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China Stays Guarded on Foreign Investment in Banking

Nicholas Howson
Berkeley Law

Lester Ross

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New regulations will allow the creation of foreign-invested fund management and securities industries in China. But market access for overseas banks may still prove problematic. Nicholas Howson and Lester Ross of Paul, Weiss, Rifkind, Wharton & Garrison explain

China's eagerly-awaited regulations on foreign participation in PRC-domiciled securities fund management companies and securities companies were promulgated by the CSRC on June 1 2002, with effect from July 1 2002.

The Regulations on the Establishment of Fund Management Companies with Foreign Equity Participation (Fund Management Regulations) and the Regulations on the Establishment of Securities Companies with Foreign Equity Participation (Securities Regulations) were both issued by the China Securities Regulatory Commission (CSRC), China's securities regulator. The Regulations allow foreign investment through one of:

- the establishment of new entities with foreign investment; or
- the conversion of existing entities already established by PRC investors into entities with foreign investment.

The Regulations are formally consistent with China's World Trade Organization (WTO) accession commitments. In fact, the Securities Regulations go beyond those commitments by establishing a procedure for the establishment of securities companies with foreign equity participation well in advance of China's agreed December 11 2004 deadline. (China is of course free to accelerate the WTO-agreed timetable with respect to its liberalization of barriers to foreign investment.)

The Regulations create the legal basis for an expansion of foreign investment in the securities fund management and securities underwriting and brokerage industries. Reducing barriers to foreign market entry is expected not just to increase capital investment but also to bring more sophisticated institutional investors and advanced technology to these industries and the Chinese capital markets generally. The hoped-for results include longer-term investment strategies, a reduction in the casino atmosphere that characterizes China's securities markets, and increased investor confidence.

The Regulations nevertheless raise new issues and do not remove all the impediments to foreign investment that prospective market entrants must take into consideration.

China's WTO commitments

China's commitments with respect to foreign investment in the securities fund management and securities industries, as recorded in Chapter 7B of China's Schedule of Specific Commitments on Services, are an integral element of the terms and conditions governing China's WTO accession. The specific commitments are as follows:

- Domestic securities investment fund management business: foreign service suppliers to be permitted to establish joint ventures with foreign investment up to 33% on accession (December 11 2001), increasing to 49% within three years of accession (December 11 2004).
- Securities industry: foreign securities institutions to be permitted to establish joint ventures within three years of accession (December 11 2004), with foreign ownership not to exceed one-third; such joint ventures permitted to engage (without a Chinese intermediary) in underwriting A-shares (domestically-listed shares traded in local currency) and underwriting and trading B-shares (domestically-listed shares traded in foreign currency) and H-shares (Hong Kong- and overseas-listed shares of Chinese issuers traded among foreign persons or institutions), as well as government and corporate debt and launching of funds.
- Criteria for authorization (that is, approval) to deal in China's financial industry to be solely prudential (that is, not subject to an economic needs test or quantitative limits on licensees).
- As in the past, foreign securities institutions to be allowed to engage in B-share business directly (without a Chinese intermediary and without having to form a joint venture).

The Regulations create the legal basis for an expansion of foreign investment in the securities fund management and securities underwriting and brokerage industries

CSRC v Moftec

As China's securities industry regulator, the CSRC issued the Regulations under its own authority, and apparently without consultation with China's Ministry of Foreign Trade and

Economic Cooperation (Moftec), the government department in charge generally of foreign investment. In doing so, the CSRC followed the path of its counterpart regulators of financial institutions, the People's Bank of China (PBoC) with respect to the commercial banking industry and the China Insurance Regulatory Commission (CIRC) with respect to the insurance industry. Each of these three regulators has now extended its exclusive supervisory powers with respect to its industry to exclusive authority over foreign investment in the same industry. This affirmative assertion of jurisdiction has occurred at the expense of Moftec, which otherwise exercises primary authority over foreign investment (including the venture capital funds management industry) as well as foreign trade.

The issue is more than mere bureaucratic jostling, and may have very significant implications for foreign institutions seeking to participate in the securities fund management or securities industries.

Joint ventures v LLCs

The terms and conditions of China's WTO accession referred to joint ventures without specifying the exact form of foreign investment. (There are two forms of joint Chinese-foreign investment permissible under Chinese law: equity joint ventures and cooperative joint ventures; the latter are sometimes still referred to as contractual joint ventures.) Either type of joint venture is created when a joint venture contract and articles of association executed by each party to the joint venture are approved by the relevant approval authority under the Moftec system (depending on the level of total investment). Both forms – originally conceived for project-specific manufacturing investments – are inflexible in key respects, especially the requirement for unanimous consent with respect to:

- amendment of the articles of association;
- termination or dissolution;
- changes in and transfers to registered capital; and
- mergers and divisions.

The issue is more than mere bureaucratic jostling, and may have very significant implications for foreign institutions seeking to participate in the securities fund management or securities industries

In addition, capital formation and liquidity are rendered cumbersome by the absence of a shareholding structure and static valuations of registered capital throughout the life of a joint venture. However, cooperative joint ventures can be more flexible. They are not bound by a strict proportionality relationship between equity interest and dividends, allow greater flexibility with respect to board representation and management control among the parties to the joint venture, and even allow equity interest to be awarded for such terms of cooperation as marketing rather than contributions in cash or in kind. With the promulgation of the PRC Company Law in 1994, and the recognition in statute of two major corporate forms – the limited liability company (LLC) and the company limited by shares (CLS) – it was determined that the LLC was in fact the corporate form of Chinese-foreign joint ventures (and wholly foreign owned enterprises) established under statutes governing such direct investment forms since the late 1970s.

However, the Regulations refer only to the formation of LLCs, speak only in terms of foreign equity participation (*waizi cangu*), and make no reference at all to the role of Moftec or the joint venture laws on the books, asserting the primacy of the PRC Company Law throughout. In addition, a CSRC spokesperson, in a set of questions and answers published on CSRC's official website, makes no reference to China's joint venture laws but rather cites only the Company Law, a statute that only addresses LLCs generically. The spokesperson further refers to investors not in terms of joint venturers, but rather to initial investors as founders or promoters (*faqiren*) and to later investors as shareholders (*gudong*).

So, it may seem on an initial reading of the Regulations that the organizational form for entities under the Regulations is not a Chinese-foreign joint venture as traditionally conceived (and approved by the Moftec system), but an LLC under the Company Law with foreign participation, examined and approved solely by the CSRC. (It should be noted that the Regulations make clear that any such entity cannot be a CLS, which would implicate the establishment of foreign-invested companies limited by shares (or FICLS) under Moftec's January 1995 provisions.)

However, despite the CSRC's assertion of exclusive authority detailed above, a Moftec official has nevertheless subsequently stated that foreign investment in the securities fund management and securities industries must conform to the general rules that apply to foreign investment in China. And, although the Regulations and CSRC's spokesperson make no use of joint venture terminology or reference to Moftec, the Regulations (and a published application form for securities companies with foreign equity participation) require submission of a "contract and articles of association" for the company with the application. (If the company formations under the Regulations were to be solely LLCs there would be no need for a contract between the co-investors, the contract being a feature solely of the joint-venture type establishment.)

The significance of these conflicting understandings is varied: LLCs may have as many as 50 shareholders; government approval is not required with respect to every change in all charter documents, capital, equity interests and other items; big decisions under law require the approval of only two-thirds by voting rights of shareholders; and such entities are easier to convert to CLSs, which can issue listed shares should their shareholders wish this as China moves to open its stock exchanges to foreign-invested issuers.

Rules relevant to traditional foreign-invested joint ventures include requirements that aggregate foreign-registered capital (equity) investment must be not less than 25% of total registered capital. They also require unanimous approval by shareholders (acting through their representatives on the board of directors) of major actions, including amendment of the articles of association; ratios of registered capital to total investment (registered or paid-in capital plus debt); investment schedules; and so on. An absolutely critical difference is the fact that there is no legal basis for direct foreign investment in an LLC (as opposed to establishment of a new joint venture with an LLC as the co-investor, the new joint venture becoming a special kind of LLC), precisely what the Regulations contemplate for the conversion of existing securities fund management companies or security companies.

Scope of business and qualifications – securities management companies

Fund management companies with foreign equity participation, under the Fund Management Regulations and/or the CSRC spokesman's answers to questions, will be allowed to act in the same manner and exercise the same functions as their counterparts without foreign investors. Such equal treatment means that foreign-invested fund management companies may manage funds that invest in A-shares despite the general prohibition on direct foreign investment in such shares or funds that hold such shares.

The CSRC spokesperson has also stated, in an elaboration of what is in the Fund Management Regulations, that a foreign investor may be the largest investor in a fund management company, which potentially provides substantially greater influence than if no single foreign investor were allowed to own more than a specified percentage of shares or prohibited from being the largest shareholder. In contrast, although the CIRC regulations allow direct foreign investment in an insurance company CLS, which may have nationwide business licences (as opposed to joint venture and wholly foreign-owned insurance companies or foreign insurance company branches in which foreign investment must be a minimum of 25%), not only is there a 25% ceiling on aggregate foreign investment, but the maximum holding of any single foreign investor is only 10%. So, a foreign investor in a securities fund management company will have substantially greater opportunity to exercise control, notwithstanding the fact that the Fund Management Regulations limit aggregate foreign investment to a minority position. The foreign investor will typically be expected to try to negotiate a right in the governing joint venture contract to increase its holding to as high as 49% when permissible under the law.

However, foreign shareholders in securities fund management companies are, subject to certain experience, merit and capitalization requirements. A foreign shareholder must:

- be an established financial institution with a clean regulatory record for the past three years (including the record of any financial industry branches and affiliates established in China);
- be domiciled in a country with a comprehensive securities regulatory system in which the securities regulatory authority has executed a memorandum of understanding and maintains an effective cooperative relationship with respect to supervision with the CSRC;
- have paid-in capital in an amount equivalent to not less than Rmb300 million ($36 million) in freely convertible currency; and
- comply with other prudential qualifications that the CSRC may impose.

So, a foreign shareholder must be a financial institution with significant experience, domiciled in a jurisdiction with a comprehensive regulatory system and in which the regulatory authority has a basis for cooperation with the CSRC, have a satisfactory record with respect to regulatory compliance and have a significant capital base.

However, one of the major constraints facing foreign investors is the identification of qualified domestic investors. The Fund Management Regulations do not specify the qualifications of domestic shareholders. Instead, article 7 merely provides that the CSRC will establish such qualifications. According to the CSRC spokesperson, the principal founders must be a securities or trust and investment company (TIC) established in accordance with regulations; have a sound business; enjoying profits for each of the most recent years; and like other founders must have actual capital of at least Rmb300 million. Moreover, no investor, whether domestic or foreign, may invest in more than two securities fund management companies or exercise actual or relative control over more than one such company. Although these restrictions reduce the potential for conflicts of interest and are motivated by the paucity of fund management experience in China, they also sharply limit the pool of domestic investors including founders. An alternative, of course, is to convert a domestic securities fund management company into one with foreign equity participation, but – according to the CSRC website – there are only eight such approved domestic fund management companies at present, with one approval pending.

So, a foreign shareholder must be a financial institution with significant experience, domiciled in a jurisdiction with a comprehensive regulatory system and in which the regulatory authority has a basis for cooperation with the CSRC

Securities companies

Foreign investment in securities companies is subject to greater restrictions with respect to scope of business. Securities companies with foreign equity participation are permitted under article 5 of the Securities Regulations to engage in local currency (A-shares) as well as foreign currency (B-shares and overseas-listed shares) shares underwriting and domestic bond underwriting. The Securities Regulations go beyond China's specific WTO commitments by allowing such companies to engage in any overseas-listed Chinese shares, not just H-shares. So, such companies can engage in N, L, S and T (New York, London, Singapore, Tokyo) as well as H-shares underwriting.

The attractions of establishing such companies are limited by restrictions on business other than underwriting and China's immature bond market, two sectors in which China desperately needs more capital and expertise. The bond market in particular is tiny, amounting to about Rmb2.8 trillion and is only half the size of the stock market despite mandates for equity funds to invest 20% of their assets in bonds and limits on alternative investments by insurance companies. Moreover, brokerage is limited to foreign capital shares and proprietary operations in share trading is prohibited. So, securities companies with foreign equity participation must be expected to focus on foreign capital shares and the immature bond market, placing them at a substantial disadvantage to domestically–invested companies. (It is important to note that the only existing foreign-invested securities company, China International Capital Corporation (CICC), did gain the right to deal in the secondary A-share market, but only after all of the foreign shareholders (including Morgan Stanley, the government of Singapore and Hong Kong's Mingly Group), sold down to an absolute minority in the joint venture.) Although authority to launch funds is important, its value is diminished by the opportunity to establish fund management companies directly.

It remains for the CSRC and Moftec to sort out exactly how their respective jurisdictions will be applied to these new establishments

In addition to these disadvantages, the conditions that securities companies with foreign equity participation must satisfy, particularly registered capital, are comparable to those of domestically-invested comprehensive securities companies even though the foreign-invested securities companies cannot broker local currency shares or trade in them for its own account. They also must have at least 50 CSRC-qualified securities personnel, which imposes substantial startup costs.

A foreign shareholder must satisfy the following qualifications:

- it must be domiciled in a country with a comprehensive regulatory system and in which the regulatory authority has executed a memorandum of understanding for cooperation with the CSRC;
- it must be licensed to engage in the securities business in its domicile with at least 10 years experience and a clean regulatory record for the past three years;
- it must have risk management indicia in accordance with regulatory requirements in its domicile over the past three years;
- it must have sound internal control systems;
- it must have good reputation and business record in international securities markets; and
- it must have other prudential qualifications that the CSRC may impose.

At least one domestic shareholder must be a securities company unless the new company is formed by conversion of an existing securities company into one with foreign equity participation. This creates a potential conflict of interest with the Chinese securities company because such conversion is unlikely until the prohibition on engaging in A-shares brokerage and proprietary trading is lifted. Furthermore, at least one domestic shareholder (a securities company in a *de novo* establishment) must hold at least one-third of equity, preventing any foreign shareholder from being the largest investor.

Conclusion

The two sets of regulations create new opportunities for foreign investment in the Chinese securities industry. The Regulations are WTO-compliant although the Securities Fund Regulations appear to offer a broader welcome to foreign investors, and not only because foreign shareholdings are subject to a higher ceiling. It remains for the CSRC and Moftec to sort out exactly how their respective jurisdictions will be applied to these new establishments, and whether or not the pre-existing Chinese-foreign joint venture statutes, regulations and practices will govern them. The Regulations themselves raise significant legal as well as commercial and strategic issues that must be considered before entering the Chinese market. ▮