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Newsletter

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Legal Updates

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Legal Updates

1. CBRC Issues Rules on Equity Investments in PRC Commercial Banks (Authors: TieCheng YANG, Yin GE, Ting ZHENG, Cecily YANG)

The rapid development of banking financial institutions has also brought disorder to the sector. In particular, some investors have illegally used non-self-owned funds to acquire equity in commercial banks, have adopted nominee arrangements to hold equity in commercial banks or have abused shareholder rights to harm the interests of commercial banks. To address this abusive conduct and to overcome regulatory shortcomings, the China Banking Regulatory Commission ("**CBRC**") promulgated the *Interim Measures for Administration of Equity of Commercial Banks* (the "**Equity Measures**")[1] on 5 January 2018 (effective as of the same date) following a month-long comment period. The Equity Measures are intended to regulate the conduct of shareholders (particularly major shareholders) of commercial banks, strengthen the look-through examination of shareholder qualifications, intensify the investigation and punishment of illegal activities, for the purpose of protecting the legitimate rights and interests of depositors and other clients of commercial banks, safeguard the legitimate interests of shareholders, so as to secure the safe and steady operation of commercial banks and to promote their sustainable and sound development.

With the liberalization of domestic financial markets, foreign investors now have more channels by which they may invest in and become shareholders of domestic commercial banks. Specifically, foreign investors can directly set up foreign-funded banks in China, including foreign-funded corporate banks (i.e., wholly foreign-owned banks and Sino-foreign joint venture banks) and branches of foreign banks in China (non-legal person entities), or directly acquire shares in domestic commercial banks (which generally refer in practice to Chinese-funded commercial banks). Where a domestic commercial bank is an A-share listed company, foreign investors can also invest through investment schemes such as the Qualified Foreign Institutional Investors ("**QFII**") / the Renminbi Qualified Foreign Institutional Investors ("**RQFII**") as well as the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect. If the domestic commercial bank is an H-share listed company or is listed on other overseas exchanges, foreign investors may directly invest in shares of domestic commercial banks traded on overseas exchanges. Foreign investors can include foreign financial institutions, various types of offshore financial products or even foreign individual investors, but the latter two types of investors can only acquire shares of domestic commercial banks listed and traded on the relevant stock exchanges.

This newsletter will present brief comments on the impact of the Equity Measures on foreign investors

[1] 《商业银行股权管理暂行办法》[Interim Measures for Administration of Equity of Commercial Banks] (China Banking Reg. Comm., Decree [2018] No. 1; promulgated and effective 5 Jan 2018), *available at* http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/CB5510B067C649C183490211E5E3B021.html (Chinese).

and the commercial banks in which they invest.

A. Foreign-funded Banks

The Equity Measures apply to commercial banks that are duly established within the territory of China. If any other laws or regulations contain different rules on a change of shareholders or adjustment of shareholding ratios in foreign-funded banks, such rules will prevail. Thus, the Equity Measures should not be applicable to branches of foreign banks in China. As for foreign-funded corporate banks, changes of shareholders or adjustments of shareholding ratios are subject to the strict qualification requirements and approval process stipulated under the *Regulations on Administration of Foreign-funded Banks*, the *Rules for the Implementation of the Regulations on Administration of Foreign-funded Banks* and the *Measures for Granting Administrative Licensing to Foreign-funded Banks*.[2] In addition, the rules prescribed in the Equity Measures on shareholder conduct (particularly of major shareholders) are applicable to foreign-funded corporate banks and their shareholders. We do not, however, expect the Equity Measures to have a significant impact on foreign-funded corporate banks due to their relatively straightforward ownership structures.

B. Chinese-funded Commercial Banks with Foreign Investments

According to the principle of "administration by categories," the Equity Measures classify shareholders into major shareholders and ordinary shareholders based on their respective impact on the operation and management of commercial banks. Such classification has been reflected in other relevant CBRC regulations, such as the *Guidance for Corporate Governance of Commercial Banks*[3] and the *Notice on Strengthening Qualification Examinations of Major Shareholders of Small- and Medium-Sized Commercial Banks* ("**SMS Bank Notice**"),[4] but inconsistencies arise when these rules are applied in practice. Compared with other existing regulations, the Equity Measures have unified and strengthened the definition of major shareholders in the following aspects:

(i) For all commercial banks, major shareholders refer to "shareholders who hold or control more

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[2] 《中资商业银行行政许可事项实施办法》[Measures for Granting Administrative Licensing to Foreign-funded Banks] (China Banking Reg. Comm., Decree [2017] No. 1; promulgated and effective 5 July 2017), *available at* http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/A95D3E6E9DE043859C70C990156EFA7E.html (Chinese).

[3] 《商业银行公司治理指引》[Guidance for Corporate Governance of Commercial Banks] (China Banking Reg. Comm., Yin Jian Fa [2013] No. 34; promulgated and effective 19 July 2013), 2013 ST. COUNCIL GAZ. 29, *available at* www.gov.cn/gongbao/content/2013/content_2509243.htm (Chinese). Article 9 of the Guidance provides that "a major shareholder refers to a shareholder who can directly, indirectly, or jointly hold or control 5% or more shares or voting rights in a commercial bank or has a significant impact on the decision-making of a commercial bank."

[4] 《中国银监会办公厅关于加强中小商业银行主要股东资格审核的通知》[Notice of the General Office of the China Banking Regulatory Commission on Strengthening Qualification Examinations of Major Shareholders of Small- and Medium-sized Commercial Banks] (China Banking Reg. Comm., Yin Jian Ban Fa [2010] No. 115; issued 16 Apr. 2010), *available at* http://www.cbrc.gov.cn/govView_EC0BDCF11EF7467C806CBE4E63834B60.html (Chinese). Article 1 of the SMS Bank Notice provides that "a major shareholder of a small- and medium-sized commercial bank refers to a shareholder who holds or controls more than 5% (including 5%) of shares or voting rights and is one of the top three shareholders of the small- and medium-sized commercial bank, or who is not one of the top three shareholders but considered to have significant impact on the small- and medium-sized commercial bank by the regulatory authorities."

than 5% of shares or voting rights in a commercial bank, or who hold less than 5% of shares but have a significant impact on the operation and management of the commercial bank." Within this definition, the criteria of "significant impact" includes but is not limited to appointing directors, supervisors or senior management of commercial banks, affecting the financial and management decisions of commercial banks by agreement or other ways, and other situations as determined by CBRC or its local counterparts. In practice, we believe the definition of "significant impact" in accounting standards could be applied by reference, but CBRC may have discretion to make the final decision based on the specific circumstances in the banking industry and the commercial bank in question;

(ii) When defining major shareholders, the shareholding of each shareholder is determined on a consolidated basis by taking into account the holdings of the shareholder, its affiliates and other parties acting in concert with the shareholder. This calculation principle has been adopted in CBRC regulatory practice, but it had not been made entirely clear in other regulations.

According to existing CBRC rules, the total shareholding of a single foreign financial institution and the affiliates controlled or jointly controlled by it as a promoter or strategic investor in a single Chinese-funded commercial bank may not exceed 20%, and the shares in aggregate held by multiple foreign financial institutions and the affiliates controlled or jointly controlled by them as the promoters or strategic investors may not exceed 25%. In this sense, foreign investors are very likely to constitute major shareholders of domestic commercial banks.[5] In addition, according to the latest requirements under the Equity Measures, when determining whether foreign investors will constitute major shareholders, in addition to the shares held by affiliates, the investors will also need to look to the shares held by parties acting in concert (if any) in the same commercial bank.

In respect of major shareholders, the Equity Measures set forth clear requirements for information disclosures, shareholding restrictions, investment periods, capital replenishment and corporate governance, with a view to preventing major shareholders from illegally interfering with the operation and management of commercial banks. We have summarized below the impact that the Equity Measures may have on foreign investors while considering the impact of other current CBRC regulations:

(i) Look-through Disclosures and Supervision

The Equity Measures require major shareholders to disclose to the commercial banks and the regulator their complete shareholding structure, including the actual controller and ultimate beneficiary, as well as their affiliate relationships with other shareholders of the commercial bank and whether they are parties acting in concert. Major shareholders have been required to disclose their controllers and affiliates under current CBRC regulatory requirements, but the Equity Measures further require disclosure of ultimate beneficiaries and parties acting in concert. The "ultimate beneficiary" is a newly introduced concept and refers to "the person who actually

[5] See, e.g., Measures for Granting Administrative Licensing to Foreign-funded Banks, at Art. 2.

benefits from the equity interest of a commercial bank," and "concerted action" refers to "the act or fact that an investor works with other investors through an agreement or any other arrangement to jointly increase the number of shares representing voting rights under their control in a company. The relevant investors who reach an agreement are parties acting in concert." It is noteworthy that in the public comment draft of the Equity Measures, the definition of "parties acting in concert" cross-referenced Article 83 of the *Measures for Administration of Acquisition of Listed Companies*, but this cross-reference was deleted in the final version of the Equity Measures. We believe this may trigger the following issues for foreign investors:

First, the application of "concerted action" may not be limited to listed banks;[6]

Second, for "concerted action" towards banks listed on overseas exchanges, the applicable rules in such relevant overseas securities markets may be considered; and

Third, the definitions of "ultimate beneficiary" and "concerted action" are quite broad and CBRC has discretion to further define their scope.

Moreover, as for affiliated transactions, commercial banks are also required to manage their major shareholders, controlling shareholders, actual controllers, affiliates, parties acting in concert and ultimate beneficiaries as the bank's own affiliates in accordance with the look-through principle. As a result, foreign investors need to carefully consider whether there are ultimate beneficiaries or parties acting in concert with respect to the target commercial bank in the course of making investment decisions.

(ii) Parallel Investments

The Equity Measures limit the number of commercial banks in which major shareholders can invest, and stipulate that one investor as a major shareholder, along with its affiliates and parties acting in concert, may either invest in no more than two commercial banks or control no more than one commercial bank (the "**participate in two or control one**" rule).[7] The Equity Measures provide, however, that the "participate in two or control one" rule does not apply in cases where an investment entity or banking financial institution is authorized by the State Council to hold the equity of commercial banks, or an entity is otherwise permitted by laws and regulations, or the investor is approved by CBRC to acquire or restructure certain high-risk commercial banks.

Prior to the release of the Equity Measures, the permitted parallel investments in commercial banks were not clear. The sole relevant requirement could be found in the SMS Bank Notice,

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[6] E.g.《商业银行与内部人和股东关联交易管理办法》[Measures for Administration of Affiliated Transactions between Commercial Banks and their Insiders or Shareholders] (China Banking Reg. Comm., Decree [2004] No. 3; promulgated 2 Apr. 2004, effective 1 May 2004), *available at*: http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/311.html (Chinese). Article 9 contains the concept of "acting in concert," and stipulates that "the term 'jointly control' shall mean the joint control of an economic activity in accordance with contractual arrangement or by acting in concert."

[7] Equity Measures, at Art. 14. In Chinese, this is commonly referred to as the 两参或一控 (Liang Can Huo Yi Kong) rule.

which provides that "one shareholder cannot acquire shares in more than two banking financial institutions of the same nature; where the shareholder can control a bank, it is only permitted to invest in (or retain an investment in) one banking financial institution." In practice, however, CBRC also applies this rule when reviewing proposed investments in other categories of commercial banks. The Equity Measures now make it clear that the "participate in two or control one" rule will be applied to investments by major shareholders in all commercial banks (with listed exceptions).

(iii) Five-year Lock-up Period

Major shareholders are prohibited from transferring equity in a commercial bank within five years from the date of obtaining the equity interest. This lock-up period does not apply to certain special-purpose equity transfers, such as (i) transfers ordered by CBRC or its local counterparts, (ii) transfers approved by CBRC or its local counterparts as a risk handling measure, (iii) transfers involving judicial enforcement, or (iv) transfers made between different entities controlled by the same investor.

The five-year lock-up period was first seen in a public discussion by the CBRC Chairman and in the SMS Bank Notice.[8] CBRC already imposes comparable lock-up obligations on investments in other commercial banks. The Equity Measures make it clear that such lock-up requirements must be applied to investments by major shareholders in all commercial banks (with listed exceptions), which are generally in line with existing regulatory practices.

(iv) Capital Replenishment

The Equity Measures require major shareholders to undertake to replenish the capital of a commercial bank when it is necessary pursuant to regulatory requirements, and to report their capital replenishment capacity to CBRC or its local counterparts annually via the commercial bank.

The capital replenishment obligations of major shareholders are reflected in other existing rules. For example, the SMS Bank Notice states that the board of directors of a major shareholder must issue a formal written commitment that the major shareholder will commit to replenish capital as a major source of capital for the commercial bank. The *Guidance for Corporate Governance of Commercial Bank* also stipulates that when a commercial bank's capital fails to meet regulatory requirements, the commercial bank must formulate a capital replenishment plan to secure its capital adequacy ratio and meet regulatory requirements within a prescribed time period, and to replenish capital by way of an increase of core capital or other means, and its major shareholders may not prevent other shareholders from replenishing capital or prevent the commercial bank

[8] SMS Bank Notice, at Art. 2 (d) stipulates that "the board of directors of the major shareholder shall issue a formal written commitment, to indicate, among others, the shareholder shall commit not to transfer the shares of the bank it holds within five years from the closing date of its acquisition, and such statement should be reflected in the bank's articles of association or relevant agreements; after the five-year lock-up period expires, the transfer of shares and the qualification of the transferee shall be subject to the consent of the regulatory authorities."

from accepting new qualified shareholders. Furthermore, a commercial bank is required to specify in its articles of association that major shareholders are obligated to make a long-term commitment regarding capital replenishment to the commercial bank in writing, and this commitment must be incorporated as a part of the commercial bank's capital plan. In CBRC regulatory practice, such capital replenishment requirements have been applied to the foreign investors who become major shareholders following their investments in Chinese-funded commercial banks. In this sense, the Equity Measures do not substantively increase the obligations and responsibilities of major shareholders. That being said, these rules may expose foreign investors to unlimited liability to make capital contributions to invested commercial banks in China, which may violate the applicable laws of the country or region in which foreign investors are incorporated.

(v) Risk Prevention

The Equity Measures require major shareholders to establish an effective mechanism for isolating risk, and to prevent risks from spreading to other shareholders, the commercial bank and other affiliates. Major shareholders are also required to effectively manage the co-current positions held by directors, supervisors and senior management of each of the commercial banks and their affiliates so as to prevent conflicts of interest. Although these are newly-established requirements under the Equity Measures, they are inherent requirements that obligate commercial banks to establish effective risk prevention systems.

C. Financial Products Invested in Commercial Banks

Article 25 of the Equity Measures stipulates that financial products can acquire shares of listed commercial banks, but the aggregate shares held by financial products in one commercial bank that are controlled by a single investor, an issuer or a manager and their actual controllers, affiliates and parties acting in concert, cannot exceed 5% of the total shares of such commercial bank. CBRC explains that financial products cannot satisfy the qualifications of shareholders holding more than 5% of the shares in a commercial bank, and that they usually have durations and do not have the ability to continuously replenish capital to commercial banks. In addition, Article 25 of the Equity Measures requires that major shareholders of a commercial bank not hold shares in the same commercial bank via the financial products that they issue, manage or otherwise control. This requirement is to prevent major shareholders from using financial products to hold shares of commercial banks, enhancing their control over commercial banks and to circumvent regulatory requirements on equity investments with self-owned funds. The above regulations are intended to prevent misconduct such as large acquisitions through financial products or nominee arrangements that may be detrimental to the interests of commercial banks, and to reduce the opportunities for investors to leverage acquisitions of listed commercial banks by using financial products on the secondary market.

Based on the above, where a foreign investor indirectly acquires shares in a listed commercial bank

(including A-shares, H-shares or other shares trading on overseas exchanges) through financial products, the shares held by financial products that it controls as an investor, an issuer or a manager, or by its actual controllers, affiliates and parties acting in concert, should all be included for the purpose of calculating shareholding, and such shares in aggregate may not exceed 5% of the total shares of the commercial bank. If a foreign investor already satisfies the conditions to be a major shareholder, it is not permitted to invest in the A-shares of the commercial bank through channels such as QFII / RQFII or Shanghai-Hong Kong Stock Connect or Shenzhen-Hong Kong Stock Connect by using the financial products that it issues, manages or otherwise controls. This restriction should also be applied to investments in H-shares or other shares traded through financial products on overseas exchanges of domestic commercial banks. These "financial products" include various offshore publicly-traded funds, PE funds, trust products, wealth management products and various financial derivatives.

D. Cross-border Regulation and Responsibilities of Commercial Banks

Since the public comment draft of the Equity Measures, there has been a discussion in the market that the Equity Measures should adopt a unified regulatory scheme for domestic and foreign shareholders and thus prevent overseas regulatory arbitrage. However, CBRC has yet to clarify how to take appropriate measures to regulate the trading of overseas-listed shares of commercial banks by foreign investors and how to co-ordinate regulatory rights in different jurisdictions. Meanwhile, the requirements for major shareholders and shareholding of financial products under the Equity Measures also to some extent increase the compliance pressure on foreign investors investing in domestic commercial banks. Thus far, it remains unclear whether investors' desire to invest in domestic commercial banks will be suppressed by the requirements.

At a press conference, CBRC mentioned that the Equity Measures establish a trinity regulatory framework covering shareholders, commercial banks and regulatory authorities, along with the look-through principle of regulation (as discussed above regarding the CBRC look-through rules for shareholders). Commercial banks should strengthen the examination of shareholders' qualifications, verify the information of major shareholders and their controlling shareholders, actual controllers, affiliates, parties acting in concert and ultimate beneficiaries and be informed of any changes to such parties; the board of commercial banks, at least once a year, should assess the qualifications of major shareholders, and their performance of commitments, implementation of the articles of association or terms of the agreement and the compliance conditions, and timely submit the assessment report to CBRC or its local counterparts; failing so will subject the commercial bank to legal liabilities. The allocation of responsibilities to commercial banks can to some extent ease CBRC's regulatory burden with respect to cross-border regulation, but the compliance costs to commercial banks have indeed increased, especially when foreign investors trade shares of domestic commercial banks in overseas markets, such banks need to timely monitor changes in investors and their shareholdings.

E. Non-Banking Financial Institutions

Unless otherwise stipulated by CBRC, the rules under the Equity Measures will apply by reference to foreign investors that invest in other CBRC-regulated financial institutions (other than commercial banks), such as financial asset management companies, trust companies, financial leasing companies, auto finance companies, money brokers, consumer finance companies, etc.

F. Grace Period

The Equity Measures are effective as of 5 January 2018, and foreign investors' existing investments in domestic commercial banks that do not conform to the requirements under the Equity Measures are in technical non-compliance of the relevant regulations. In this regard, CBRC confirmed in a press conference that it would issue rectification notices to the relevant existing shareholders and grant them varying grace periods based on specific circumstances so as to implement the requirements under the Equity Measures in a stable, predictable manner.

We also expect that CBRC will issue more detailed explanations or guidelines based on the specific and reasonable demands of commercial banks and their existing shareholders (including foreign shareholders) during the grace period so as to ensure that commercial banks and their shareholders can meet regulatory requirements under the Equity Measures in a reasonable, transparent and feasible environment.

The promulgation of the Equity Measures constitutes one of the steps that the Chinese government has taken to prevent financial risks and more regulations are expected to be released to rectify instances of disorder in the market. Although these laws and regulations focus on the domestic market, they indeed have an impact on foreign investors. We will continue to monitor the Equity Measures and other legal developments and share with you any developments on this topic.

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2. CBRC Bringing Trust Services Back to Basics? (Authors: TieCheng YANG, Yin GE, Cecily YANG, Ting ZHENG)

The Central Economic Working Conference, held in December 2017, recognized that the prevention and control of financial risks are vital in the battle to prevent and resolve major risks, and requested financial services to be the main focus of supply-side structural reforms in order to form a virtuous cycle between the financial industry and the real economy, the financial industry and the real estate sector, as well as within the financial system. Subsequently, the China Banking Regulatory Commission ("**CBRC**") on 22 December 2017 issued the *Circular on Regulating Bank-Trust Business*

(the "**Circular**")[9] which is intended to streamline business co-operation between commercial banks and trust companies (the "**Bank-Trust Business**"), and particularly the so-called "channel business" between them (the "**Bank-Trust Channel Business**").

How does the Bank-Trust Channel Business relate to the basic trust concepts under the PRC Trust Law? This newsletter begins with the newly-promulgated regulatory requirements under the Circular and briefly analyzes the regulatory trends of the Bank-Trust Business, particularly the Bank-Trust Channel Business, in the context of the current phase of the trust industry.

De-channelization is an Inevitable Trend

According to the China Trustee Association, as of 2017 Q3, the total balance of trust assets in China was RMB24.41 trillion, an increase of RMB1.27 trillion from 2017 Q2 (i.e., RMB23.14 trillion). The year-on-year growth rate in 2017 Q3 reached 34.33% and the month-on-month growth rate was 5.47%. Among these growth figures, the balance of the channel trust business increased from RMB12.48 trillion (2017 Q2) to RMB13.58 trillion (2017 Q3), and the corresponding proportion of channel trust business assets increased from 53.92% (2017 Q2) to 55.66% (2017 Q3). Since 2013, the channel trust business has grown at a rapid pace and has exceeded 50% of all trust assets as of 2017 Q3.[10] The rapid expansion of the channel trust business has resulted in a gradual increase in underlying risks and has thus attracted the attention of the regulator.

The Position of the Bank-Trust Business and Bank-Trust Channel Business

Bank-Trust Business was born with the RMB 4 trillion fiscal stimulus package designed to counteract the 2008 financial crisis. CBRC facilitated the issuance of loans by permitting trust companies to channel loan funds through "bank-trust co-operations" (the original funds were collected from bank wealth management products). During the period from 2008 to 2010, CBRC issued the *Guidelines on Business Cooperation between Banks and Trust Companies*,[11] the *Notice of the China Banking Regulatory Commission on Further Regulating Matters Concerning Cooperation between Banks and Trust Companies*,[12] and the *Notice on Regulating Relevant Matters on Wealth Management*

[9] 《中国银监会关于规范银信类业务的通知》[Circular of the China Banking Regulatory Commission on Regulating Bank-Trust Business] (China Banking Reg. Comm., Yin Jian Fa [2017] No. 55; issued 22 Nov. 2017), *available at* http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/656ED8C75FA44F0387EF393B842A8A11.html (Chinese).

[10] *See* China Trustee Assoc., *Comments on the Development of China's Trust Industry in the Third Quarter of 2017*, (8 Dec. 2017), *available at* http://www.xtxh.net/xtxh/statistics/43707.htm (Chinese).

[11] 《银行与信托公司业务合作指引》[Guidelines on Business Cooperation between Banks and Trust Companies] (China Banking Reg. Comm., Yin Jian Fa [2008] No. 83; issued 4 Dec. 2008), *available at* http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/20081222D75C0AA1792B5FBBFFC19BF9CCDB9000.html (Chinese).

[12] 《中国银监会关于进一步规范银信合作有关事项的通知》[Notice of the China Banking Regulatory Commission on Further Regulating Matters Concerning Cooperation between Banks and Trust Companies] (China Banking Reg. Comm., Yin Jian Fa [2009] No. 111; promulgated 14 Dec. 2009), *available at* http://www.cbrc.gov.cn/govView_F0BF92FE32814EF3A0614803E0D33367.html (Chinese).

Cooperation between Banks and Trust Companies.[13] In these documents, CBRC has defined "wealth management (business) co-operation between banks and trust companies" as "an activity where a bank entrusts capital collected from wealth management products to trust companies, which shall manage, utilize and dispose of such capital as trustees according to agreed trust documents."[14] Meanwhile, CBRC also clarified that, during such bank-trust co-operation," a trust company shall observe the principle of self-management, strictly perform the duties of choosing projects, conducting due diligence, making investment decisions, and conducting post management; in this case, no channel business is permitted for the bank-trust co-operation" (underline added).[15] Such provisions are in line with trust concepts under the PRC Trust Law, which provides that trustees are to provide asset management as authorized by and on behalf of their clients.

The definition of "cross-industry channel business" first appeared in the *Guidelines for the Consolidated Management and Supervision of Commercial Banks* in 2014,[16] which provides that "cross-industry channel business refers to transaction arrangements whereby a commercial bank or an affiliate inside a bank group, as a client, uses internal or outside third-party institutions, such as securities companies, trust companies or insurance companies, as a channel to establish a single-layer or multi-layer asset management plan, trust plan or other investment product with funds from wealth management products, entrustment loans or its own funds so as to raise funds or invest in other assets for the target customers of the client." Meanwhile, the Guidelines expressly stipulate that, when engaging in cross-industry channel business, the client must assume the credit risk, liquidity risk and market risk arising from these activities.

Although CBRC has recognized the general existence of the Bank-Trust Channel Business in its various notices in recent years, and has required that the financial institutions engaging in cross-product or co-operative business clarify the risk allocation mechanism in written contracts (i.e., to identify the party to assume legal risk and the party merely serving as the channel),[17] there was no

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[13] 《中国银监会关于规范银信理财合作业务有关事项的通知》[Notice on Regulating Relevant Matters on Wealth Management Cooperation between Banks and Trust Companies] (China Banking Reg. Comm., Yin Jian Fa [2010] No. 72; promulgated 5 Aug. 2010), *available at* http://www.cbrc.gov.cn/govView_24263283F98D4F32AAD4AD0A9C66A2B2.html (Chinese).

[14] See Guidelines on Business Cooperation between Banks and Trust Companies, Art. 2; Notice of the China Banking Regulatory Commission on Further Regulating Matters Concerning Cooperation between Banks and Trust Companies, Art. 1.

[15] Notice on Regulating Relevant Matters on Wealth Management Cooperation between Banks and Trust Companies, Art. 2.

[16] 《商业银行并表管理与监管指引》[Guidelines for the Consolidated Management and Supervision of Commercial Banks] (China Banking Reg. Comm., Yin Jian Fa [2014] No. 54; promulgated 30 Dec. 2014), *available at*: http://www.cbrc.gov.cn/chinese/home/docView/27E97E0235134CBDBD5AD4F5AD0A4D42.html (Chinese).

[17] In 2013, the General Office of the State Council issued the *Notice on Issues concerning Strengthening the Supervision of Shadow Banking* (Guo Ban Fa [2013] No. 107) and on 8 April 2014, the General Office of CBRC issued the *Guiding Opinions on the Risk Supervision of Trust Companies* (Yin Jian Fa [2014] No. 99), both of which require that, for cross-products and cooperative business between financial institutions, the party assuming risks and liabilities in a transaction or arrangement must be specified in the form of a contract, and the industry regulator of the parties assuming risks is responsible for supervision and administration. On 28 March 2017, the General Office of CBRC issued the *Notice on Special Inspection of Regulatory Arbitrage, Idle Arbitrage and Related Arbitrage in the Banking Industry*, whereby the banking financial institutions were requested to summarize information on channel business and assume risk management responsibilities for the asset management products invested with banks' funds. Risk management duties, such as due diligence, risk review and post inspections

official definition of "Bank-Trust Channel Business" prior to the promulgation of the Circular. The Circular for the first time incorporates into the scope of the Bank-Trust Business both the on-balance-sheet and off-balance-sheet capital of banks and the right to receivables, which serves to further confirm that the Bank-Trust Channel Business is an activity whereby "a commercial bank (as an originator) establishes a monetary or a property right in trust and the trust company only serves as a channel; the management, utilization and disposal of such trust funds or trust assets are all decided by the originator and the risk management responsibilities and risk of loss resulting from improper management shall be entirely borne by the originator." This clarified definition explicitly assigns the risks and liabilities among the parties involved in the Bank-Trust Channel Business arrangements and provides instructive guidelines for disputes that arise from bank-trust co-operations, since banks generally hold a stronger market position than trust companies and it is often difficult to attribute liabilities in case of a failure of the co-operation.

Regulation of Banks and Trust Companies

The Circular sets forth specific requirements for banks and trust companies engaging in the Bank-Trust Business (particularly the Bank-Trust Channel Business):

For banks, the Circular requires that the Bank-Trust Business is to be regulated under the principle of "substance over form," regardless of whether it is a channel business or not; banks are required to set aside capital and reserves according to substantive credit risks, regardless of whether the arrangement is on- or off-balance-sheet. With respect to the Bank-Trust Channel Business, the Circular further requires banks (i) to monitor risk based on business substance, (ii) not use trust channels to conceal risks or to circumvent prohibitive regulations on use of funds, classification of assets, reserve provisions and capital occupation, and (iii) not to falsely take advantage of channels to place assets off-balance sheet. Meanwhile, commercial banks are required to manage counterparties (i.e., the trust companies) through a name-list system, where the risk management and investment capacity of these trust companies is to be carefully evaluated.

For trust companies, the Circular requires that trust companies not i) accept guarantees directly or indirectly from banks (as originators); (ii) enter into under-the-table agreements with banks; (iii) circumvent regulatory requirements for banks or unlawfully provide channel services to third parties; or (iv) channel trust capital to restricted or prohibited industries such as real estate, local financing platforms, the stock market or other sectors with excess production capacity.

Bank-Trust Channel Business vs. Basic Concept of Trusts

cannot be assigned to institutions only providing channel services. In addition, in a notice issued by the General Office of the China Banking Regulatory Commission on 6 April 2017, the *Notice on Carrying out the Special Campaign against "Inappropriate Innovations, Inappropriate Transactions, Inappropriate Incentives, and Inappropriate Collections of Fees" in the Banking Industry* (Yin Jian Ban Fa [2017] No. 53), the regulator cites as an inappropriate transaction the case where the parties failed to specify the risk management responsibilities of all participants in a Bank-Trust Business arrangement, which may lead to investor complaints or legal disputes.

In the Circular, CBRC emphasizes that trust companies, rather than blindly pursuing scale and speed, should actively transform their growth models by exploiting their strengths as professional trustees, provide professional trust services to the banks in substance, and support the development of the real economy based on trust concepts.

However, how the Bank-Trust Channel Business connects with the basic trust concepts in the PRC Trust Law is an issue worth noting. According to the PRC Trust law, a trustee must manage and dispose of trust assets under its own name, even if the trustee may appoint a third party to handle trust matters pursuant to a special arrangement in the trust documents, the trustee will be responsible for trust affairs managed by the third party. There is a similar provision under the *Measures for Administration of Trust Companies* (the "**Trust Company Measures**"),[18] which provides that trust companies are required to handle trust matters themselves. Where there are different arrangements under the trust documents, the trust company may in certain cases appoint a third party to handle matters on its behalf, but the trust company is still obliged to undertake supervisory obligations and assume all liabilities for the trust matters so handled by the third party. As a result, if the rules under the PRC Trust Law and the Trust Company Measures apply, trust companies may still be liable under the Bank-Trust Channel Business arrangements, even if the management responsibilities have been expressly assigned to the originator (or its third party designee) in the trust documents and the risk/liability allocation is explicitly pre-agreed in the trust document.

Regulatory Outlook

The regulatory trend of de-channelization is quite clear, and it may undergo a long process. The Circular states that CBRC will further study and clarify the regulatory measures on the channel business of trust companies, and CBRC will hopefully clarify in future regulations how channel trust business may fit into the basic trust concepts under the PRC Trust Law and the Trust Company Measures.

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[18] *See*《信托公司管理办法》[Measures for Administration of Trust Companies] (China Banking Reg. Comm., Decree [2007] No. 2; promulgated 23 Jan. 2007, effective 1 Mar. 2007).

Important Announcement

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