漢坤律師事務所
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Newsletter

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Legal Updates

Legal Updates

1. China Expands Disclosure Requirements over Chinese Enterprises' Overseas Investment Activities --- Brief Commentary on the Set of Forms Related to the Management Rules for Overseas Investment by Enterprises and the Catalogue on Overseas Investment in Sensitive Industries (Authors: Aaron ZHOU, Bing XUE, Charles WU)

On December 26, 2017, China's National Development and Reform Commission ("NDRC") issued the "Management Rules for Overseas Investment by Enterprises", Order No. 11 of 2017 ("Order 11"). On February 11, 2018, the NDRC issued the "Catalog on Overseas Investment in Sensitive Industries (2018 Edition)" (the "Sensitive Industries List") and the "Set of Forms Related to the Management Rules for Overseas Investment by Enterprises" (the "Standard Forms").

The NDRC will closely scrutinize overseas investment by Chinese enterprises in industries specified in the Sensitive Industries List. The Standard Forms set forth detailed documentation and information requirements that Chinese enterprises will need to submit to the NDRC when making overseas investments, whether such investments require NDRC approval or only a record-filing with the NDRC. Order 11, the Sensitive Industries List and the Standard Forms will all come into effect on March 1, 2018.

It is important to note that, in addition to the approval or record-filing requirements under Order 11, Chinese investors may also need to comply with other pre-existing PRC regulatory requirements when making overseas investments, such as approval or record-filing with the Ministry of Commerce and approval for the remittance of funds out of China.

Order 11 is novel because it effectively creates long-arm jurisdiction over the overseas investment activities of Chinese investors by imposing new regulations and requirements on overseas arms controlled by such Chinese investors. Accordingly, even if these overseas arms are legally independent of a Chinese parent, or have raised funds or generated revenue outside of China, they are still subject to the requirements of Order 11. Accordingly, when these overseas arms intend to conduct other investments outside of China, they will have to comply with Order 11.

Part I – Sensitive Industries List

Any investment by a Chinese investment in a sensitive industry requires approval under Order 11. This is true even if the investment is made by an overseas arm controlled by a Chinese

parent.

The Sensitive Industries List defines the following as sensitive industries:

- Research, development, production or repair of weapons and related equipment
- Development or use of cross-border water resources
- News media
- Real estate
- Hotels
- Cinemas
- Entertainment
- Sports clubs
- Establishment of equity investment funds or investment platforms without a specific industrial project

The Sensitive Industries List includes items that are, to date, not well-defined. For example, "entertainment" is not defined, meaning variants of entertainment such as gaming may fall within the scope of the Sensitive Industries List. For well-defined items such as real estate, the implication for potential sellers and non-Chinese investors is starting to take shape. Starting on March 1, 2018, any overseas investment by a Chinese buyer in a sensitive industry, including a buyer incorporated outside of China that is controlled by Chinese investors, is required to obtain NDRC approval pursuant to Order 11.

Part II – Comprehensive Disclosure Requirements

The Standard Forms expand and more specifically set forth the application and disclosure requirements under Order 11. What is worth noting is that the application materials for transactions requiring NDRC approval and transactions only requiring a record-filing with the NDRC are both expansive as compared to existing requirements.

Below is a detailed list of requirements divided into different categories of Chinese resident persons.

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
Disclosure of Ultimate Controlling Shareholders	Not applicable	➢ The five largest direct shareholders of the Chinese investor and shareholders who directly own 10% or more of the Chinese investor (if the Chinese investor is a partnership, the general partner and the five largest limited partners) ➢ If the direct shareholder is a company, the ultimate controlling persons of such shareholder, up to individual persons or the State-owned Assets Supervision and Administration Commission or its local counterpart (the "SASAC") ➢ If the direct shareholder of the Chinese investor is a partnership, the general partner. If the general partner is a company, the ultimate controlling persons of such general partner, up to individual persons or the SASAC. If the general partner is a partnership, the general partner of such partnership and the ultimate controlling persons of such general partner, up to individual persons or the SASAC ➢ If there is no controlling shareholder in the above "look-through" exercise, the largest shareholder and the ultimate controlling persons of such largest shareholder, up to individual persons or the SASAC The "look-through" exercises set forth above are also required for persons who are proxies of or persons acting-in-concert with the above controlling shareholder, general partner or largest shareholder ➢ If control is achieved through contractual arrangements (including management contracts), trusts or other methods, clearly state the controller and the method of control, and the "look-through" exercise will also apply to the controller (look-through to the controlling persons of such controller, up to individual persons or the SASAC)	Not applicable
Basic Information	Name, identification number, address set forth in the identification card	Name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type (state-owned or state-controlled, privately-owned or privately-controlled, foreign invested, others), incorporation date, scope of business, and main business	Basic information (including the incorporation or registration certificate or similar documents)

	Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
Business Operations	Not applicable	The main operational and financial indicators (such as assets, debt, revenue and profit) for the past two years	Main financial indicators, consisting of audited financials for the past year or 6 months (calendar year or fiscal year), or if the investing entity cannot provide audited financials because it was only recently incorporated, the most recent audited financials of its controlling shareholder, general partner or ultimate controlling persons, up to individual persons or the SASAC
Credit Information[1]	Credit information for the past two years	Credit information of the investing entity, the controlling shareholder of the investing entity, and the ultimate controlling person of the investing entity for the past two years	Credit information for the past two years
Controlled Enterprises (for approvals only)	➢ Basic information about enterprises controlled by the individual ➢ If the individual controls multiple enterprises, the information and operational information of the three most important enterprises	Not applicable	Not applicable
Requirements for Attachments to be Submitted	1. Identification documents 2. Internal investment approval by the investing entity 3. Legally binding investment agreement or similar document	1. Incorporation documents of the investing entity 2. Most recent audited financials of the investing entity, or if the investing entity cannot provide audited financials because it was only recently incorporated, the most recent audited financials of its controlling shareholder, general partner or ultimate controlling persons, up to individual persons or the SASAC 3. Internal investment approval documents of the investing entity	

[1] "Credit information" means records maintained by different Chinese regulators and authorities that can be used to evaluate the credit-worthiness of Chinese legal entities and individuals, such as non-compliance with overseas investment regulations, failure to comply with court judgments or orders, and tax defaults.

<table>
<tr><th></th><th>Individual Chinese Resident</th><th>Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)</th><th>Non-Enterprise Chinese Entity</th></tr>
<tr><td rowspan="2"></td><td rowspan="2">4. Undertaking letter confirming that the investment and the documents provided are authentic</td><td colspan="2">4. Legally binding investment agreement or similar document
5. Supporting documents proving the source of funds used in the investment is legitimate
6. Undertaking letter confirming that the investment and the documents provided are authentic</td></tr>
<tr><td>The shareholding structure chart of the investment entity, traced up to the ultimate controlling persons</td><td>Not applicable</td></tr>
<tr><td rowspan="2">Internal Investment Approval Documents</td><td>Documentation setting forth the decision to make such investment</td><td>➢ Board resolution, approval from the investment committee
➢ If the investment decision is made by the controlling shareholder or the ultimate controlling person, documentation of the decision by such controlling shareholder or ultimate controlling person, as applicable, to make such investment</td><td>Documentation as determined by specific circumstances</td></tr>
<tr><td colspan="3">If the investment is through an offshore entity controlled by the Chinese investor, the offshore entity’s board resolutions or similar documents approving the transaction</td></tr>
<tr><td>Information about the Investment Destination</td><td colspan="3">➢ Clear disclosures about all jurisdictions involved in the transaction, including:
• Immediate overseas destination: the jurisdiction of incorporation of the offshore entity directly controlled by the Chinese investor
• Final destination: the jurisdiction of the operational target entity
• Other countries or jurisdictions: the location of all entities between the above immediate overseas destination and the final destination (such as intermediate holding companies)
➢ Details about each jurisdiction should cover at least the provincial level
➢ Details about each jurisdiction should include (i) the political and security situation, (ii) laws and regulations, (iii) market access and regulatory policies, (iv) the state of the jurisdiction’s natural resources, (v) the state of the jurisdiction’s infrastructure, (vi) the economic and financial situation of the jurisdiction, and (vii) the state of the jurisdiction’s society, culture and environment. Further elaborate whether (i) the transaction is warranted given the jurisdiction’s political and security situation, and (ii) whether the jurisdiction’s laws and regulations and policies prohibit or restrict the current transaction</td></tr>
<tr><td>Information about Intermediate Entities (if the investment is made through an offshore entity controlled by a Chinese individual or enterprise)</td><td colspan="3">➢ Basic information, including name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type, date of incorporation, scope of business, and main business
➢ Shareholding structure, including basic information about the five largest shareholders (if the target is a partnership, the general partner and the five largest limited partners), such as name, nationality or jurisdiction of incorporation, and shareholding ownership percentage
➢ The control relationship between the offshore acquiring entity and the Chinese investor
➢ Operational matters: main operational and financial indicators (such as assets, debt, revenue and profit) for the past two</td></tr>
</table>

		Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
		years ➢ Criminal or administrative penalties in the past two years (if applicable, provide relevant detail)		
Legally Binding Investment Agreements		➢ For a tender offer, merger or acquisition, joint venture or joint cooperation transaction, the legally binding investment agreements or similar documents ➢ If binding definitive agreements cannot be obtained, a full and reasonable explanation as to why such binding definitive agreements cannot be obtained		
Evidence that the Source of Funds is Compliant		➢ If the Chinese enterprise uses its own funds to fund the transaction's consideration, a deposit certificate issued by a bank or a similar document ➢ For intangible consideration such as equity securities, in-kind assets, technology, intellectual property, equity interest, or debt interest, an audited report, asset valuation report, or similar report issued by a qualified accounting firm, asset valuation firm or other intermediary firm, or other documents that can certify the value of the intangible assets ➢ If the Chinese investor uses bank financing to fund the transaction's consideration, a letter of intent or similar document issued by a bank that includes the total financing amount ➢ If the Chinese investor issues equity securities, debt securities, or uses other methods to fund the transaction's consideration, the relevant supporting or explanatory document		
Investment and Financing Plan		➢ Transaction structure, including (i) the transaction's total consideration, investment valuation (including the total valuation, the basis for calculating such total valuation, and relevant explanations), and (ii) the amount contributed by each party and such party's ownership percentage, the method of contribution, and any joint venture or joint cooperation arrangement ➢ The total consideration paid by the Chinese investor and the composition of the consideration: The total amount invested by the Chinese investor and any offshore entity controlled by the Chinese investor in such transaction, including cash, equity securities, in-kind assets, technology, intellectual property, equity interest and debt interest, as well as the amount of financing and the guarantees provided For each Chinese investor and investment vehicle controlled by the Chinese investor, a description of the method of payment, the investment amount, the source of funds, the currency of payment, and the total consideration amount ➢ A description of how the investment funds will be used, and a plan for the use of such funds ➢ Financial assessment of the transaction, including estimates of key financial indicators such as revenue, profit, internal rate of return, and the investment return period		
Transaction Background		➢ Reasoning for the transaction ➢ Work carried-out to date: due diligence, feasibility study, negotiations with overseas parties and the investment decision ➢ Approvals for the transaction: national security review for foreign investment, market entry, antitrust, and the progress of the foregoing		
Key Terms and Size of	**New Project**	➢ Particulars and the size of the construction, including location, the particulars, the size of the construction, the engineering technical proposal, the length and plan of construction, the scale of main products, and the target markets. With respect		

		Individual Chinese Resident	Chinese Enterprise (including companies, partnerships, and financial and non-financial enterprises)	Non-Enterprise Chinese Entity
the Transaction		to the development of natural resources, a description of the amount of natural resources that may be developed, the grade of the natural resources, the amount of interests in the natural resources that may be attained by the Chinese investor, and the development plan ➢ Status of support conditions, including the status and plans for staffing, land, materials and relevant infrastructure such as roads, railways, ports and natural resource supplies, and whether the transaction fulfills the target jurisdiction's technological, environmental, energy consumption and security requirements		
	M&A	➢ The target • Share Acquisition: the target's basic information such as name, jurisdiction of incorporation, share capital, legal representative (if applicable), entity type, scope of business, basic information of the target's main shareholders, including their names, jurisdictions of incorporation or nationality and shareholding percentages, the location of its main assets (by industry and location), production, operational and financial situation, whether the target is listed and the performance of its stock price (if applicable), the target's industry position in terms of its products, technology and branding • Asset Acquisition: The composition and location of the target assets (by industry and location), the basic information about the owners of the assets (name, jurisdiction of incorporation or nationality and ownership percentage), the price or valuation of the assets by a professional appraiser (if applicable) ➢ Acquisition plan, including the acquisition target, purchase price (including an explanation of the method for calculating the valuation and the main parameters used), the acquisition entity, the transaction structure and plan, and a shareholding structure chart showing the ultimate controlling persons of the target before and after the closing of the transaction		
Transaction Risks and Mitigation Measures		An analysis of the transaction's main risk factors such as political, security, economic, societal and environmental risks, along with risk mitigation measures		
Impact on National Interest and National Security		➢ The transaction's impact on the development of the industry ➢ The transaction's macroeconomic impact ➢ The transaction's impact on relations between China and the countries involved ➢ Whether the transaction (i) is in an industry prohibited under Order 74 of 2017 (prohibiting investment into certain industries, many of which are the same as those set forth in the Sensitive Industries List), (ii) involves resources, products, technology or services that are subject to export control under relevant PRC law, (iii) constitutes a material adverse effect with respect to China's compliance with its international obligations such as implementing U.N. Security Council sanctions resolutions, or (iv) involves other matters that may threaten the national interest or national security		

Part III – Practical Observations

The Standard Forms' requirement that applicants submit legally binding agreements means the parties may no longer rely on non-binding term sheets, letters of intent or memorandums of understanding when submitting application materials.

The Standard Forms also require the disclosure of indirect control arrangements, such as contractual control (including management contracts) and trusts, along with the entire investment holding structuring, including all intermediate special purpose vehicles. Accordingly, the Standard Forms increase transparency requirements with respect to ultimate beneficial ownership, which may impact Chinese investors who, for one reason or another, do not wish to disclose such arrangements.

Part IV – The Standard Forms' Requirements are more Comprehensive as Compared to Existing Requirements

Compared with the NDRC's current application documentation requirements for overseas investment, the Standard Forms' requirements are more comprehensive, resulting in increased disclosure obligations for Chinese investors.

One of the consequences of the new requirement to disclose ultimate beneficial owners is that the NDRC will now be able to access the credit records of the applicants. Accordingly, applicants will no longer be able to avoid this evaluation through the establishment of intermediate holding companies or different investment vehicles.

In addition, the Standard Forms codify a recent practice requiring applicants to demonstrate that they have evaluated the risks of the overseas investment and have taken appropriate countermeasures. This requirement may be in response to recent overseas investment activities by large, heavily indebted Chinese conglomerates in industries now labeled as sensitive.

As the Standard Forms impose more comprehensive application documentation requirements, we predict that Chinese enterprises will need more time to prepare these application materials. The new application requirements, such as the need to submit definitive and binding documentation, may result in increased deal costs and uncertainty. Accordingly, non-Chinese sellers should consult qualified PRC counsel with on-the-ground knowledge of law and, more importantly, its practical implementation, when discussing transactions with potential Chinese buyers.

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2. GSP of Personal Information Security Arrived (Authors: David TANG, Min ZHU, TieCheng YANG, Ying HUANG)

Many industries, such as food, pharmaceuticals and medical devices, focus on quality management and have their own management practices, such as GMPs (Good Manufacturing Practices) and GSPs (Good Sales Practices). There is no doubt that the newly released *Information Security Technology – Personal Information Security Specification (GB/T 35273-2017)* (the "**Specification**") is the "GSP" (Good Security Practices) of personal information protection in terms of its structure and content. In the financial industries, financial regulators have their own rules protecting personal financial information. Promulgation of the Specification will help financial institutions to give more protection to their customers.

On December 29, 2017, the Office of the Central Leading Group for Cyberspace Affairs, the State Administration of Quality Supervision, Inspection and Quarantine, and the National Information Security Standardization Technical Committee jointly released the Specification in the form of a national standard. The full text of the Specification was officially published on the national standards public system on January 24, 2018, and will be effective on May 1, 2018. The Specification establishes a framework for personal information protection in accordance with requirements of the Cybersecurity Law, providing comprehensive and detailed compliance obligations for all aspects of the personal information processing life cycle.

Distinguish Functions + Qualitativeness and Quantitativeness + Process Management

Upon analyzing the content of the Specification in its entirety, we believe that the overall internal logic of the Specification can be summarized as "distinguish functions + qualitativeness and quantitativeness + process management." Specifically, the Specification first distinguishes core and additional business functions, since there may be different basic compliance obligations for different functions. Next, the Specification qualitatively and quantitatively puts forward different requirements for personal information which may be involved in the business, such as stipulating the clear purpose principle (legitimate, justified and necessary) and minimum sufficient use principle (minimum quantity and lowest frequency) etc., and also stipulates the collection methods, storage area, and storage period, etc. Third, the Specification stipulates specific standardization requirements for each stage of the personal information life cycle, which involves collecting, storing, using, commissioned processing, sharing, transferring, public disclosure, and mergers and acquisitions, etc.

In order to illustrate the above framework more intuitively and clearly, we have provided the following table. We believe that this table will not only aid in understanding the overall structure and content of the Specification, but also be instructive for enterprise personal information compliance practices.

Table 1

Information / Function	Qualitativeness and Quantitativeness			Process Management						
	Type	**Quantity**	**Frequency**	**Collect**	**Store**	**Use**	**Commissioned Process**	**Share / Transfer**	**M&A and Reorganization**	**Public Disclosure**
Applicable Principles	Clear purpose, minimum sufficient use			Selective consent, transparency, guarantee of security, participation of subject						
Core Business Function 1 (Ex.: Payment)	Identity information, bank account etc.	1	1	Explicit consent	Minimized time, de-identification, encryption	-	-	Explicit consent, security impact assessment, informing sharing information	-	-
Core Business Function 2										
…										
Additional Business Function 1 (Ex.: location)										
Additional Business Function 2 (Ex.: money management)										
…..										

The Specification Clearly Answers Some Pending Questions in Practice

i. Ownership of Personal Information

The Specification creatively puts forward the concept of "personal data controller" ("**Controller**"), and defines it as "an organization or individual that has the right to decide the purpose and method of personal information processing." From this term, we can observe that the Specification continues to gloss over the issue of ownership of personal information, in line with many previous documents dealing with the protection of personal information. At this point, we believe that the personal information ownership issue is actually a false proposition, or at least that a clear and definite definition of ownership cannot be established at this stage due to the balancing between personal information protection and the economic development of big data. The expression "personal data controller" in the Specification emphasizes that this entity or person is the actual controller of personal information rather than the owner. In fact, the Specification cleverly handles the ownership issue at this stage by not influencing the creation of a set of rules for the protection of personal information. Remaining silent as to the ownership of personal information may be conducive to promoting the overall process of personal information protection without this issue creating a prerequisite obstacle.

ii. Consent Rules at the Collection Stage

In practice, use of consent terms inconsistent with the consent rules is a common industry phenomenon. For many network operators, it is common to efficiently and at low cost obtain users' consent by allowing users to accept the operator's privacy policy when registering for the operator's services. However, the general and ambiguous wording of these types of privacy policies is often used to obtain general user authorizations, so as to lessen or even exempt network operators of their own obligations. The Specification stipulates in detail specific compliance requirements for informed user consent rules.

Article 5.3 of the Specification provides general requirements for personal information collection, namely that personal information subjects ("**Subjects**") must be clearly informed of the circumstances related to the collection and that authorized consent be obtained from the Subject. We believe that "authorized consent" includes both "explicit consent" and "implied consent." Article 5.5 of the Specification distinguishes functions of network products into core functions and additional functions, and further stipulates special consent requirements for personal sensitive information.

With respect to the collection of personal sensitive information, for example, Article 5.5 of the Specification provides that if the collection is necessary for core business functions, network operators should inform the Subjects of specific types of personal sensitive information to be collected, clearly inform them of consequences of refusal to provide information or consent, and allow the Subjects to choose whether to provide the information or agree to automatic collection. If the collection is for other additional business functions, network operators should explain each item of personal sensitive information necessary for each additional business function separately, and allow the Subjects to choose whether to provide or agree to the automatic collection of personal sensitive

information. Where the Subject refuses to provide personal sensitive information for the additional functions, those functions may not be provided, but the core functions should not be terminated due to this refusal, and the quality of the services should still be guaranteed. Because additional business functions are inherently not essential to the service, the compliance requirements for collecting personal sensitive information for such functions is clearly more demanding.

The following three steps should be considered when network products or services involve personal information collection:

- Step 1: determine whether it is a collection activity. Local access to users' information via some network products or services may not be a collection activity, and therefore there would be no need for authorization from the Subject.
- Step 2: if it is confirmed to be a collection activity, distinguish whether the business functions belong to core or additional functions of products or services. For core functions, privacy policies may still be used for general authorized consent, while separate authorizations should be used to obtain explicit consent for additional functions.
- Step 3: distinguish whether the information belongs to general personal information or personal sensitive information. For general personal information, enterprises may obtain general authorizations, including "implied consent" (Opt-Out) and "explicit consent" (Opt-In); as for personal sensitive information, enterprises should only adopt the method of "explicit consent," that the Subjects should make written statements or affirmative actions, for example by affirmatively ticking a box and clicking "Agree."

Table 2: types of authorized consent

Information / Function	Personal Sensitive Information	General Personal Information
Core Business Function	Explicit consent	Explicit or implied consent
Additional Business Function	Separate explicit consent	Explicit or implied consent

Four departments, including the Cyberspace Administration of China ("**CAC**"), the Ministry of Industry and Information Technology, the Ministry of Public Security, and the Standardization Administration jointly launched a special program for the privacy policies of 10 network products and services during the period from August 24, 2017 to September 24, 2017. The results of the program indicated that the privacy policies for the products and services had all improved to various degrees. Subsequently, the companies offering the ten products and services also jointly signed the *Proposal for Personal Information Protection*, which includes "respecting the user's right to know" and

"complying with user authorization and strengthening self-restraint." It is noteworthy that the Specification also provides the main content of and compliance requirements for privacy policies in detail, and displays privacy policy templates in a 9-page appendix. This appendix provides an important reference guide for platforms and apps to develop their own privacy policies.

iii. Limited Due Diligence in Indirectly Obtaining Personal Information

As for sources of personal information, besides being voluntarily or automatically collected from Subjects, there is the possibility that a Controller will indirectly obtain personal information from third parties. The Specification stipulates specified regulations for third-party sources.

a. Personal information providers ("**Providers**") are required to indicate the sources of personal information and to verify the legitimacy of those sources.

b. Controllers should understand the scope of authorized consent to process personal information which Providers have obtained, including the purpose of use, and whether the Subjects consented to the transfer, sharing, or public disclosure of the information. If the organization processes personal information for business beyond the scope of the authorization, explicit consent of the Subjects should be obtained within a reasonable time after obtaining the personal information or prior to processing the personal information.

These rules present the diligence and care obligations for Controllers which indirectly obtain information via third-party channels. In order to satisfy these compliance requirements, the relevant enterprises should conduct limited but necessary due diligence on the relevant business activities of the Providers, review the relevant policy documents of the Providers, and examine their personal information protection activities to maximize the protection of the enterprise's own interests.

iv. Information Preservation and Processing after Termination of Services

For the storage stage of the personal information life cycle, the Specification provides specific requirements for minimizing the time for saving and de-identifying the information in accordance with the minimum sufficient use principle and the ensure security principle. As for the storage of personal sensitive information, Controllers should use security methods such as encryption, and technical measures should also be employed in advance to handle personal biometric information.

Subjects are relatively concerned in practice regarding Controllers' handling of personal information following the termination of products or services. The Specification clarifies a solution to this issue by requiring Controllers to stop collecting information, notify Subjects individually or in the form of an announcement, and to delete or anonymize the personal information held when the Controller's product or service is no longer being offered.

v. Tripartite Relationship Rules in the Personal Information Life Cycle

The previous discussion involved the bilateral relationship between the Controllers and the Subjects, but the Specification also regulates tripartite relationships in handling personal information. In this section, the Specification focuses on the regulatory requirements for personal information processing

involving third parties and clearly distinguishes the stages and applicable rules for commissioned processing, sharing, transferring, public disclosure, common control, mergers and acquisitions involving personal information.

For Controllers commissioning others to process users' personal information, the Specification provides that the Controller should not exceed the scope of authorization, and that the Controller should conduct a personal information security impact assessment on the commissioned activity. In accordance with the Specification, personal information should in principle not be shared, transferred or publicly disclosed, and prior consent of the Subjects should be obtained when it is necessary to perform such actions. The consents should be explicit if personal sensitive information is involved. In addition, receivers of personal information should be subject to personal information security impact assessments, and Controllers should inform the Subjects of the specific details relating to sharing, transferring and publicly disclosing the information.

Section of "Personal Information Sharing and Transfer" in Article 8.2 of the Specification, item e) is of particular note by requiring "the undertaking of corresponding liability for causing damage to the legitimate rights and interests of Subjects due to the sharing and transfer of personal information." We understand that, the liability here includes not only the Controller causing adverse consequences, such as through information leakage or damage during the process of sharing and transferring information, but also the Controller failing to carefully investigate the information receiver and sharing or transferring personal information to a receiver which lacks appropriate information security capabilities. Potential liability due to a failure to investigate information receivers should be of note to Providers, because in this case the personal information is beyond the Provider's control, and presents a broadening of potential risk.

Additionally, to a certain extent, the Specification explicitly gives affiliated companies / affiliates and authorized partners (such as suppliers, service providers, etc.) limited access to information in the Appendix D "Privacy Policy Templates." For the transfer of personal information in the case of mergers, acquisitions, and reorganizations, the Controllers should undertake the obligation to notify Subjects. And if the purpose of using the personal information changes, the explicit consent of the Subjects should also be obtained again.

vi. Personal Financial Information and Cross Border Transfer of Personal Information

In its preamble, the Specification provides that where there are other requirements in laws and regulations in relation to personal information, those requirements shall prevail. In each of financial instructress (e.g. securities, funds, futures, banking and insurance), there is general requirement that financial institutions must keep their customers personal information confidential. In 2011 the People's Bank of China issued the Circular to Banking Financial Institutions in Protecting Personal Financial Information (the "**PBoC Circular**"). The PBoC Circular focus on protection of an individual's financial information, such as the information of an individual's financial accounts and financial trading. The detailed standards and procedures set out in the Specification (which is lacking in the PBoC Circular) could help financial institutions improve their protections on their customers' financial

information.

For cross-border transfer of personal information, the Specification requires the Controller to conduct safety assessment in accordance with the rules and standards issued by CAC and other competent authorities. In the Privacy Policy Templates, there is a template statement on cross-border transfer of personal information and a general requirement that the Controller should specify the type of personal information to be transferred abroad and the standards, agreements and the legal mechanism that it will comply with for the transfer.

vii. Other Highlights of the Specification

Previously, the Cybersecurity Law and other laws and regulations provided a definition of personal information, but they did not clarify the key terms related to personal information processing. The Specification responds to many concepts closely related to the practice of personal information protection and provides clear guidelines, such as for personal sensitive information, Subjects, Controllers, collection, explicit consent, user profiles, deletion, public disclosure, transfer, sharing, anonymization, de-identification.

It is also notable that the Specification concludes by providing informative appendices which include examples of personal information, criteria for personal sensitive information, to protect Subjects' right to selective consent, and privacy policy templates. The first two appendices set out the scope and types of personal information and personal sensitive information, and clearly include the controversial network identity information and personal Internet records as personal information. The latter two appendices display the corresponding functional interface and policy text in the form of templates, which are of high practical reference value. This is particularly so for privacy policy templates which will be widely referenced and adopted by Internet and platform-based companies.

Advice for Enterprises

The Specification provides detailed provisions for the protection of personal information that is mentioned in the Cybersecurity Law. Some of the provisions are somewhat strict and the compliance requirements for enterprises have also been significantly raised, which in turn will result in the corresponding increase in enterprise operating costs. However, compared with the previous policy blanks, the promulgation of the Specification will undoubtedly provide a more comprehensive guide for the formulation of corporate compliance policies and the protection of personal information.

Therefore, we recommend enterprises to improve their internal compliance systems as early as possible. Enterprises whose scale meet certain conditions should clarify responsible departments and officers, and the position of chief information officer ("**CIO**") will be customary for the enterprises engaged in big data services. In addition, enterprises also need to establish systems, such as personal information management personnel positions and training systems, personal information security impact assessments and auditing systems, personal information security incident handling and reporting systems, and then strictly comply with requirements in the Cybersecurity Law, the

Specification and other supporting regulations in all stages of the personal information processing life cycle.

It is worth noting that although the Specification is a recommended national standard, and it is not mandatory for all kinds of organizations to implement, it does not mean that the Specification is without significance. The Specification expresses in the beginning that it "applies to the supervision, administration and assessment of personal information processing by competent authorities or third party evaluation agencies." In addition, a responsible officer of the CAC has also stressed the spirit advocated by the Specification in a recent hot incident. It can be seen that although the Specification is a recommended standard, it may be used as an important reference for the supervision and enforcement of government departments in practice, and thus the Specification should attract adequate attention from network operators. For financial institutions, in addition to their own financial regulatory requirements, they may wish to take into account the detailed standards and procedures of the Specification in order to give their financial customers more protection.

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3. Detailed Rules for Chinese CRS Arrived, but Are Banks Ready? − Interpreting the Detailed Rules of Due Diligence on Non-Residents' Financial Accounts of Deposit-taking Banking Financial Institutions for Tax Purpose (Authors: TieCheng YANG, Yin GE, Bing XUE, Michael KAN)

On 18 December 2017, the People's Bank of China, the State Administration of Taxation and the State Administration of Foreign Exchange jointly issued *Detailed Rules for Due Diligence on Taxation-related Information of Non-Residents' Financial Accounts at Deposit-taking Banking Financial Institutions* ("**Detailed Rules**"),[2] and the People's Bank of China published the Rules on its website on 29 December 2017.

The Rules provide detailed operating guidelines for Chinese deposit-taking banking financial institutions ("**banks**") to conduct due diligence on tax-related information of financial accounts held by non-residents in China. In accordance with the Detailed Rules, banks are required to collect tax-related information of non-residents and report such information to the competent authorities.

Background

On 19 May 2017, the State Administration of Taxation, together with the Ministry of Finance, People's

[2] 《银行业存款类金融机构非居民金融账户涉税信息尽职调查细则》[Detailed Rules for Due Diligence on Taxation-related Information of Non-Residents' Financial Accounts at Deposit-taking Banking Financial Institutions] (People's Bank of China, St. Admin. of Taxation, St. Admin. of For. Exch., Yin Fa [2017] No. 278; issued 18 Dec. 2017).

Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission formally promulgated the *Regulation of Due Diligence on Financial Accounts of Non-Residents for Tax Purpose* (the "**Regulation**") which came into effect on 1 July 2017.[3] This indicates that the Chinese version of the Common Reporting Standard ("**CRS**") is finally taking root in China, with an aim to adapt the internationally applicable CRS into specific requirements in line with national conditions in China, and to provide a legal basis and operating guidelines for China to implement CRS.

The Regulation requires "financial institutions established in the People's Republic of China" to be responsible for conducting due diligence on the tax-related information of financial accounts held by non-residents, and prescribes that "financial institutions" includes depository institutions, custodial institutions, investment entities, specified insurance institutions and their branches. Moreover, the Regulation clarifies that private equity investment funds, private equity fund management companies and partnerships engaging in private equity fund management business are all listed as within the scope of financial institutions (for detailed background information, refer to *Analysis of Private Equity Fund Managers' Due Diligence Obligations under the Chinese Version of CRS (《私募基金管理人在中国版 CRS 下的尽职调查义务解析》*).

Key Contents of the Detailed Rules

The Detailed Rules provide specific guidance to banks on how they should fulfill their due diligence obligations under the Regulation with respect to common types of banking business and account management methods. Compared to the Regulation, the Detailed Rules are more capable of being implemented in practice.

I. **Which accounts are subject to due diligence?**

In line with CRS requirements, the Regulation simply divides accounts subject to due diligence into three broad categories: depository accounts, custodial accounts and other accounts; each category is provided with examples for clarification. However, it will be a substantial challenge to determine account categories under the Regulation for banks that engage in a variety of financial services and hold different types of accounts.

In order to address this issue, the Detailed Rules clarify that banks will conduct due diligence on the following ten types of accounts opened while handling the relevant banking services based on the major types of services that banks presently undertake:

(1) demand deposits;

(2) time deposits;

[3] 《非居民金融账户涉税信息尽职调查管理办法》[Regulation of Due Diligence on Financial Accounts of Non-Residents for Tax Purpose] (St. Admin of Taxation, Min. of Finance, People's Bank of China, China Banking Reg. Comm., China Sec. Reg. Comm., China Ins. Reg., Comm., Announcement of the St. Admin of Taxation [2017] No. 14; promulgated 19 May 2017, effective 1 July 2017).

(3) pre-paid credit card services

(4) security deposit services;

(5) self-operated wealth management services;

(6) precious metals account services;

(7) national bonds services;

(8) financial derivatives services;

(9) other financial asset services which are initiated, established or managed by banks;

(10) other services prescribed by the Regulation.

The foregoing services (1) - (9) are the major services that banks currently undertake, among which precious metals account services do not include the handling of physical precious metals. Therefore, banks do not need to conduct due diligence on accounts of customers that handle physical precious metals.

II. **What is the scope of "financial asset management companies" ("FAMCs")?**

Article 8 of the Regulation excludes FAMCs from the scope of financial institutions. Many institutions indicated that the definition of "FAMCs" is unclear, and deviations may occur at the time of determining FAMC status.

FAMCs are more clearly defined in Article 8 of the Detailed Rules, which provides that FAMCs only refer to financial asset management companies established under the "*Regulations on Financial Asset Management Companies (金融资产管理公司条例)*", which presently means the "Big Four" asset management companies in the traditional sense, and which does not include local FAMCs established by the way of filing with the China Banking Regulatory Commission ("**CBRC**").

III. **How to classify the accounts which are re-opened after being closed?**

Article 15 of the Regulation defines the terms of "pre-existing accounts" and "new accounts," but remains unclear as to accounts that are re-opened after having been closed.

Article 13 of the Detailed Rules gives an explanation of this circumstance and states that a customer who had closed all accounts at a bank on or before 30 June 2017 and re-opened a financial account at the same bank on or after 1 July 2017 will be treated as a new customer and will be required to complete the relevant declaration documents, even if the bank still possesses the customer's information after the accounts were closed. Any financial accounts re-opened in this manner will be classified as new accounts.

IV. **What kind of "supporting materials" should a customer provide to prove his/her identity as a Chinese tax resident?**

The Regulation at Article 18 provides only a rather ambiguous description of the supporting materials

to be provided to prove Chinese tax resident status. Banks may therefore encounter difficulty in practice when requiring customers to provide the appropriate supporting materials.

To this end, Article 15 of the Detailed Rules refines this description and clarifies that relevant supporting materials include:

(1) the Certificate of China Tax Resident Status issued by tax authorities to an organization or individual;

(2) Resident Identity Card of the People's Republic of China;

(3) Foreign Permanent Resident Identity Card;

(4) Evidence that an individual has actually lived in China for more than a year, such as the entry/exit records in his or her passport; and

(5) Other valid materials.

The above tax authorities include the state taxation bureaus and local taxation bureaus, but the authority to issue Chinese tax resident identity certificates is made in reference to actual local circumstances. It should be noted that the supporting materials only refer to that which proves a customer with non-resident indicia as a Chinese tax resident, meanwhile materials issued by foreign authorities are excluded. If the customer has already claimed his/her status as a non-resident, the bank is only required to have the customer directly file the declaration document.

V. The period requirements of obtaining declaration documents for accounts pending activation

The Regulation stipulates that banks are required to obtain declaration documents from customers at the time of opening an account for new accounts opened after 1 July 2017. However, for an account which requires activation to be put in use, is it feasible to obtain the customer's declaration documents at the time of activation so that the bank can conduct its business more conveniently? In this regard, Article 18 of the Detailed Rules stipulates that: "for a bank account opened by an organization on behalf of an individual, which can only be used to receive deposits and not to make payments, the bank shall obtain a declaration document from the account holder at the time of opening; for accounts which can neither receive deposits nor make payments before activation such as credit card accounts, the bank shall obtain a declaration document from the account holder before activation..."

Why is a different approach taken for accounts pending activation? The reason is that a credit card account cannot be used before activation, i.e. the account cannot receive deposits or make payments before activation, which is essentially a "dormant account." Therefore, the bank can choose to conduct due diligence on the account holder when such account is officially put into use. By contrast, for accounts opened by organizations on behalf of individuals (e.g., wage card services), these accounts, in general, can receive deposits but cannot make payments before activation, and once a certain amount of money is deposited into these accounts, there would be time difference in

information reporting if the relevant declaration documents cannot be obtained timely. For example, in November 2017, a wage account for Country-A tax resident (X) was opened with a bank and wages were deposited into that account since December 2017. Compliance risk exists in that X's financial information would be omitted by the bank when it reports to the State Administration of Taxation at the designated time, 31 May 2018, as X had not signed a declaration document. In Hong Kong, the competent authorities also closely scrutinize accounts opened without complete materials that can only receive deposits and cannot make payments, since they suspect such accounts may be used for money laundering. Hong Kong banks are required to ask for the remaining documents from account holders within three (3) months. Failure to timely submit the required documents may result in closure of the account upon consideration of the relevant circumstances.

VI. **How to determine whether there are any discrepancies in the declaration documents provided by the customer?**

Articles 19 and 25 of the Regulation require financial institutions to determine whether there are any discrepancies between the information stated in the declaration documents and other materials, but the criteria for making the determination are not clearly defined. In order to facilitate the banks' implementation of the Regulation in practice, Articles 19 and 24 of the Detailed Rules provide certain judgment criteria. However, it should be noted that if an individual holding a Chinese identity card declares that he/she is a non-resident when opening an account, this should not be considered an obvious contradiction. The bank is only required to record and report the relevant information based on the declaration documents submitted.

VII. **Declaration document requirements for entity accounts**

The Regulation only prescribes that declaration documents are also required when opening an entity account, but remains silent as to the formatting requirements for the signature on the declaration document provided by the institution. In order to maintain consistency with the existing entity account opening procedures, Article 23 of the Detailed Rules prescribes that an official seal is required in addition to the signature of an authorized person of the institution. If relevant business is handled by an authorized person, the corresponding power of attorney shall also be provided. Certain overseas institutions that do not have an official seal can submit declaration documents with the signature or personal stamp of an authorized representative.

VIII. **Newly-added exempted accounts**

Compared with the Regulation, Article 33 of the Detailed Rules additionally provides that the accounts opened for the purpose of registered capital verification can be exempted from due diligence obligations, mainly because this type of account is a temporary transitional account, and the ownership of funds in this account is difficult to confirm within specified period, as the funds neither belong to an individual, nor a company (not yet established).

In addition, the Detailed Rules clarify the definition of "exempted accounts." Take a tax-payment

account as an example. If Company A specially opens a payment account for the purpose of making tax payments, the account can be exempt from due diligence so long as all account fund inflows and outflows are only to make tax payments. However, if Company A uses this account to pay for products, or receive any payments, the account would no longer fall within the scope of the exemption, and the bank would be required to conduct due diligence on the account.

IX. **Issues requiring attention**

Although the Detailed Rules provide more clear guidance for banks to a certain extent, and substantially reduce the workload of banks, the Detailed Rules cannot cover all of the potential issues, and banks should in practice continue to pay attention to the following:

(1) Types of accounts subject to due diligence

Although the Detailed Rules has clarified the account types subject to due diligence, the types of services offered by different banks and the corresponding types of accounts are not entirely the same as provided in the Detailed Rules. In such case, if a bank finds any other types of services similar in nature to those listed in the Detailed Rules, the bank should conduct due diligence on the relevant accounts in light of the Regulation and the Detailed Rules. Banks should be prudent in determining whether the relevant services meet the requirements of the Regulation and the Detailed Rules, since different banks may reach different conclusions based on different judgment criteria.

(2) System adjustments

The Detailed Rules impose certain requirements on banks' systems. Each bank must adjust its business procedures accordingly based on their actual circumstances, such as adding procedures for taxpayer identity information, identifying passive non-financial entities, controlling person information, etc. In addition, if a bank's business systems are not yet able to properly consolidate customer assets, care should be exercised so as to avoid duplications or omissions when reporting customer asset information.

(3) Understanding the scale of "due diligence" obligations

According to the requirements in the Regulation and the Detailed Rules, banks must have completed the due diligence procedures for pre-existing high-value individual customers (whose aggregate account balances exceed US$1,000,000) before 31 December 2017, and for pre-existing customers other than high-value customers, the due diligence reviews must be completed before 31 December 2018. Currently, some banks have published corresponding announcements on their official websites requiring their customers to co-operate and fulfill the relevant obligations. For banks, this is a relatively safe practice which means that they have already notified customers to submit the declaration documents according to the provisions in the Regulation. Even if the customer does not co-operate, banks have fulfilled their notification obligation.

As provided in the Regulation, banks are only required to have pre-existing customers with non-resident indicia in the bank's systems submit declaration documents, rather than all customers. Banks are likely to be able to contact customers whose account balances exceed US$1,000,000, as these are key customers. Thus, for these customers, banks should consider notification by telephone or messaging them through their dedicated client managers for co-operation, which will guarantee a certain degree of privacy and also improve the customer experience.

(4) Due diligence on the pre-existing institutional customers

According to the Regulation and the Detailed Rules, banks must identify whether an existing institutional customer is a non-resident enterprise or a passive non-financial institution based on existing customer information, public information, etc. However, it may be difficult for a bank to determine whether the institution is a passive non-financial institution. In general, most institutional customers do not provide their financial statements when opening an account, and it is difficult to determine whether an institution is a passive non-financial institution solely based on its business scope. Therefore, when banks are unable to make a determination, they can only require the customer re-submit declaration documents for confirmation, which imposes heavy workload and is a substantial challenge for banks.

(5) The duty to conduct due diligence on banking products offered on behalf of other financial institutions

Article 30 of the Detailed Rules only prescribes that banks must co-operate with other financial institutions to conduct due diligence on funds and other financial products sold on a commissioned basis. However, the Detailed Rules do not specify how the parties are to co-operate in conducting the due diligence. Thus, it will be a critical issue to divide the due diligence duties between banks and the other financial institutions.

(6) Non-compliance risks for financial institutions other than banks

The Detailed Rules only refine the work required of banks, but remain silent as to other financial institutions, such as securities institutions, funds, trusts, private equity funds, etc. Although these financial institutions do not maintain as large a customer base as banks and handle relatively less business, their understanding of their customers may also be relatively low and not be as deep as that of banks. Therefore, such institutions may be at risk of non-compliance if they do not refine their due diligence procedures.

In addition, when the above-mentioned financial institutions sell their financial products on third-party platforms other than through banks, the relevant account opening materials are generally transferred from the third-party platforms to the financial institutions. However, it is understood that third-party platforms have not begun implementing due diligence procedures yet, and thus it is uncertain whether the financial institutions can obtain customer declaration documents from the third-party platforms. According to the provisions of the Regulation,

financial institutions are allowed to appoint third-party platforms to conduct due diligence and to obtain customer declaration documents. However, there could be a great risk of non-compliance if the financial institutions failed to request the third-party platforms to fulfill their due diligence obligations and obtain customers' declaration documents after 1 July 2017.

(7) Applicability of the Regulation on third-party payment institutions ("**TPIs**")

TPI accounts can also receive a certain amount of deposits. However, we understand that TPIs have not yet implemented due diligence checks in accordance with the Regulation. Article 7 of the Regulation provides for a miscellaneous clause that includes other institutions satisfying certain conditions in the definition of "financial institution" under the Regulation. Thus, it remains uncertain whether TPIs are within the scope of financial institutions as prescribed by the Regulation. If TPI account balances continue to increase, it is likely that the regulatory authorities will incorporate TPIs into the regulatory scope of the Regulation in the near future.

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4. Total Return Swaps – Using Derivatives to Access the PRC's Capital Market (Authors: TieCheng YANG, Yin GE, Michael KAN, Charles WU, Ting ZHENG)

I. Background

Non-PRC investors have long used total return swaps ("TRS") to gain economic exposure to the underlying shares, funds, bonds and other debt instruments (collectively, "PRC Securities") listed and traded on PRC exchanges and its interbank bond market. Non-PRC investors engage in these TRS transactions for a variety of reasons, such as the following:

(i) *Access Restrictions* – PRC exchanges and the PRC interbank bond market (collectively, the "**PRC Capital Market**") are not fully open to non-PRC investors. Currently, non-PRC investors are only permitted to trade PRC Securities (including A-shares, funds and bonds, etc.) listed on the PRC exchanges, and debt instruments (including government bonds, financial bonds, corporate bonds, commercial papers, asset-backed securities, panda bonds, etc.) traded in the PRC's interbank bond market, via certain access schemes. These include:

(a) the Qualified Foreign Institutional Investor program ("**QFII**"),

(b) the Renminbi Qualified Foreign Institutional Investor program ("**RQFII**"),

(c) the mutual market access programs between the PRC and Hong Kong, namely the Stock Connect and the Bond Connect, and

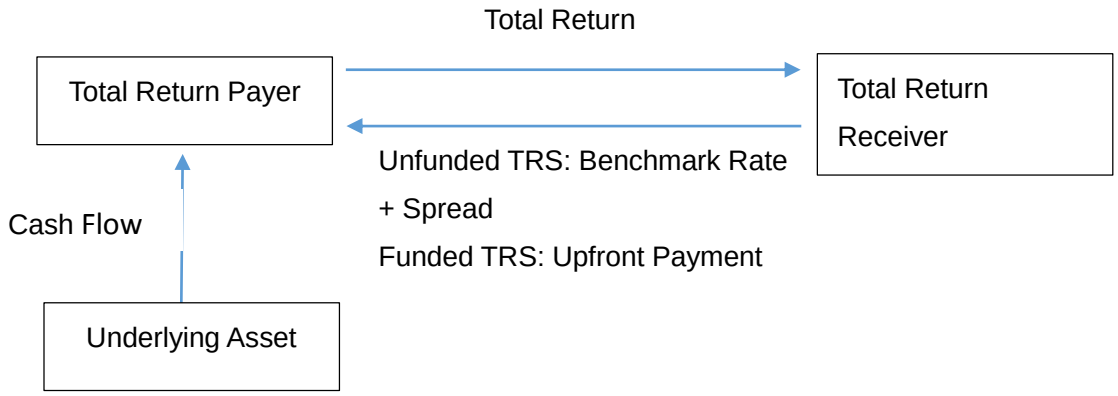
(d) a direct access program for non-PRC participation in the PRC's interbank bond market (collectively, the "**Permitted Access Schemes**").

Each Permitted Access Scheme imposes different restrictions on eligible investors, eligible PRC Securities, investment quota/size, currency exchange, and the remittance and repatriation of funds, etc. For example, hedge funds are not qualified to apply for QFII/RQFII licenses. As a result, until the Stock Connect, Bond Connect and direct access programs, hedge funds had to use TRS to gain exposure to PRC Securities.

(ii) *Fund Management* –Like typical TRS structures used in non-PRC markets, from the perspective of the total return receiver, TRS referencing PRC Securities as underlying assets ("**PRC Securities TRS**") may optimize balance sheet management, portfolio management, hedge fund leverage and asset swap maturity manipulation. From the perspective of the total return payer, such TRS may create a hedge for both price risk and default risk.

II. Basic Structure and Essential Features

Generally, PRC Securities TRS involves a total return receiver paying a specified fixed or floating interest rate to a total return payer in exchange for a total return on a specified reference asset or index, as illustrated below:



- Total return refers to interest plus appreciation (i.e., the difference between the final value and the initial value of the underlying asset).
- The underlying assets may be a single PRC Security or a basket of PRC Securities.

This TRS often contains the following essential features:

(i) the total return receiver is synthetically long on the subject PRC Securities, with or without the need to fund the investment upfront, while the total return payer is synthetically short on the same PRC Securities;

(ii) the total return payer may acquire the underlying PRC Securities via one or more Permitted

Access Schemes as a hedge[4] for its obligations under the terms of the TRS;

(iii) if the total return payer acquires the underlying PRC Securities, it will hold them on its balance sheet; and

(iv) during the term of the TRS, the total return receiver gains off-balance sheet exposure to the PRC Securities.

III. Legal and Regulatory Issues

PRC Securities TRS may raise legal and regulatory issues under PRC law. This note touches on some key issues but is not intended to provide an exhaustive analysis. PRC laws and regulations are rapidly changing as TRS structures evolve, so there may be additional legal and regulatory issues that arise in the future.

(i) Legal Documentation

Non-PRC investors often use the ISDA Master Agreement and Credit Support Annex ("**ISDA Documentation**") to document PRC Securities TRS transactions. When negotiating early termination clauses in the ISDA Documentation, the parties may need to take into account risks associated with the total return payer's use of the Permitted Access Schemes. In some instances, total return payers may rely on the cash flow generated from its trading of underlying PRC Securities to fulfill its payment obligations under the ISDA Documentation. However, this cash flow may be disrupted due to restrictions under the relevant Permitted Access Schemes. For example, if the total return payer uses the QFII/RQFII program to hedge its obligations under the ISDA Documentation, it would have to consider the unavailability of QFII/RQFII investment quota, lock-up periods, non-PRC share aggregation limits and repatriation limitations, each of which or a combination of which may lead to an event of default or a termination event under the ISDA Documentation. Accordingly, the ISDA Documentation for PRC Securities TRS may need to be amended to account for these PRC-specific restrictions.

(ii) Legal Ownership and Beneficial Ownership

Pursuant to the terms of a non-PRC TRS, the total return payer may be deemed as the "legal owner" of underlying assets, while the total return receiver may be deemed as the "beneficial owner" of such underlying assets (on the basis that it is acquiring a total return on the reference asset). However, under PRC law, the concepts of "legal owner" and "beneficial owner" are not well established. To date, while PRC regulators have attempted to affirm the legal rights of “legal owners” and “beneficial owners” under the Stock Connect and Bond Connect programs, there is uncertainty as to whether a total return receiver can be

[4] Total return payers may also use existing PRC Securities and assets to hedge their exposure under a PRC Securities TRS rather than acquire PRC Securities for the purposes of covering their exposure under a specific PRC Securities TRS. A PRC Securities TRS does not require the total return payer to hedge.

considered a "beneficial owner" of PRC Securities. Accordingly, with respect to PRC Securities TRS, the total return receiver would face major legal hurdles in claiming "beneficial ownership" over the underlying PRC Securities in the PRC.

(iii) Non-PRC Share Aggregation Limits, Disclosure of Interests and the Short-Swing Profit Rule

Under PRC law, when trading PRC Securities through Permitted Access Schemes, non-PRC investors are subject to certain non-PRC share aggregation limits, disclosure of interest rules, and short-swing profit rules. The level of ownership and control will determine whether TRS parties are subject to PRC regulatory jurisdiction.

(a) During the term of a PRC Securities TRS, if the total return receiver has *de facto* control over the voting rights of the underlying PRC Securities, the total return receiver may be subject to the above PRC regulatory obligations.

(b) If, under the terms of a PRC Securities TRS, the total return receiver becomes the legal owner of the underlying PRC Securities, whether through physical settlement or other title transfer arrangements, the total return receiver may be subject to the above PRC regulatory obligations.

(c) If the PRC Securities TRS is only settled in cash, and there is no arrangement enabling the total return receiver to control the voting rights of the underlying PRC Securities, the total return receiver may not be subject to the above PRC regulatory obligations.

(d) As long as the total return payer remains the record owner of the underlying PRC Securities, it would be subject to the above PRC regulatory obligations.

Irrespective of the level of ownership and control set forth in the terms of a PRC Securities TRS, both the total return receiver and the total return payer may also be subject to the PRC's rules in relation to inside trading or market manipulation.

(iv) Off-exchange Transfer Restrictions

Under PRC law, PRC Securities trading in the PRC Capital Market is required to be executed via designated trading facilities (with very limited exceptions for non-trade transfers). This means that non-PRC custodians or brokers are not permitted to match buy and sale orders for non-PRC investors under the Permitted Access Schemes. They are also not permitted to provide any off-exchange services relating to the transfer of PRC Securities in any other form. These restrictions may affect the legality and enforceability of physical settlement of PRC Securities TRS under PRC law. For example, if the PRC Securities TRS agreement states that on maturity of the TRS, the total return receiver has an option to purchase the PRC Securities at a market price or a pre-determined price, or otherwise may cause delivery of the PRC Securities from the total return payer to the total return receiver, the parties should carefully consider whether this delivery arrangement is permissible under PRC law.

(v) Quota Transfers and Lending Restrictions

Certain Permitted Access Schemes (such as the QFII/RQFII program) do not permit eligible investors to transfer or lend its investment quota to non-eligible investors in non-PRC markets.

PRC Securities TRS are commonly structured as unfunded TRS, whereby the total return receiver does not make upfront payments and the total return payer uses its own funds or financing proceeds to purchase the underlying PRC Securities. If, however, the terms of the unfunded TRS permit the total return receiver to buy and sell the underlying PRC Securities at its discretion using the total return payer's investment quota, the transaction may be deemed as an unauthorized transfer or lending of investment quota. The grounds for this determination would be that the total return payer has used the PRC Securities TRS to allow a non-eligible third party (i.e. the total return receiver) to trade PRC Securities.

Where the PRC Securities TRS is structured as a funded TRS, whereby the total return payer uses upfront payments received from the total return receiver to purchase underlying PRC Securities, the transaction may be more likely to be deemed as an unauthorized transfer or lending of investment quota. The grounds for this determination would be that the total return payer has used funds provided by the total return receiver to trade PRC Securities for a non-eligible third party (i.e. the total return receiver).

(vi) Leverage Through Unfunded TRS

An unfunded PRC Securities TRS may be deemed as an indirect form of margin financing, on the grounds that a PRC Securities TRS has an equivalent economic effect, as a total return receiver has borrowed funds from a total return payer (at the rate equal to the benchmark rate plus a spread) to trade PRC Securities. Derivative products involving a high amount of leverage have gained the attention of PRC regulators since the 2015 securities market turmoil. Specifically, PRC brokerage firms have been urged to cease financing their clients' securities trading in the PRC Capital Market through TRS and other OTC derivatives. Accordingly, non-PRC investors are advised to closely monitor the business and regulatory environment of the PRC Capital Market to ensure their leverage arrangements under PRC Securities TRS do not attract additional regulatory scrutiny.

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Important Announcement

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