

# Legal Commentary

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## Financial Market Infrastructures to be Further Regulated

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### Overview

On 14 December 2022, the People's Bank of China (“**PBOC**”) issued for public comments the *Measures for Administration and Supervision of Financial Market Infrastructures* (the “**FMI Measures**”). The public comment period is open until 14 January 2023.

According to PBOC in a separate explanatory statement, the legal regime governing China's financial market infrastructures (“**FMI**s”) lag behind the rapid development of financial technology, and the absence of a unified regulation is not compatible with the complex international environment and the increasing external cybersecurity challenges. The FMI Measures aim to unify regulatory standards, set up a sound management system for market access, optimize facility layouts, and improve governance structures to facilitate the establishment of an FMI system of a reasonable layout, effective governance, and of an advanced, reliable, and flexible nature.

Back in 2012, CPSS<sup>2</sup> and IOSCO<sup>3</sup> issued the *Principles for Financial Market Infrastructures* (the “**PFMI**”) to enhance their member states' awareness regarding the safety, efficiency, and steady operation of FMIs following the 2008 financial crisis and called for the implementation of the PFMI among the member states. China is a member state of CPSS and IOSCO<sup>4</sup>.

In 2013, PBOC and the China Securities Regulatory Commission (“**CSRC**”) successively promulgated circulars<sup>5</sup> to implement the PFMI among the institutions within their respective regulatory purviews. The promulgation of the draft FMI Measures demonstrates China's continuing efforts in complying with its international obligations and aligning with international standards in this area.

<sup>1</sup> Vito Wang (intern) has made contribution to this article.

<sup>2</sup> The Committee on Payment and Settlement Systems.

<sup>3</sup> The International Organization of Securities Commissions.

<sup>4</sup> PBOC joined the CPSS in July 2009, and CSRC joined IOSCO in July 1995.

<sup>5</sup> PBOC Circular: Yin Ban Fa (2013) No. 187; CSRC Circular: Zheng Jian Ban Fa [2013] No. 42.

We set out in this newsletter the key aspects of the draft FMI Measures to provide readers with a general picture of the proposed FMI regulatory regime, which includes the scope of FMIs covered, market access and key compliance requirements, risk resolution, and the extra-territorial application of the draft FMI Measures.

## Key aspects

### I. Scope of FMIs covered

#### 1. Defined scope

Article 2 of the draft FMI Measures enumerates six types of FMIs, including the financial assets registration and custody systems, clearing and settlement systems (including the central counterparty engaged in centralized clearing business), trading venues, trading repositories, important payment systems and basic credit reporting systems<sup>6</sup>. This enumeration conforms to the *Work Plan for Coordinated Supervision and Regulation of Financial Infrastructure*, jointly promulgated on 6 March 2020 by PBOC, the National Development and Reform Commission, the Ministry of Finance, the China Banking and Insurance Regulatory Commission (“**CBIRC**”), CSRC, and the State Administration of Foreign Exchange (“**SAFE**”).

The list of FMIs will be published by the financial administration authorities of the State Council (i.e., PBOC, CBIRC, CSRC, and SAFE) (the “**Financial Administration Authorities**”). According to the draft FMI Measures, there are currently 26 FMIs (the “**Existing FMIs**”) approved by the State Council or the Financial Administration Authorities. The administrative authorities have not yet published an official list of these FMIs, and we summarize the typical FMIs in China based on market information below for reference only.

Type	Name of the FMI
Financial assets registration depository systems	China Securities Depository and Clearing Co., Ltd(中国证券登记结算有限责任公司), China Central Depository & Clearing Co., Ltd.(中央国债登记结算有限责任公司) and Shanghai Clearing House(上海清算所)
Clearing and settlement systems (including the central counterparties (CCPs) engaged in centralized clearing business)	NetsUnion Clearing Corporation (网联清算有限公司) and Cross-Border Interbank Payment System Co., Ltd. (跨境银行间支付清算有限责任公司), etc.
Trading venues	Shanghai Stock Exchange(上海证券交易所), Dalian Commodity Exchange(大连商品交易所) and China Foreign Exchanges Trade System(中国外汇交易中心), etc.
Trade repositories	China Futures Market Monitoring Center Co., Ltd. (中国期货市场)

<sup>6</sup> Basic credit reporting system was not an enumerated type of financial infrastructure in the PFMI. However, it plays an important role in effectively reducing information asymmetry, preventing financial risks, and maintaining national financial security.

Type	Name of the FMI
	监控中心有限责任公司) and China Securities Internet Inter Agency Quoted Systems, Inc. (中证机构间报价系统股份有限公司)
Important payment systems	China UnionPay (中国银联)
Basic credit reporting systems	Credit Reference Center, the People's Bank of China (中国人民银行征信中心)

## 2. Systemically important FMIs

The draft FMI Measures further differentiate systemically important FMIs (“**SIFMI**”) from ordinary FMIs. PBOC will exercise macro-prudential supervision of SIFMI and their operators in addition to the supervision by the responsible Financial Administration Authorities. The stipulation follows the suggestions in the PFMI that any member authority may designate FMIs as systemically important for the purposes of applying the principles in the PFMI for FMIs<sup>7</sup>. However, PBOC has not specified the additional regulatory requirements for SIFMIs.

According to the draft FMI Measures, an FMI will be deemed systemically important if it meets any of the following conditions:

- having a large number and wide distribution of participants;
- having a high market share;
- having complex operations, being highly interconnected with financial institutions, or being interconnected with other SIFMIs; and
- providing critical services in the financial market that are difficult to replace and may have a significant adverse impact on the financial system and the real economy in the event of a major risk event, etc., resulting in unsustainable operations.

## II. Market access

### 1. Approval authorities

The establishment of FMIs in China will be approved by the relevant Financial Administration Authorities. Specifically:

- CSRC is responsible for the market access of new FMIs engaging in securities, futures, and related activities;
- PBOC is responsible for the market access of new payment systems, basic credit reporting systems and interbank market FMIs;
- the market access of other new FMIs will be under the joint management of PBOC and the other

<sup>7</sup> Section 4.1.2 of the PFMI.

Financial Administration Authorities; and

- FMIs that involve or may involve significant impact on the financial system or are considered necessary by Financial Administration Authorities shall be reported to the State Council for approval.

In addition, for foreign investments which affect or may affect the national security of the PRC, foreign investment security review is required by law. Without approval, any entity or individual may not establish or operate any form of FMIs and may not use FMI service names such as “financial” “exchange”, “trading center”, “depository and settlement”, “clearing”, and “transaction reporting”.

## 2. Eligibility requirements

The operator of an FMI will be required to satisfy the following eligibility requirements for establishing an FMI in China. Existing FMIs do not need to undertake the application process again.

Items	Specific requirements
Legal person status	The FMI operator must be a legal person duly established within the territory of the PRC.
Corporate governance	The FMI operator must possess a clear and transparent organizational structure and governance arrangements that are not contrary to state or public interests.
Capital requirements	The FMI operator’s paid-in capital should satisfy the relevant prescribed requirements.
Place of business and facilities	The FMI operator must possess a place of business with secured systems and facilities in compliance with laws that are necessary for its business operations.
Control systems	The FMI operator must possess risk management systems, internal control systems, established business rules and other rules compatible with its intended business operations.
Personnel	Proposed directors, supervisors and senior executives of the FMI operator must satisfy certain requirements, which include: <ul style="list-style-type: none"> <li>■ having a bachelor’s degree or above;</li> <li>■ having a good credit record;</li> <li>■ being familiar with the laws, regulations and international regulatory standards related to the type of FMI to be established;</li> <li>■ having at least five years of relevant experience in the financial industry and the management ability required to perform their duties;</li> <li>■ having no material violations of the law or regulations in the last five years; and</li> <li>■ other requirements stipulated by the relevant Financial Administration Authorities.</li> </ul>
Shareholders	The FMI operator’s shareholders must have: <ul style="list-style-type: none"> <li>■ a good credit record;</li> </ul>

Items	Specific requirements
	<ul style="list-style-type: none"> <li>■ no record of intentional or grossly negligent criminal offenses; and</li> <li>■ no material violations of law or regulations and not subject to material regulatory penalties in the last three years.</li> </ul>
Requisite qualifications	The FMI operator must possess the requisite qualifications to conduct the relevant business as approved by the Financial Administration Authorities.
Other	Other requirements as provided by the Financial Administration Authorities.

### III. Key compliance requirements

According to the draft FMI Measures, the key compliance requirements for FMIs are summarized below.

Items	Specific requirements
Prior approval	<p>FMI operators are required to obtain prior approval from the relevant Financial Administration Authorities for any of the following:</p> <ul style="list-style-type: none"> <li>■ Change the name of the FMI or the FMI operator;</li> <li>■ Change of registered capital;</li> <li>■ Change of domicile;</li> <li>■ Adjusting the business scope of the FMI or the FMI operator;</li> <li>■ Change of major shareholder or actual controller that holds more than 5% of the total capital or shares;</li> <li>■ Change of legal representative, chairman of the board of directors, chairman of the board of supervisors or general manager;</li> <li>■ Amending the articles of association;</li> <li>■ Establishing system connection or carrying out major business cooperations with other domestic or overseas FMI operator;</li> <li>■ The launch, major change, or shutdown of important business systems; or</li> <li>■ Other matters stipulated by Financial Administration Authorities.</li> </ul>
Filing	<p>An FMI operator should timely file with the Financial Administration Authorities upon the occurrence of any of the following:</p> <ul style="list-style-type: none"> <li>■ the formulation and implementation of a recovery plan;</li> <li>■ the replacement of other director (committee member), supervisors and senior executives; and</li> <li>■ other matters provided by the Financial Administration Authorities.</li> </ul>
Reporting	<ul style="list-style-type: none"> <li>■ Periodic reporting on its own operations and the conduct of its FMI business engagements.</li> <li>■ Timely reports of the occurrence of the following significant matters: (1) system failure, human error, or other circumstances such as natural disasters that cause abnormalities in core business and have a material impact; (2) litigations having significant impact on its normal operations or the other situations with significant potential liabilities or losses; or (3)</li> </ul>

Items	Specific requirements
	<p>other matters provided by the Financial Administration Authorities.</p> <ul style="list-style-type: none"> <li>■ Financial reports for the previous year should be provided to the Financial Administration Authorities at the end of April each year.</li> </ul>
Risk management	<ul style="list-style-type: none"> <li>■ The operator is required to maintain high quality liquid assets of not less than six months' current operating costs (the scope of high-quality liquid assets will be provided separately).</li> <li>■ The operator is required to keep its own assets used to meet the six months' operating needs and participants' assets at a financial institution or professional institution recognized by the Financial Administration Authorities.</li> <li>■ The operator should regularly monitor and assess the risks that participants, participants' clients, and other entities may pose to the FMI.</li> </ul>
Data protection	<ul style="list-style-type: none"> <li>■ Disaster backup: the operator should have an established system failure emergency handling mechanism and disaster backup mechanism, with complete data security protection and data backup measures, and the disaster backup center should be located in China.</li> <li>■ Data transfer: All data collected and generated in the course of operations in the territory of China, including but not limited to personal information and other important data, must be stored entirely within the territory of China. If it is necessary to provide it outside of China due to business needs, it should comply with relevant national regulations.</li> </ul>
Data retention	<p>Operators should properly preserve records, original documents, and data information related to financial infrastructure services, as well as information related to internal management and business operations, for a period of not less than 20 years, unless otherwise provided by laws and regulations.</p>

#### IV. Extraterritorial application

##### 1. Scope of offshore FMIs covered

The draft FMI Measures provide a broad extraterritorial application clause, which provides that where relevant laws and regulations permit overseas FMIs to provide cross-border delivery services to domestic entities or individuals, the Financial Administration Authorities will manage the market access of such FMIs according to their division of responsibilities and relevant laws and regulations. This clause seems to indicate that the provision of cross-border services to domestic entities or individuals by offshore FMIs is subject to approval under PRC law. However, the approval or licensing procedures and the scope of services is not specified.

As of today, many offshore FMIs have been granted approval on a case-specific basis by the Financial Administration Authorities under the recently launched connect programs to provide services to PRC clients, such as trading venues (e.g., Bloomberg, Tradeweb, and MarketAxess) under the Bond Connect, financial assets registration depository systems (e.g., CMU, HKSCC) under the Bond Connect and the Stock Connect, and clearing and settlement systems (e.g., OTC Clearing) under the

Swap Connect.

However, it is unclear whether offshore FMIs under other programs that also provide FMI services to PRC clients would fall within the scope of the draft FMI Measures and trigger the approval requirement and supervision by Financial Administration Authorities. For example, Euroclear and Clearstream provide services to PRC clients (e.g., qualified domestic institutional investors) when they trade offshore fixed income products. We expect the regulators will formulate more detailed regulations in this area after the draft FMI Measures are formally promulgated and provide more certainty for offshore FMIs in this regard.

## **2. Eligibility requirements**

Eligible offshore FMIs must meet the following conditions, including:

- having more than three years of experience in providing FMI services;
- be subject to equivalent and comprehensive supervision and regulation by the corresponding local authorities; and
- not having encountered any major risk incidents and not having been subject to any serious punishment by the relevant authorities.

## **3. Reporting requirements**

Eligible offshore FMIs are also required to report to the Financial Management Departments on their business engagement based on the principle of reciprocity with the local authority.

Specifically, the offshore FMIs that provide relevant services for PRC residents or institutions are required to periodically report to the Financial Administration Authorities the following: (1) their offshore business engagements and compliance status; (2) the acquisition of regulatory authorizations (or exemptions), business licenses and permits outside China; (3) PFMI-based self-assessment reports; and (4) other matters provided by the Financial Administration Authorities.

The above reporting requirements should equally apply to existing offshore FMIs that have already obtained the approval from Financial Administration Authorities after the draft FMI Measures are formally promulgated.

## **V. Others**

### **1. Risk resolution**

It has long been an issue for offshore investors to enter China's financial markets due to lack of clarity in the extreme event of an FMI's insolvency under PRC law. Despite the low possibility of an FMI's financial difficulties in China, especially when all of the FMIs in China are state-owned and backed by China's sovereign credit, the legal analysis as to the safety of offshore investors' assets remains a critical issue, particularly as this may be required by their local financial regulators for their entering into a new financial market.

In this respect, Article 36 of the draft FMI Measures provides that an FMI is required to formulate and

update recovery plans and will be called to exit the market if it (or its operator) has difficulty in continuing operations or severely endangers the financial order and damages public interests. This is in line with a similar regulatory requirement imposed by PBOC in the *Financial Stability Law of the People's Republic of China (Draft for Consultation)*, promulgated earlier this year, which is also applicable to FMIs. The option of market exit means the entrance by an FMI into a bankruptcy proceeding would not be entirely impossible even for a state-owned FMI. However, the conditions for market exit, the specific exit procedure and how the claims and debts would be treated in are all subject to broad regulatory uncertainty.

## 2. Legal liability

The draft FMI Measures provide parallel liabilities for FMI operators and persons directly responsible for the following violations:

- breach of the draft FMI Measures falling within the scenarios enumerated in Article 39;
- unlicensed operation, out-of-scope business operations, or the falsification of a business license or permit; and
- endangerment to the FMI or its safe operation.

The penalties vary depending on the seriousness of the violation and the monetary penalties are capped at RMB 1 million.

## Outlook

The promulgation of the draft FMI Measures indicate that the Chinese regulators are imposing more comprehensive and stringent control on FMIs, including offshore FMIs that provide services for PRC clients. Given the different types of FMIs and financial industry regulators are involved, the regulators may need to shed light on how to interpretate and enforce the provisions in the context of different financial regulations, and cope with the application uncertainties as discussed above. The current draft of the FMI Measures is also subject to change and amendments may be made before it is formally promulgated. We will keep a close eye on any noteworthy developments.



## ***Important Announcement***

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