Legal Commentary

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Opening-up of China's Unified Bond Markets is Under Way

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Background

As at the end of 2019, China's bond markets recorded a total cash bond trading volume of RMB217.4 trillion, comprising RMB209 trillion in the China Inter-bank Bond Market ("**CIBM**") and RMB8.4 trillion trading volume in the exchange-traded bond market. Foreign institutional investors reached a total of RMB5.3 trillion in cash bond trading in 2019, representing a 66% year-over-year increase, but accounting for only slightly over 2% of the total bond trading volume in China. Among the types of bonds in which foreign institutional investors invested, transaction volumes of policy bank bonds, government bonds, and interbank certificates of deposit accounted for 43%, 33%, and 20%, respectively.

With the intention to gradually promote the unity of rules across the CIBM and the exchange-traded bond market based on the principle of "One Set of Standards and One Set of Rules for One China Bond Market", and promote the allocation of RMB bond assets among foreign institutional investors, on 2 September 2020, the People's Bank of China ("**PBOC**"), the China Securities Regulatory Commission ("**CSRC**") and the State Administration of Foreign Exchange ("**SAFE**") jointly released the consultation draft of the *Announcement on Investment in China's Bond Markets by Foreign Institutional Investors* (《关于境外机构投资者投资中国债券市场有关事宜的公告》) (the "**Draft Announcement**") along with explanatory notes to the Draft Announcement (the "**Explanatory Notes**").[1]

Key Aspects

I Broadening Scope of Foreign Institutional Investors Permitted to Participate in China's Bond Markets

Under the current rules, the following foreign institutional investors are permitted to participate in China's bond markets by filing with PBOC (or the PBOC Shanghai Head Office) (including under the CIBM Direct Access and Bond Connect schemes):

[1] The Chinese version of the Draft Announcement and the Explanatory Notes are available at: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4080874/index.html.
We have prepared the English version of the Draft Announcement and the Explanatory Notes, which are available upon your request.

1. Sovereign entities: foreign central banks or monetary authorities, international financial organizations, sovereign wealth funds;

2. Commercial entities: financial institutions registered and established outside PRC, including commercial banks, insurance companies, securities companies, fund management companies, and other asset management institutions, etc. and investment products issued by the aforementioned financial institutions in a legal and compliant manner; and mid- and long-term institutional investors, including pension funds, charity funds and endowment funds, etc.

   The Draft Announcement further expands this scope to include futures companies and trust companies while removing investment products. The Explanatory Notes clarify that investment products which these financial institutions issue no longer require filing with PBOC on a product-by-product basis for access to China's bond markets. Instead, the Draft Announcement provides that CIBM market access applications will be conducted on a legal entity level, i.e. managers are to file with PBOC for all the products under their management.

II Providing Access to the Exchange-traded Bond Market

Under the current rules, only R/QFIIs are allowed to trade in the exchange-traded bond market.

On 19 July 2020, PBOC and CSRC jointly issued *PBOC and CSRC Announcement [2020] No. 7* ("**Announcement No. 7**"),[2] which approved inter-connectivity between CIBM and exchange-traded bond market infrastructure institutions, so that qualified investors in the CIBM and exchange-traded bond market may trade bonds in the other bond market (the "**Market Connect**"). Article 4 of the Draft Announcement and the Explanatory Notes further clarify that foreign institutional investors which have access to CIBM, either under the CIBM Direct Access or Bond Connect schemes, may access the exchange-traded bond market directly or via the Market Connect scheme.

Announcement No. 7 contemplates that, under the Market Connect scheme, the relevant infrastructure institutions in the CIBM and exchange-traded bond market will jointly provide services to investors in these two bond markets for bond issuances, registrations, custody, clearing, settlements, interest payments, and redemptions. However, the detailed implementing rules for the Market Connect scheme have yet to be issued, and there are still a number of outstanding issues.

For example, the China Central Depository and Clearing Co., Ltd. (CCDC)[3] adopts a gross settlement method, while the China Securities Depository and Clearing Corporation (CSDC)[4] and Shanghai Clearing House (SCH)[5] adopt either a multilateral net central counterparty settlement or gross settlement method, depending on the types of bonds under settlement. It thus remains unclear at this stage which settlement method should be used for cash bond trades between a CIBM investor

[2] The English version is available at http://www.pbc.gov.cn/en/3688253/3689009/3788480/4061345/index.html.

[3] CCDC is the centralized depository for some fixed income products in the CIBM (e.g. China government bonds, financial bonds and enterprise bonds).

[4] CSDC is the centralized depository for most of the fixed income products in the exchange-traded bond market (e.g. corporate bonds).

[5] SCH is the centralized depository for some other fixed income products in the CIBM (e.g. non-financial enterprise debt financing instruments).

and an exchange-traded bond market investor via the Market Connect scheme.

III Clarifying Investment Scope under the Market Connect Scheme

Article 5 of the Draft Announcement provides that foreign institutional investors can trade cash bonds, derivatives, bond funds (including ETF), and other instruments as permitted by PBOC and CSRC. However, the Explanatory Notes further clarify that the scope of instruments open to investment should remain consistent with the current rules and foreign institutional investors that participate in China's bond markets may conduct cash bond trading, and, based on hedging needs, trade bond lending, bond forwards, forward rate agreements, and interest rate swaps.

Given the above "consistency with current rules" principle, it appears that, even if the Draft Announcement is promulgated in its current form, foreign institutional investors under the Bond Connect scheme could only trade cash bonds but not trade derivatives for hedging purposes which are available under the CIBM Direct Access scheme and available to R/QFIIs under the current rules.

Additionally, under the current rules, only R/QFIIs are allowed to invest in bond funds (including ETFs). It appears from the Explanatory Notes that foreign institutional investors acting in the capacity of R/QFIIs will continue to be allowed to invest in bond funds (including ETFs). However, these investors may not be able to invest in bond funds (including ETFs) under either the CIBM Direct Access scheme or Bond Connect scheme, as they are not permitted to do so under the current rules.

These differentiated arrangements for the Bond Connect and CIBM Direct Access schemes and the R/QFII program may not be in line with the Draft Announcement, which is intended to unify the rules for foreign institutional investors to participate in "unified" Chinese bond markets. This issue requires further clarification from regulators.

IV "Global Custodian + Local Custodian" Mechanism

The Draft Announcement introduces the "global custodian + local custodian" mechanism and promotes the implementation of nominee holding and multi-level custody systems, which are more prevalent in offshore markets and familiar to foreign institutional investors. Article 6 of the Draft Announcement provides that foreign institutional investors that access the CIBM can appoint an onshore custodian either directly or via an offshore custodian bank. CIBM bonds purchased by foreign institutional investors via an onshore custodian bank will be registered under the name of the onshore custodian bank and the investors will enjoy beneficial ownership in accordance with law. Article 13 of the Draft Announcement further provides that where foreign institutional investors purchase bonds via an onshore custodian, the onshore custodian and offshore custodian shall have agreement in place to specify matters such as principal and interest redemption and payment, and ensure funds are paid to foreign institutional investors in full and in a timely manner. The lower-level custodian is further required to report to the upper-level custodian information regarding the foreign institutional investors level-by-level and their custody and settlement of bonds, and to take responsibility for the truthfulness, accuracy and completeness of the information so reported.

The "global custodian + local custodian" mechanism is intended to run in parallel with the current settlement agent mechanism. Under the "global custodian + local custodian" mechanism, foreign institutional investors would no longer need to appoint a settlement agent to access Chin's bond markets.

Regulators have taken the following measures to facilitate the contemplated removal of the appointment of a settlement agent under the "global custodian + local custodian" mechanism:

1. Pursuant to the *Notice on Trial Operation of CIBM-Direct Trading Services for Overseas Institutional Investors*[6] issued by the China Foreign Exchange Trade System ("**CFETS**") on 18 August 2020, the direct Request for Quote ("**RFQ**") service has been launched in the CIBM Direct Access scheme for foreign investors to trade bonds directly with market makers on CIBM via CFETS beginning 2 September 2020. Foreign institutional investors under the CIBM Direct Access scheme can send an RFQ to onshore market makers via a Tradeweb or Bloomberg terminal. Upon receipt of executable pricing from market makers, foreign institutional investors can confirm the trade on the terminal.

   The introduction of this direct RFQ service has certainly facilitated the implementation of the proposed "global custodian + local custodian" mechanism. Prior to the introduction of this direct RFQ service, foreign institutional investors trading bonds under the CIBM Direct Access scheme had to go through their settlement agent, who entered the information and conducted transactions on their behalf.

2. Additionally, foreign institutional investors under the CIBM Direct Access scheme have been allowed to hedge their foreign exchange risks by transacting with financial institutions other than their settlement agent or entering the interbank foreign exchange market as a prime broker pursuant to the *Circular of the State Administration of Foreign Exchange on the Improvement of Foreign Exchange Risk Management by Foreign Institutional Investors in the Interbank Bond Market,* promulgated by SAFE on 13 January 2020 and effective as of 1 February 2020.[7]

V Non-trade Transfers

On 30 September 2019, PBOC and SAFE jointly issued the *Circular of the People's Bank of China and the State Administration of Foreign Exchange on Further Facilitating Investments by Foreign Institutional Investors in Interbank Bond Markets (Yin Fa [2019] No. 240)*,[8] which provides that the same foreign institutional investor may, based on its own investment management needs, conduct two-way non-trade transfers of CIBM bonds in its bond accounts invested through the R/QFII program and bonds in bond accounts invested under the CIBM Direct Access scheme, and may conduct two-way non-trade transfers of funds in R/QFII custodian accounts and funds in direct investment fund accounts under the CIBM Direct Access scheme.

The Draft Announcement expands the applicability of two-way non-trade transfers to cover the Bond Connect scheme, i.e. foreign institutional investors, either under the CIBM Direct Access or Bond Connect scheme, are allowed to conduct onshore two-way non-trade transfers between bonds invested under R/QFII program and bonds invested pursuant to the Draft Announcement, and between

[6] The English version is available at http://www.chinamoney.com.cn/english/svcnrl/20200903/1764613.html.

[7] The English version is available at http://www.safe.gov.cn/en/2020/0113/1625.html.

[8] The English version is available at http://www.safe.gov.cn/en/2019/1030/1584.html.

funds in R/QFII custodian accounts and funds in fund accounts opened pursuant to the Draft Announcement.

Notably, bonds transferrable in this manner are limited to those invested pursuant to the Draft Announcement and such transfers may only take place onshore. This indicates that bonds may not be transferrable which are invested under the Bond Connect scheme and not through the "global custodian + local custodian" mechanism, because foreign institutional investors do not have onshore securities accounts under the Bond Connect scheme under the current rules. This ambiguity may require the further clarification of regulators.

Outlook

Recently, regulators have actively issued rules to further the opening-up of China's bond markets, facilitate investment by foreign institutional investors, align China's bond market practices with offshore markets, and unify the CIBM and exchange-traded bond market. The Market Connect scheme is expected to help create unified bond markets in China and attract more foreign institutional investors and liquidity to the exchange-traded bond market. Conversely, foreign institutional investors may be able to diversify their portfolios and gain access to more high-yield credit bonds (e.g. corporate bonds that are solely traded on the exchange-traded bond market).

The above being said, as explained in the Explanatory Notes, the Draft Announcement is intended to provide high-level systemic arrangements for China's bond markets, but detailed implementation rules still need to be drafted and issued. We will keep you updated of any further material developments.

Important Announcement

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