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Legal Updates

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Legal Updates

1. Financial Market Liberalization May Trigger Merger Filing (Authors: Ma Chen, Yang TieCheng, Ge Yin, Zheng Ting, Shi Da)

On 28 June 2018, the National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") jointly issued the *Special Administrative Measures for Foreign Investment Access (Negative List for Foreign Investment Access)* (the "**2018 Negative List**")¹. The newly published 2018 Negative List officially allows foreign control of securities firms, fund management companies ("FMCs"), futures companies and life insurance companies in China, which is widely considered a significant move to further open up China's financial services sector.

China's recent relaxation of foreign investment restrictions in the financial services sector will no doubt increase the number and size of acquisition transactions by foreign financial institutions of Chinese counterparts. Thus far, there have been notably few merger filings in relation to foreign acquisitions of Chinese financial institutions. Will that change? This article will analyze the relevant legal issues relating to merger filings in anticipation of the expected wave of increased foreign investment in China's financial services sector.

I. Merger filing requirements generally

Determination of notifiability requires a two-step analysis: whether a transaction is a "concentration", and whether it meets certain turnover thresholds. Under the Anti-monopoly Law of the People's Republic of China ("AML"), concentrations refer to mergers of undertakings, or the acquisition of control or the ability to exert decisive influence over other business undertakings. The turnover thresholds for merger filings include prior fiscal year aggregate business turnover (RMB 10 billion turnover worldwide or RMB 2 billion turnover in China) and individual business turnover (RMB 400 million turnover in China for at least two undertakings to the concentration). Special rules for turnover calculation are provided for financial institutions (10 times the standard threshold amounts). The time needed to complete a merger control filing varies significantly. Simplified procedure filings may take fewer than two months to clear. Normal procedure filings typically take four to six months, and could take as long as one to two years if there are serious competition concerns. In general, the State Administration for Market Regulation ("SAMR") clears most transactions without imposing any conditions. In 10 years of AML enforcement, the merger filing authorities have only issued 38 conditional clearances and only two cases were prohibited (one of them being Coca Cola's acquisition of Huiyuan Juice Company). Failure to report a notifiable transaction leads to fines (22 such cases to date). Theoretically, SAMR can order the unwinding of a transaction that has been

¹ 《外商投资准入特别管理措施(负面清单)(2018年版)》 [Special Administrative Measures for Foreign Investment Access (Negative List for Foreign Investment Access) (2018 Version)] (28 June 2018), available at <http://www.mofcom.gov.cn/article/b/f/201806/20180602760432.shtml> (Chinese)

closed to restore competition to the status quo ante, but this severe punishment has never before been imposed.

II. Relationship between AML enforcement authorities and industry regulators

SAMR, which is authorized by the AML to review merger filings, is now the only antitrust enforcement agency in China following the recent PRC State Council's institutional reforms. The financial services sector is heavily regulated by the relevant industry regulators, and traditionally these industry regulators have been heavy-handed when reviewing and approving acquisitions by foreign financial institutions of Chinese financial institutions. Traditionally, however, MOFCOM, the predecessor to SAMR, gave great deference to industry regulators with respect to merger filings, especially in regulated industries. There are few precedents in the financial services sector that are instructive about the regulatory boundaries between SAMR and industry regulators. The primary reason is that foreign financial service providers were not previously permitted to take controlling interests in Chinese financial institutions by way of acquisition.

III. The regulatory environment may now change

2018 marks the tenth year since the AML took effect, yet there have been few merger filings concerning foreign investment in the financial services sector. Over the past ten years, there have been only several merger filings that have involved foreign financial institutions acquiring shares of, or setting up a joint venture with, Chinese financial institutions. Examples include Warburg Pincus's acquisition of Fortune SGAM Fund Management Co., Ltd. (美国华平投资有限公司收购华宝兴业基金管理有限公司股权案), as well as the establishment of a joint venture among WL Ross and Co. LLC, Huabao Investment Co., Ltd. and other business operators (WL 罗斯有限责任公司与华宝投资有限公司等经营者新设合营企业案), etc.

This is partly due to the foreign ownership restrictions in respect of financial institutions. However, it is clear that restrictions on foreign investment in the financial services sector are being relaxed, and it is anticipated that more merger filings will be made by foreign acquiring entities when they take control of Chinese financial institutions as a result of these new regulatory developments.

At the 2018 Boao Forum for Asia on 11 April 2018 (the "**2018 Boao Forum**"), China announced a series of opening-up commitments which offer broader development opportunities to foreign market players in the financial services sector, specifically:

- In the banking industry, China committed to (1) removing the limit on foreign ownership in commercial banks and offering equal treatment for foreign banks and domestic banks; (2) allowing foreign banks to open both subsidiaries and branches in China in parallel; and (3) substantially expanding the business scope of foreign-invested banks.
- In the securities industry, China committed to raising the limit on foreign ownership in securities firms up to 51%, and to removing this limit after three years. The permitted scope of business

of foreign controlled securities firms will also be expanded in incremental steps.

- In the funds industry, China committed to raising the limit on foreign ownership in FMCs up to 51%, and to removing this limit after three years.
- In the futures industry, China committed to raising the limit on foreign ownership in futures companies up to 51%, and to removing this limit after three years.
- In the insurance industry, China committed to raising the limit on foreign ownership in life insurance companies up to 51%, and to removing this limit after three years.

Following the official announcement of these commitments at the 2018 Boao Forum, we have observed that some commitments have already been fulfilled by way of regulatory changes. For example, we have discussed the raising of foreign shareholding limit in securities firms to 51% in one of Han Kun's previous articles, "[China to Allow Foreign Control of Securities Firms: CSRC Officially Promulgates Measures for Administration of Foreign Investment in Securities Firms](#)"; in addition, on 28 April 2018, the Chinese regulator also confirmed that it now permits foreign investors to hold 51% stakes in FMCs in China, and the shareholding cap of 51% will eventually be removed in 2021². Other opening-up measures in the financial services sector have also entered the planning or consultation stage, such as in the futures and insurance industries.

Further, according to the 2018 Negative List jointly issued by NDRC and MOFCOM as we have mentioned above in the *Executive Summary*, the previous requirements have been removed on the holding of a relative majority of shares by Chinese parties in securities firms, FMCs, futures companies and life insurance companies, which means that, effective 28 July 2018, foreign investors will officially be allowed to take controlling stakes of up to 51% in the these four types of financial institutions, and the 51% limit will be further removed by 2021.

As reported by the media, some international financial institutions have kicked off their initial communications with the regulators or have even submitted applications to take majority control of domestic financial institutions either by way of acquisition or by capital increase.

IV. Possible strategies for foreign acquirers in relation to merger filings in China

Some acquirers prefer not to submit merger filings for business reasons. To achieve this objective, an acquirer must structure the transaction in a way so that it is not legally required to submit a merger filing. In minority acquisition transactions, this typically means veto rights are significantly watered down so that the acquirer only obtains veto rights associated with the protection of its minority interest, which does not result in the acquirer gaining control and thus the acquisition does not constitute a concentration transaction. If a foreign investor now takes a controlling interest in a domestic financial institution, this "dancing around the veto rights" approach may not work for outright

² 《证监会新闻发言人就〈外商投资证券公司管理办法〉答记者问》 [News Briefing by CSRC on the Release of Measures for Administration of Foreign Investment in Securities Companies] (28 Apr. 2018), available at: http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201804/t20180428_337508.html (Chinese).

acquisition of control transactions because it is clear that the acquirer will have obtained control of the target company by its 51% shareholding in the target financial institution. However, with respect to existing foreign minority joint venture financial institutions where the minority shareholder has significant veto rights, there may be room to argue that the quality of control by the foreign investor has not improved in a substantive way, because the shareholding increase from a minority to 51% does not in fact give the foreign investor increased control over the target company. Please contact us for specific legal advice on structuring transactions to suit your business needs or those of your clients.

V. Consequences for failure to file

SAMR may impose administrative penalties in cases of failure to submit merger filings or closing the transaction before obtaining clearance. The most frequent penalty is a fine, which is currently capped at RMB 500,000, with account taken of the nature, extent, and duration of the violation. For serious violations, SAMR also has the authority to order firms to dispose of shares, assets, and businesses to restore competition to the status quo ante, although none of these measures have been taken against an undertaking to date. During a SAMR failure to file investigation, refusal or obstruction of the investigation can lead to fines or even criminal charges. Refusal and obstruction typically include refusal to provide materials and information, the provision of false materials and information, or the concealment, destruction or transfer of evidence.

Concluding Remarks

The financial services sector in China is dominated by Chinese financial institutions. Foreign-invested companies have played only a minor role to date and have taken relatively little market share, even in specialized industry sub-segments. With the upcoming relaxation of foreign investment restrictions, it is possible that a foreign acquisition in this area could cause serious competition concerns in terms of substantial market share. In addition, antitrust regulators may also consider other factors that may affect competition, such as entry barriers based on technology and knowhow, conglomerate effects (capital availability and customer bases), etc. So far, MOFCOM/SAMR have not indicated how they will review merger filings for acquisition transactions by foreign financial institutions, and it is not clear how much deference SAMR will give to the relevant financial industry regulators. We will certainly see more merger filings as a result of the further opening-up of the financial services sector, and most of these filings may be cleared without conditions under the simplified filing procedure. Until now, foreign investors in the financial services sector have not been accustomed to submitting merger filings for their investments, and it is therefore necessary to be mindful that competition law will come to play a more important role in acquisition transactions as foreign investment restrictions are gradually withdrawn.

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2. HK Firms Can Now Offer Securities Investment Consulting Services to the Mainland (Authors: TieCheng YANG, Yin GE, Ting ZHENG, Michael KAN)

On 29 June 2018, the China Securities Regulatory Commission ("**CSRC**") officially promulgated the *Interim Provisions on the Use of Hong Kong Institution Securities Investment Consulting Services by Institutions Engaged in Securities or Funds Business* (the "**Interim Provisions**")³, following CSRC's issuance of a consultation draft of the same on 20 April 2018 for public comment⁴. The Interim Provisions officially came into effect on 1 July 2018. It is widely regarded as a favorable measure to further promote common development and mutual cooperation between the capital markets of mainland China and Hong Kong.

How will the Interim Provisions deepen the opening-up and cooperation between the capital markets of mainland China and Hong Kong? This newsletter begins with a background of the Interim Provisions, interprets the key requirements, and analyzes the impact on mainland-based securities firms and fund management companies ("**Mainland Institutions**") and Hong Kong-based institutions ("**HK Institutions**").

I. Background

Since the launch of the Shanghai-Hong Kong Stock Connect on 17 November 2014 and the launch of the Shenzhen-Hong Kong Stock Connect on 5 December 2016, the two-way trading links between mainland and Hong Kong stock markets have been operating smoothly and have continued to realize breakthroughs. For example, as of 30 March 2018, the total trading volume on the Shanghai-Hong Kong Stock Connect has reached RMB 7.8 trillion (USD 1.2 trillion). Among these figures, the Northbound Shanghai-Hong Kong Stock Connect has a total of 795 stocks traded, with a trading volume of RMB 4.3 trillion (USD 642.5 billion); the Southbound Shanghai-Hong Kong Stock Connect has a total of 385 stocks traded, with a trading volume of RMB 3.5 trillion (USD 533.9 billion)⁵.

On 11 April 2018, in order to further enhance the two-way trading links between mainland and Hong

³ 《证券投资基金经营机构使用香港机构证券投资咨询服务暂行规定(正式稿)》 [Interim Provisions on the Use of Hong Kong Institution Securities Investment Consulting Services by Institutions Engaged in Securities or Funds Business (Official Version)] (China Securities Reg. Comm., Announcement [2018] No. 23; effective 1 Jul. 2018), available at: http://www.csrc.gov.cn/pub/zjhpublic/zjh/201806/t20180629_340512.htm (Chinese)

⁴ 《证券投资基金经营机构使用香港机构证券投资咨询服务暂行规定(征求意见稿)》 [Interim Provisions on the Use of Hong Kong Institution Securities Investment Advisory Services by Institutions Engaged in Securities or Funds Business (Draft for Comment)] (China Securities Reg. Comm., issued 20 Apr. 2018, for public comment until 21 May. 2018), available at: http://www.csrc.gov.cn/pub/zjhpublic/zjh/201804/t20180420_337079.htm (Chinese)

⁵ 《深化互联互通机制 沪港通每日额度扩大四倍》 [Deepening the Trading Links between Mainland and Hong Kong and quadruple the daily quota for Shanghai-Hong Kong Stock Connect] (Shanghai Securities Exchange, issued 11 Apr. 2018), available at: www.sse.com.cn/aboutus/mediacenter/hotandd/c/c_20180412_4499566.shtml (Chinese)

Kong stock markets, CSRC and the Hong Kong Securities and Futures Commission ("**SFC**") jointly announced that they have agreed to quadruple the daily trading volume quota⁶. Effective 1 May 2018, the daily trading volume quota for each of the Southbound Trading Link (under Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect) was adjusted to RMB 42 billion.

With the increasing willingness of mainland investors to invest in H-shares under the Southbound Trading Link, the scale of trading has surged to new highs. Meanwhile, mainland investors are also facing growing demand for securities research reports and securities investment advisory services on H-shares under the Southbound Trading Link. However, the market research of Mainland Institutions on Hong Kong stock market is currently in its early stages. Compared with the current research capabilities of Mainland Institutions, HK Institutions enjoy a local competitive advantage in securities analysis and research on the Hong Kong stock market, with key strengths in terms of the scale and capabilities of analyst teams as well as the advantage of location proximity. In this regard, the cooperation between Mainland Institutions and HK Institutions will be mutually beneficial and helpful.

On the basis of the continuous development of the two-way trading links between mainland and Hong Kong stock markets, CSRC recently promulgated the Interim Provisions to regulate Mainland Institutions' use of securities consulting services provided by HK Institutions under the Southbound Trading Link, which aims to further deepen the mutual cooperation between the securities and fund industries of mainland China and Hong Kong and to better fulfill investors' needs during cross-border investment.

II. Two Business Models under the Interim Provisions

The Interim Provisions apply to the use by Mainland Institutions of HK Institutions' securities investment consulting services under the Southbound Trading Link. The Interim Provisions allow for the following two business models:

- i. **H-shares research report business model.** According to the *Guidelines for Institutions Engaged in Securities or Funds Business in Interconnection of Mainland and Hong Kong Stock Markets*⁷ issued by CSRC on 11 October 2016, licensed HK Institutions may issue securities research reports under the Southbound Trading Link under the name of Mainland Institutions. As a further step, the Interim Provisions allow Mainland Institutions or their subsidiaries that issue securities research reports to re-issue the reports of HK Institutions to their mainland

⁶ 《中国证券监督管理委员会 香港证券及期货事务监察委员会联合公告》 [Joint Announcement of the China Securities Regulatory Commission and the Hong Kong Securities and Futures Commission] (China Securities Reg. Comm.; issued 11 Apr. 2018 and effective 1 May 2018), available at:

http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201804/t20180411_336497.html (Chinese)

⁷ 《证券基金经营机构参与内地与香港股票市场交易互联互通指引》 [Guidelines for Institutions Engaged in Securities or Funds Business in Interconnection of Mainland and Hong Kong Stock Markets] (China Securities Reg. Comm., Announcement [2016] No. 24; effective 11 Jan. 2016), available at:

http://www.csrc.gov.cn/pub/xiamen/xxfw/gfxwj/201611/t20161102_305349.htm (Chinese)

clients with the authorization of the HK Institutions. These reports contain investment analysis on eligible H-shares under the Southbound Trading Link.

- ii. **H-shares investment adviser business model.** Mainland Institutions are allowed to appoint HK Institutions to provide investment advisory services for eligible H-shares under the Southbound Trading Link for securities investment funds that Mainland Institutions manage and which participate in the Southbound Trading Link.

For purposes of the Interim Provisions, "eligible H-shares under the Southbound Trading Link" refer to the stocks listed on the Stock Exchange of Hong Kong within the scope of the Southbound Trading Link as provided in the *Several Provisions on the Interconnection Mechanism for Mainland and Hong Kong Stock Markets*⁸.

The following table summarizes the two types of business models that are applicable under the Interim Provisions.

⁸ 《内地与香港股票市场交易互联互通机制若干规定》 [Several Provisions on the Interconnection Mechanism for Mainland and Hong Kong Stock Markets] (China Securities Reg. Comm., Order No. 128; effective 30 Sept. 2016), available at:

www.csrc.gov.cn/pub/zjhpublic/G00306201/201609/t20160930_304241.htm (Chinese)

Business model	H-shares research report business model	H-shares investment adviser business model
Applicable service scope	<ul style="list-style-type: none"> • Distribution of securities research reports on eligible H-shares under the Southbound Trading Link. 	<ul style="list-style-type: none"> • Provision of investment advisory services for eligible H-shares under the Southbound Trading Link invested in by securities investment funds.
Eligible Mainland Institutions	<ul style="list-style-type: none"> • Mainland-based securities firms or their subsidiaries that engage in the issuance of securities research reports; (except for firms that have been subject to administrative punishment or major administrative supervision measures in the past three years due to the violation of laws or regulations). 	<ul style="list-style-type: none"> • Mainland Institutions which manage securities investment funds investing through the Southbound Trading Link.
Eligible HK Institutions	<ul style="list-style-type: none"> • Licensed by SFC to provide advice on securities; • Experienced in issuing securities research reports. 	<ul style="list-style-type: none"> • Licensed by SFC to provide advice on securities and to conduct asset management; • Experienced in asset management.
Key requirements for Mainland Institutions	<ol style="list-style-type: none"> (1) Have a signed agreement with an HK Institution to obtain proper authorization from the HK Institution; (2) Review the qualifications of the HK institution; (3) Submit the agreement and other related materials to the local CSRC office for filing as required; (4) Establish a mechanism for reviewing the H-shares research reports to be re-issued; (5) Notify the HK Institution of relevant laws and regulations on 	<ol style="list-style-type: none"> (1) Sign an agreement with the HK institution appointing the HK institution to provide investment advisory services for eligible H-shares; (2) Conduct due diligence on the HK Institution; (3) Submit the agreement and other related materials to the local CSRC office for filing as required; (4) Submit relevant materials in accordance with laws and regulations, when registering or record-filing a securities investment fund that will use the H-shares investment advisory

	<p>the issuance of securities research reports in mainland China;</p> <p>(6) State relevant issues in the H-shares research reports as required by the Interim Provisions.</p>	<p>services;</p> <p>(5) Truthfully disclose relevant information and risks in fund contracts, prospectuses, and other documents;</p> <p>(6) Maintain records of using the H-shares investment advisory services.</p>
<p>Key requirements for HK Institutions</p>	<p>(1) Ensure that the requirements from SFC are followed during the issuance of H-shares research reports and authorization of the mainland-based securities firms to re-issue such reports;</p> <p>(2) Ensure that the H-shares research reports follow the relevant laws and regulations on the issuance of securities research reports in mainland China;</p> <p>(3) In principle, shall not communicate with clients of the securities firms to discuss the content of the H-shares research report (with very limited exceptions);</p> <p>(4) Undertake to cooperate with supervision and regulation by CSRC and its local offices, and provide relevant business materials and information as required.</p>	<p>(1) Follow relevant laws, regulations and regulatory requirements of mainland China and Hong Kong on securities investment advisory business, and file basic information with the Asset Management Association of China in accordance with its rules;</p> <p>(2) Undertake to cooperate with supervision and regulation by CSRC and its local offices, and provide relevant business materials and information as required.</p>

III. Outlook

The official promulgation and implementation of the Interim Provisions will have a broad and positive impact on mutual cooperation between the capital markets of mainland China and Hong Kong. Mainland Institutions can fully leverage investment advisers' familiarity with the Hong Kong stock market to provide professional advice which will help these institutions to carry out professional investing in H-shares and improve the performance of fund products. Meanwhile, by cooperating with Mainland Institutions, HK Institutions can further expand their client base in mainland China and take advantage of the beneficial two-way opening-up and cooperation between the capital markets of mainland China and Hong Kong.

In addition, we note that, for both the H-shares research report business model and the H-shares investment adviser business model in the Interim Provisions, the applicable service scope is currently limited to eligible H-shares traded on the Stock Exchange of Hong Kong through the Southbound Trading Link as specified in the *Several Provisions on the Interconnection Mechanism for Mainland and Hong Kong Stock Markets*. For now, the scope of the Interim Provisions does not include H-shares outside the scope of the Southbound Trading Link and stocks listed on other overseas exchanges. In this regard, we look forward to the future expansion of the applicable scope for both the H-shares research report business model and the H-shares investment adviser business model. We believe the inclusion of H-shares outside the scope of Southbound Trading Link and stocks listed on other overseas exchanges will facilitate broader cooperation between Mainland Institutions and HK Institutions, which will also benefit mainland investors for their cross-border investments.

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Important Announcement

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