>28 August 2017</td>
<td>The Hongkong and Shanghai Banking Corporation Limited</td>
<td>51%</td>
</tr>
</tbody>
</table>

*Source: CSRC website, the National Enterprise Credit Information Publicity System and annual reports
1. Foreign shareholders of CICC include GIC(5.478%); TPG(4.31%); Mingly Corporation(3.075%); Oppenheimer Fund(2.017%); KKR Institutions(1.916%), according to its 2017 annual report
2. Morgan Stanley Asia Limited has increased its shareholding to 49% according to an announcement from Huaxin Holding in 2017 and Morgan Stanley Huaxin’s website
3. Willie International Holding Limited and Freeman Securities Limited each holds 15%
Conclusion

EY insights and perspectives

The unveiling of the Exposure Draft marks a historical new stage in the opening up of China's securities industry and represents a positive contribution to the global financial industry. It presents an excellent scaling-up opportunity for existing joint venture securities companies in China, which were previously hobbled by lack of scale, profitability and market influence, to narrow any gap in reputation or capabilities with respect to their own overseas shareholders. New entrants will also benefit from the more lucrative market environment.

We see the Exposure Draft as offering the following opportunities for the future development of foreign-funded securities firms in the Chinese market:

► **Full liberalization of the shareholding ratio:** Prior to the publication of the Exposure Draft, taking a full 51% position in the shares of the joint venture securities companies was only specially permitted to Hong Kong- and Macau-funded securities firms under the Supplementary Agreement 10 to the Mainland and Hong Kong on the Establishment of Closer Economic Partnership Arrangements. The Exposure Draft removes this territorial restriction and also lifts the 51% foreign ownership cap, clearing the path for more proactive strategic approaches by foreign-funded securities companies to their development in the Chinese market.

Recognition of the steady opening up of China's capital markets can be seen in Morgan Stanley Capital International's (MSCI) decision to add mainland China-listed A shares to its MSCI Emerging Market Index. Feedback from foreign-funded securities companies also indicates their growing interest in the Chinese market. Such companies are expected to enjoy a qualitative improvement in their influence and embrace new development opportunities following the loosening of the foreign ownership cap.

► **Full opening-up in permitted business activities:** The Exposure Draft also loosens restrictions on the business scope of foreign-funded securities companies. Full national treatment on par with other Chinese securities companies will follow from the removal of the original restrictions. In principle, foreign-funded securities companies will be able to progressively apply for business licenses in all areas stipulated in Article 125 of the Securities Law.

Newly-established joint venture securities companies will immediately be able to move beyond the core activities of underwriting and sponsorship of stocks and bonds to pursue licenses for non-investment banking businesses, such as securities brokerage, investment consulting and proprietary trading, as long as they can demonstrate a relevant track record for their controlling shareholders.

Moreover, large foreign financial institutions will enjoy the opportunity to take a group-wide perspective and fulfill their ambitions for development in the Chinese market by putting in place collaborative mechanisms to develop their securities business in concert with other business pursuits in China.

► **Full relaxation of eligibility requirements for joint venture shareholders:** The domestic shareholders of foreign-funded securities companies will no longer be limited by business type to securities firms or by territory to free trade zones. This will provide foreign-funded securities companies with an expanded pool of eligible domestic business partners and easier avoidance of direct business competition with their joint venture counterparts.

However, the new freedom presented by the loosening of the shareholding ratio, business scope and eligibility criteria poses new challenges alongside the development opportunities.

► **Challenges of operating in varied legal environments and meeting compliance requirements:** Foreign-funded securities firms expanding their domestic business will encounter fresh challenges in compliance and risk management, as the applicability of overseas experience is not guaranteed in dealing with the varied legal environments and compliance requirements of China.

The Exposure Draft also fine-tunes the eligibility criteria for foreign shareholders, who will now need to show a 5-year track record in the securities business and a home country regulatory record free of major blemishes for the preceding three years. The draft also raises the bar on business scale, revenues and profits for the foreign investors in order to extend a welcome to high-quality companies with extensive experience in finance. We foresee greater convergence in the treatment of domestic and foreign capital under the future regulatory regime, following increased entry by foreign investors.

► **IT system upgrades and facility transfers:** Domestic compliance requirements on data security and confidentiality may require foreign-funded securities companies to transfer and host some of their IT systems within China’s borders. In addition, legacy systems may face capacity challenges in keeping pace with the transaction volumes and processing speeds demanded by their China-based business.

► **Hiring and training employees to serve business development needs and fit corporate culture:** As foreign securities firms take controlling stakes and expand their business scope, they will need to consider how to use appropriate channels within China to attract personnel comfortable operating in the home country language and culture and who are also proficient in China's securities business. A further medium- to long-term challenge is presented by the rolling out of talent training processes in line with both business development needs and the firm’s corporate culture.

Release of this Exposure Draft is a catalyst for opening up the Chinese securities industry to foreign capital, bringing in additional international development experience and increasing competition within the industry. Although the Exposure Draft already provides relatively clear operational guidance for foreign investors wanting to enter the Chinese securities markets, as stated above, some details remain to be fleshed out. We will continue to closely follow any interim updates leading up to the final version of this Exposure Draft to further analyse the impact of the new regulations on foreign financial institutions.
Outline

Yi Gang, Governor of the People’s Bank of China (PBOC), followed upon Xi Jinping’s speech at the opening ceremony of the BOAO Forum for Asia on 10 April 2018 announcing China would substantially relax restrictions on market access by announcing a set of liberalization measures for the financial sector tied to a clear timetable at the Monetary Policy Normalization Sub-forum on 11 April. The move is a further indication of the determination and confidence of the Chinese government in further opening up China’s financial sector.

The breadth and depth of the measures exceeded public expectations, illustrating China’s strong will to embrace free trade and to open up to the outside world. Since the initiatives have not yet been developed into implementation rules, we simply summarize them in the Supplement to this POV for the reference of foreign financial institutions.

Three principles for opening-up China’s financial sector

Yi said in his speech that China’s further opening-up of the financial sector would adhere to three underlying principles as follows:

► Adopting the management model of pre-establishment national treatment (PENT) subject to a negative list;
► Promoting the opening-up of the financial sector in step and in coordination with reforms of the exchange rate formation mechanism and capital account convertibility;
► Guarding against financial risks at all times so that financial supervision capabilities will keep up with the development of the opening-up.

12 liberalization measures

Yi announced twelve measures that would be implemented in two separate phases in 2018.

The first phase, corresponding to the first half of 2018, includes expected implementation of the following 6 measures:

1. Removing caps on the foreign shareholding ratio in banks and financial asset management companies, treating domestic and overseas investments equally; and allowing foreign-funded banks to simultaneously establish both branches and subsidiaries;
2. Initially relaxing caps on the foreign shareholding proportion in securities companies, fund management companies, futures companies and life insurance companies to 51%, then subsequently completely phasing out within three years;
3. Abolishing the requirement for at least one securities company to be included among the domestic shareholders of a joint venture securities company;
4. Fourfold expansion starting 1 May of the daily line of interoperability mechanism between the mainland and Hong Kong stock markets. (Specifically, the daily line of Shanghai Stock Exchange and Shenzhen Stock Exchange will be adjusted from RMB 13 billion to RMB 52 billion, and from RMB 10.5 billion to RMB 42 billion for Hong Kong Stock Exchange);
5. Allowing qualified foreign investors to operate insurance agency business and insurance assessment business in China;
6. Expanding the business scope of foreign-funded insurance brokerage companies to keep it consistent with that of Chinese-funded institutions.

The second phase spans to year-end and includes 6 more measures for implementation:

1. Encouraging the inbound flow of foreign capital into the banking industry including trust business, financial leasing, auto finance, currency brokerage and consumer finance;
2. Removing caps on the foreign shareholding proportion in the financial asset investment companies and wealth management companies which are newly established by commercial banks;
3. Expanding the business scope of foreign-funded banks substantially;
4. Removing restrictions on the business scope of joint venture securities companies to keep them in line with those applicable to domestic institutions;
5. Abolishing the requirement for a 2-year track record as representative office as a prerequisite for establishing a foreign insurance company;

Yi also stated that preparations for the Shanghai-London Stock Connection are progressing smoothly, and the launch is expected within the year 2018 thanks to joint efforts of the Chinese and British sides. Furthermore, Yi expressed that orderly execution has been achieved for certain previously announced opening measures in the financial and service industries, such as the relaxation of market access requirements for bank card settlement agencies and non-banking payment institutions, the liberalization of credit rating services for foreign financial service companies, and the implementation of national treatments for foreign-funded credit investigation companies.

Non-discriminatory prudential supervision over domestic and foreign investments

Yi noted that, at present, the PBOC and other related government authorities are sparing no time and effort to revise relevant laws and regulations to ensure timely implementation of the above-mentioned measures. In addition, in order to promote a smooth execution of relevant work, supporting measures will be provided to strengthen financial supervision when enlarging the opening-up measures. Chinese regulators will conduct prudential supervision in a non-discriminatory and legally-bound manner over all companies irrespective of their ownership, while liberalizing both the market access and business scope permitted to foreign capital, with an aim to effectively manage and address financial risks, maintain financial stability, enhance the competitiveness of China’s financial sector, pursue financial globalization, and promote the opening up of China’s broad financial market.

Outlook

These financial liberalization measures will substantially lower the threshold of market access and send a clear signal to the international community that China has not only the determination but also concrete measures to fulfill its commitment to opening up to the outside world. Moreover, these measures will undoubtedly facilitate more diversified exchanges of ideas and communication between the domestic and international financial markets and promote an environment of learning from each other’s strengths and removing weaknesses, so as to achieve mutual benefits by further enhancing the global competitiveness of China’s financial sector while providing overseas investors with more channels and opportunities to access the Chinese market.

We will continue to pay attention to the implementation rules of these opening-up measures that are expected to be announced subsequently this year, and share our insights on their impacts on foreign financial institutions.

China further opens up financial sector (III)
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