



HAN KUN LAW OFFICES

Legal Commentary



CHINA PRACTICE • GLOBAL VISION

January 15, 2018

Banking & Finance Law

CBRC Issues Rules on Equity Investments in PRC Commercial Banks

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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

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).

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 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

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).

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 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

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_EC0BDCE11EF7467C806CBE4E63834B60.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."

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 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

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

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."

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, 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.

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.

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 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.

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."

(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.

● **Important Announcement**

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