FANGDA PARTNERS
方達律師事務所
2020
PRC Financial Regulation Annual Report

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Preface

2019 marked the third full year since the holding of the Fifth National Financial Work Conference, which was a landmark event heralding the transformation of China's financial services industry. During the year, financial regulation underwent significant change, the market was further opened to foreign participation and, generally, the process of market reform accelerated. Some notable developments included the launch of the STAR market, the trialing of the IPO registration system, commercial banks being permitted to open wealth management subsidiaries, and the implementation of the loan prime rate (LPR) as the benchmark lending rate. The combined result of these changes spelled out major opportunities for businesses in financial services.

We have been working in the financial services industry for many years. We have a deep understanding of the market, which we know is very important to our clients. We look forward to discussing with you the direction in which financial regulation in China is headed, talking you through judicial thinking, reviewing recent reforms in China's financial policy, and giving insight into likely developments. To this end, we have prepared this Annual Financial Regulatory Report (2020) to provide practical and forward-looking guidance, covering milestone events, main regulatory developments and key trends in the banking, securities, asset management, financial technology and insurance sectors.

Our core mission is to provide effective, creative and timely legal services to meet the commercial needs of our clients. Fangda's Financial Institutions Group comprises 30 experienced lawyers. Our lawyers offer a full range of legal services related to China's financial institutions and financial markets. We advise both domestic and overseas clients on the most cutting-edge and complex legal issues in China's financial services industry. We are at the forefront of significant initiatives in the industry, leading on the market's most significant transactions and new product structures. With our deep understanding of the market and our unparalleled experience of advising on groundbreaking transactions, we are able to provide creative solutions in a complex financial regulatory environment. We look forward to sharing with you our observations that we have accumulated over years of practice.

We are always happy to absorb feedback from those working directly in the financial services industry, so please feel free to get back to us with any comments or suggestions on the content of this report.

Much has happened in the financial services industry in 2019. We live in challenging times, but nevertheless there is much to look forward to in 2020.

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PRC Financial Regulation: Annual Report (2020) General

2019 Key Dates

February 2
The Provisions on the Functions, Organizational Structure and Staffing of the PBOC was issued. The office of the Financial Stability and Development Commission was set up in the PBOC to undertake the daily work of the Commission

April 23
PRC financial regulatory authorities reached the first ever administrative settlement with a counterparty

May 1
The CBIRC published 12 new opening-up measures

May 22
The first batch of commercial bank wealth management subsidiaries opened for business

May 24
The CBIRC took over Baoshang Bank, signaling the regulator's intent of the disposal of high-risk problematic banks

June 13
Shanghai Stock Exchange Science and Technology Innovation Board (STAR) began trading and piloted the IPO registration system

July 11
Dajia Insurance was set up to acquire the equity, assets and liabilities of AnBang Insurance, signaling the start of the disposal of high-risk insurance companies

July 20
The Financial Stability and Development Commission announced 11 new opening-up policies for the financial sector

July 26
The PBOC published the Interim Measures for the Supervision and Administration of Financial Holding Companies (Consultation Draft)

August 17
The PBOC issued an announcement on reforming the LPR formation mechanism, which is an important step in market-oriented interest rate reform

August 22
The PBOC issued FinTech Development Plan (2019-2021)

November 8
The Supreme People's Court issued the Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work, with opinions on important legal issues in the financial industry, such as financial consumer protection

December 5
The PBOC initiates a pilot regulation program for FinTech innovations in Beijing, marking China's first steps into the "regulatory sandbox" era

December 28
The amended Securities Law was adopted after its fourth reading

2019 Regulatory Observations

01

Top-level authorities were promoting regulatory coordination and consistency

There have been ongoing refinements in China to help reduce and diffuse market risk in the financial markets. The process started three years ago with the Fifth National Financial Work Meeting. There have been significant changes in regulatory structures, frameworks and approaches.

In this process, there was unprecedented co-effort and coordination between: the PBOC, the CSRC, and CBIRC; the executive, judicial and legislative authorities; and the central and local governments. The Financial Stability and Development Commission held five meetings in the second half of 2019 to discuss and assign various tasks. And at the executive level, the CSRC initiated uniform law enforcement action against illegal conduct in the inter-bank bond market and the exchange bond market following the promulgation of the Opinions on Issues Concerning Further Strengthening Law Enforcement in the Bond Market by the PBOC, the CSRC, and the NDRC. For illegal or non-compliant information disclosure, insider trading, market manipulation and other acts that violate the Securities Law involving all types of bonds and debt financing instruments, the CSRC has exerted its regulation and law enforcement by investigating violations and imposing administrative penalties according to the Securities Law. This concentration of power by the CSRC sets an example for regulators to strengthen their coordination and cooperation in establishing a unified law and regulatory enforcement regime for the securities market.

02

Regulation focus has shifted from institutions to conduct and function, while the government has rolled out a more comprehensive system for business and individual creditworthiness

The regulatory authorities paid more attention to function-based regulation and conduct-based regulation in their regulatory philosophies. Commenting on asset management, a CBIRC official said in an interview that the wealth management business of a commercial bank and its wealth management subsidiaries is built on a trust relationship with clients, breaking the long-term "trust" taboo for the asset management and wealth management business of commercial banks. The newly revised Securities Law also clearly authorizes the State Council to formulate administrative measures for the issuance and trade of asset management products under the principles set out under the Securities Law. All these mean, the asset and wealth management product/service offered by different financial institutions, being identical in nature, will be subject to uniform rules. In internet finance, the regulatory authorities have clearly defined the parameters to which banks and other lending institutions assisting the banks may be subject in undertaking their cooperation. The “sandbox” regulation is an even more important reflection of the change from institution-based regulation to conduct-based regulation – it applies to all innovative fintech activities rather than any specific type of institutions.

Meanwhile, following the Outline of the Plan for the Building of a Social Credit System (2014-2020), the State Council issued the Guiding Opinions on Accelerating the Construction of a Social Credit System and Building up a New Credit Based Regulatory Regime, specifying that such matters as the priority given in future administrative licensing and the proportion and frequency of random market checks will both be adjusted according to the credit conditions of enterprises. In the financial service sector, great importance has been attached to the credit conditions of financial institutions in the grant of regulatory approvals on significant matters and tiered regulation of financial institutions, and therefore the opinions will not materially impact the regulation of financial institutions. That said, the linking of enterprise credit with administrative supervision in the broad society will significantly strengthen and improve the establishment of the entire social credit system, which will be more conducive to risk control of financial institutions, and of course, but also set higher standards for their due diligence work regarding KYC and anti-money laundering.

03

Market-oriented reform of financial resources and financial regulation were deepened

The reform in 2019 addressed several core and fundamental financial market problems that had remained unsolved for a long time, and took a big step towards the marketization of the financial resources allocation and the financial regulation. Loan prime rate (LPR) reform has made significant progress in the "two-track merger" of interest rates. The securities issuance registration system was piloted with the launch of the STAR in the middle of 2019 and was fully adopted in the revised Securities Law. According to the relevant statistics, 203 new A-shares were listed on the stock exchanges in 2019, and 70 enterprises were successfully listed on the STAR within less than half a year of its opening, representing 32% of the total financing in the A-share IPO market. This reflects the positive results of market oriented reform.

In terms of resolving risks posed by problematic financial institutions, the PBOC, the MOF, and other competent financial regulatory authorities and local governments took various measures that combined administrative actions with market-oriented disposals. These combined methods could be seen in the takeover of Baoshang Bank, the capital injection into Hengfeng Bank, the restructuring of AnBang Insurance and the administrative winding-up and entrustment of Huaxin Securities and including the remaining assets in the bankruptcy procedures of Huaxin Group. In addition, in some fields, extensive but general regulation has been gradually replaced with targeted and precise regulation. For example, in terms of payment business, in addition to the license requirement, payment companies were further required to terminate their direct links with banks and to deposit 100% of the advance payments they receive into the central reserves. Moreover, in terms of internet finance, after extensive investigations by regulatory authorities, market players were required to gradually and positively exit from the market. Regulatory authorities have also provided guidance for them to exit P2P business depending on specific targets and business, which is in sharp contrast with the previous practice of immediately suspending all illegal businesses at one time.

04

"Look through" approach was taken for regulating financial institution shareholding and separation of industry and finance was required.

Following the joint issuance of the Guiding Opinions on Strengthening the Supervision Over Non-financial Enterprises' Investment in Financial Institutions by various regulatory authorities, the Provisional Measures on Administration of Equities of Commercial Banks and the Administrative Measures on Equity of Insurance Companies were issued in 2018. In 2019, the regulatory authorities continued to comprehensively implement the Guiding Opinions with the issuance of the Administrative Provisions on Equities of Securities Companies and the issuance of the draft of Provisional Measures on Administration of Equities of Trust Companies for public consultation.

These provisions, as well as the regulatory examination and approval practices implemented in 2019, strictly require regulatory authorities to enhance examination of shareholders' qualifications, shareholding structure and source of capital by taking the "look through" approach and to differentiate the regulation of different types of shareholders. These also impose shareholding limits on non-financial enterprises in respect of certain types of institutions (such as securities companies). The SASAC issued a document to central State-owned enterprises early 2019, requiring those enterprises to "strictly control new investments in financial business, and not to, in principle, make new investments in banks, trust companies and other financial institutions that are not highly related to the group's main business and have little effect on the integration of industry and finance". This is in line with the rules jointly issued by various financial regulatory authorities which emphasized the separation of industry and finance to prevent investments shifting from the real economy to the fictitious economy.

05

Regulatory authorities continued their focus on greater enforcement, and considered expanding range of enforcement measures

All financial regulatory authorities continued to apply strong regulatory pressure in 2019. Out of the cases in which sanctions were imposed by the PBOC, the CSRC, CBIRC and SAFE, the number in the asset management industry including banks' wealth management products, trust schemes, securities companies' asset management products and others grew steadily and moderately; based on the data disclosed by the CBIRC as an example, the total amount of penalties imposed by the CBIRC during 2017 to the first quarter of 2019 is about RMB6 billion, which is higher than the total amount of penalties imposed in the past ten years.

In addition, new law enforcement models were experimented with and innovated in the tightened regulatory environment. In 2019, the CSRC announced China's first administrative settlement under the Measures for Implementing the Pilot Program of Administrative Settlement, which took effect in 2015. This marked a new model for law enforcement in financial regulation.

Technology was used more widely in regulation and law enforcement, and the CSRC was reported to establish the Technology Supervision Bureau at the end of 2019 to propel Regtech into version 3.0. Protecting financial consumers' rights and interests was a focus of financial institutions in 2019. In the middle of the year, the alarm was sounded for the whole asset management industry when China Construction Bank was required to fully compensate a client for the bank's failure to perform suitability obligations. At the end of 2019, the Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work set out a high number of provisions on cases involving financial consumer rights and interests. Financial consumers has become the focus in both administrative and judicial practice in 2019, and this has triggered deep thought about how to accurately define and classify financial consumers.

06

It became apparent that judicial practice become more administration-oriented and policy-oriented.

The Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work, which generated a significant impact on the judiciary in 2019, granted for the first time legal force equivalent to mandatory laws and regulations to departmental rules involving financial security. The minutes formally establish a direct relationship between the violation of financial regulations and the violation of public order in their quasi-judicial interpretation following the nominee shareholding case involving J.K. Life Insurance Co., Ltd. The minutes provide that "the contract which violates departmental rules involving public order and good morals such as financial security, market order and national macro policies shall be determined to be invalid. When determining whether departmental rules involve public order and good morals, the people's courts shall, on the basis of examining the objects being regulated, prudently consider the intensity of regulation, protection of transaction security, social impact and other aspects, and make full reasoning in the judgments."

In light of this, regulatory rules in the financial sector will no longer be simply considered as administrative regulations (not regulations impacting on validity of contracts). That said, whether a violation of such rules will impact the validity of a contract will be subject to the regulatory environment and social impact of such violation at the specific time and place. This means that violation of the same provision may lead to different results depending on different regulatory environments. Meanwhile, the judiciary has made more innovations to further support and promote financial regulation, and the introduction of "demonstration cases" by the Shanghai Financial Court is a good example of this innovation.

07

China's financial markets opened up, including lifting limits on foreign shareholdings in financial institutions

In view of the driving force of "promoting reform through opening up the market" and the changes in international and domestic environments, the top levels of the Chinese government reached a consensus in 2019 to further the opening-up of the financial industry. The administration model has been gradually transformed from the traditional "positive list" to a "negative list" and a number of opening-up policies and implementation rules were issued. As a result, break-through was made in comprehensively opening up the financial market to foreign investors.

As far as onshore commercial presence is concerned, several fields that had never been officially opened to foreign investors were starting to open. For example, Paypal was approved to become the first foreign-invested payment institution to operate in China, and American Express was approved to establish a payment and clearing institution. The restrictions on the shareholding ratio for foreign investors in the financial industry were also removed generally. In 2020, foreign investors will be allowed to hold 100% share in securities, funds, futures, insurance and other types of financial institutions, or to acquire 100% interest in domestic financial institutions. Moreover, conditions for foreign investment to access the Chinese market were substantially relaxed. For instance, "quantitative qualification requirements" were reduced for the banking and insurance industries, leaving room for small- and medium-sized foreign-invested institutions to participate. National treatment to foreign investors was further implemented in terms of business scope, and licenses for certain critical businesses were issued to foreign-invested banks, such as license to act as custodian for publicly offered funds and license to serve as lead underwriters in the inter-bank bond market.

In terms of cross-border transactions, many measures were implemented: the Shanghai-London Stock Connect was implemented, the first GDR was launched, Segway-Ninebot's application to the STAR was accepted (this is the first red-chip enterprise with VIE structure that seeks to be listed on the STAR by issuing CDR), a number of new futures products were opened to foreign investors, the QFII/RQFII investment quota restrictions were lifted, and further relaxation on QFII/RQFII investments was proposed.

08

China's regulatory authorities were linking up more with counterparts in other jurisdictions to coordinate enforcement

As China's financial markets have opened and become more interconnected with foreign financial markets, the demand for and the complexity of cross-border cooperation between domestic and foreign regulatory authorities in law enforcement have increased significantly. Cooperative efforts have already been underway in recent years, such as the "first case under the Shanghai-Hong Kong Stock Connect" involving cross-border market manipulation in 2018, but 2019 sought to expand on these efforts.

In 2019, for example:

- The CBIRC and the Monetary Authority of Singapore entered into a memorandum of cooperation,
- the CSRC and the Securities and Exchange Commission of Cambodia entered into a memorandum of cooperation,
- the China Anti-Money Laundering Monitoring and Analysis Centre and the Korea Financial Intelligence Unit entered into a memorandum of understanding on financial information exchange for anti-money laundering and anti-terrorist financing, and
- the MOF and the Financial Reporting Council of the Hong Kong Special Administrative Region entered into a memorandum of understanding on audit regulation.

Of these, the last is of particular importance because it allows the Financial Reporting Council to obtain audit working papers deposited in the mainland by Hong Kong based accounting firms.

In addition to these memorandums of understanding, the SAFE also cooperated with various overseas administrative and regulatory authorities in dealing with more than 2,000 domestic and overseas illegal foreign exchange trading platforms by banning, closing, penalizing, etc. the platforms.

2020 Regulatory Outlook

01

Regulatory authorities will address systematic financial risk with a proposed series of reforms, including tighter regulation and greater capital requirements

In 2019, significant progress was made in disposing of major financial risks, including the risks related to internet finance and other problematic financial institutions. In 2020, regulatory authorities is expected to establish and implement long-term risk prevention mechanisms and will fundamentally rely on reform and development to prevent and defuse risks. Those long-term risk prevention mechanisms may include enhancing commercial banks' ability to replenish capital, especially small and medium-sized banks, tightening financial regulation, promoting litigation, and promoting bankruptcy legislation. At the same time, subjecting all financial businesses to licensing and expanding the application of anti-money laundering system to more entities are expected to become the regulatory focus.

02

Institution-based regulation and function-based regulation will advance hand-in-hand with conduct-based regulation over financial institutions, and the regime of separate regulation of different types of financial institutions may be broken indirectly.

Function-based regulation and conduct-based regulation are future trends, and we expect the top-level government authorities to continue pushing for this direction, focusing on FinTech, securities enforcement and financial consumer protection. That said, we believe that institution-based regulation and conduct-based regulation as well as function-based regulation will coexist and complement each other for the foreseeable future. For example, the yet-to-be-issued administrative rules governing independent fund distributors remain to regulate market access from a licensing perspective, and while the central bank announced that "sandboxes" will be piloted in 10 cities, currently the complete sandbox was merely implemented in Beijing and Shanghai Pudong.

In contrast, the regulation of financial holding companies (FHC), which has been studied and piloted by the PBOC for years, has been added to the legislative agenda and a consultation draft was promulgated in 2019. Although the original intent behind the FHC rule was to fill the existing regulatory vacuum of separate regulation, this does not exclude the possibility that the cross-sector financial groups within non-financial corporate groups (which may be further expanded to pure financial groups in the future) may take the opportunity to achieve intra-group information sharing and resource allocation in a subtle way, so as to break the barriers of separate regulation to a certain extent through a higher level financial holding companies. This innovation may be achieved by a sandbox in the near future.

03

The derivatives market will expand, offering new opportunities as well as greater regulation. The futures regulatory framework is expected to take shape

With the CSRC's 2019 introduction of five commodity futures and three financial option products, exchange-traded derivatives have reached an unprecedented level. SAFE is also seeking market opinions on the direct participation of overseas banks in foreign exchange derivatives trading in the interbank foreign exchange market.

These all indicate that the relevant regulators have repositioned the market risks and functions of derivatives, and new derivatives business opportunities will arise on the exchange markets and over-the-counter markets in 2020. We expect the regulation of derivatives business and their market to be a regulatory focus in 2020, with a regulatory framework for cross-market and cross-agency coordination to take initial shape. In addition, as the Securities Law will no longer govern futures transactions, the promulgation of the Futures Law and the establishment of an independent futures regulatory framework will be a focus of financial regulatory legislation in 2020.

04

Financial information protection and data security will be the focus of new laws and enforcement

The protection of personal financial information and the security of financial transaction data will be the focus of legislation and law enforcement in 2020. At the end of 2019, the PBOC released the consultation draft on the Protection of Personal Financial Information (Data); The Personal Information Protection Law and the Data Security Law are both listed on the NPC's 2020 legislative agenda; and the newly revised Securities Law also contains special provisions on cross-border data transmission.

Meanwhile, the PBOC and the National Internet Finance Association of China have clearly signaled their intent to push forward the filing system for registrations and to strengthen the assessment and certification of financial apps. The PBOC will also work with the relevant ministries and departments to take joint measures to app stores and to quickly require the removal of apps that are unlawful or have material hidden risks.

05

Administrative and judicial enforcement against illegal securities activities will step up, including imposing sanctions against company managers

The revised Securities Law is scheduled to take effect in March 2020. Once it takes effect, heavier administrative punishments and collective-action lawsuits can be expected. It is noteworthy that in two cases involving a branch of the Shanghai Pudong Development Bank and a branch of the Guanfa Bank respectively in October 2019, the CBIRC abruptly imposed punishments on the current bank chairmen and senior officers of banks that violated relevant regulations in 2017 and 2018. The CBIRC's penalties indicate that the ex post administrative penalties (after penalties on the institution itself) upon senior managers, including senior managers located in the institutions' headquarters, will become the new norm. In addition, the Securities Law broadly provide that if foreign securities activities disrupted China's domestic market order and damaged the legitimate rights and interests of domestic Chinese investors, legal liabilities may be imposed pursuant to the Securities Law. While it is not clear as to how this will be applied, there remains a possibility that new types of such cases will be seen.

PRC Financial Regulation: Annual Report (2020) Banking[1]

1. "Banking industry" as discussed in this Chapter includes commercial banks, rural cooperative banks, rural credit cooperatives, policy banks and the China Development Bank established in the People's Republic of China, together with financial asset management companies, trust companies, enterprise group finance companies, financial leasing companies, auto finance companies, money brokerage companies, consumer finance companies and other financial institutions established with license from CBIRC

2019 Key Dates

January 17

Bank of China was approved to issue China's first perpetual bonds

May 22

The first batch of commercial bank wealth management subsidiaries were approved to open for business

May 24

Baoshang Bank became the first bank to be taken over in the past 20 years

July 20

The Financial Stability and Development Commission announced 11 new opening-up policies for the financial sector

August 17

The PBOC announced the reform of the Loan Prime Rate (LPR) formation mechanism

August 26

The "CCB funds distribution case" was decided. The investor was awarded full damages for the investment because China Construction Bank (CCB) failed to perform its investor suitability obligations

September 28

Privately owned banks remerged:
Jiangxi Yumin Bank opened for business

October 12

CBIRC penalized Guangfa Bank and Pudong Development Bank and held the ex-president and chairman of the board personally liable

October 15

The *Regulations on the Administration of Foreign-invested Banks* were amended to reflect the new financial market opening-up policies

November 26 and 27

New consumer finance licenses issued: Chongqing Xiaomi Consumer Finance and Ping An Consumer Finance were approved for establishment

December 18

Hengfeng Bank announced restructuring: the bank issued 100 billion new shares by private offering, and Central Huijin subscribed for 60% of those shares

December 20

Amundi and Bank of China wealth management subsidiary was approved to set up the first foreign-controlled wealth management company

2019 Regulatory Observations

01

Banking industry continued to open up, and is now almost fully open to foreign investment

The *Regulations on the Administration of Foreign-funded Banks* were revised in October 2019, officially putting in place several measures announced earlier to open up the banking industry. The measures include removing total asset requirements for the parent companies of foreign-funded banks (which follows the regulatory direction of reducing "quantitative eligibility requirements"), allowing foreign banks and domestic non-financial institutions to establish joint ventures, allowing foreign banks to establish their subsidiaries and branches simultaneously in China, removing the limits on foreign bank shareholding in domestic Chinese banks and financial asset management companies, and providing national treatment for foreign banks in terms of the number of banks they can set up and the business permit (including RMB business) they obtain. In practice, some foreign-funded banks were approved to act as custodians for publicly offered funds and as A-class lead underwriters in the inter-bank bond market, respectively. All these measures indicate that the banking industry was as good as fully accessible to foreign participation and that foreign investment was effectively given national treatment.

02

The debut of wealth management subsidiaries of commercial banks opened a new chapter for banks' asset management business, and a "two-pillar" regulatory structure was formally set up under which the CBIRC and the CSRC separately regulate publicly-offered and privately-offered asset management markets

Since the *Administrative Measures on Wealth Management Subsidiaries of Commercial Banks* were issued in December 2018, nine wealth management subsidiaries of commercial banks have started operations, and the first foreign-owned wealth management company (jointly held by Amundi and Bank of China wealth management subsidiary) was approved at the end of 2019. With the issuance of the *Administration Measures on Net Capital of Wealth Management Subsidiaries of Commercial Banks (Trial)*, a regulatory regime governing wealth management subsidiaries of commercial banks started to take shape and set the foundation for the development of the market. New policies for the wealth management of commercial bank subsidiaries include issuing publicly-offered products with a minimum investment requirement of RMB1, investing directly in the secondary securities market, and issuing both publicly-offered and privately-offered products on the same platform. These policies would enable wealth management subsidiaries to compete on a level playing field for wealth management business with other asset management service providers such as securities companies (and their subsidiaries) and fund management companies (and their subsidiaries). Added to this, commercial bank subsidiaries have the advantages of existing network and clients. These factors combined to give commercial bank subsidiaries an edge over their competitors.

This confirms the CBIRC's role in regulating the publicly-offered products issued by financial institutions in the banking sector and therefore a "two-pillar" regulatory structure under which the CBRIC and the CSRC separately regulate publicly-offered and privately-offered asset management markets. Allowing foreign investment to invest in the wealth management subsidiaries of commercial banks and allowing foreign investors to control wealth management joint ventures to be established between wealth management subsidiaries of commercial banks and foreign investors will also enable foreign investors to access the domestic asset management market through a new high-value platform.

03

Regulators sought to stop "mandatory repayments"

After the *Guiding Opinions on Regulating the Asset Management Business of Financial Institutions* set the basic rules for breaking "mandatory repayment", the regulatory requirement was implemented in full for the banking industry in 2019. Also, in 2019, the takeover of Baoshang Bank was completed with inter-bank debts being discounted for disposal and thus the "mandatory repayment" in the inter-bank business was broken. Wealth management subsidiaries of banks were opened, "shadow bank" business was moved off-balance sheet, and the banking industry's wealth management business was separated completely from credit provision. In addition, the CBIRC publicly stated that the wealth management services provided by commercial banks and their wealth management subsidiaries were built on a trust relationship with the clients. All these indicate that the "mandatory repayment" in wealth management business in the banking industry was broken. On top of this, the *Minutes of the National Courts' Ninth Civil and Commercial Trial Work Conference specifically* made invalid terms providing for minimum guaranteed returns or mandatory repayments provided by trust companies, commercial banks and other financial institutions in asset management.

Thus, the "mandatory repayment" in the inter-bank business and in the assets management business, respectively, was stopped. Further, the structural deposit products that have substituted for principal-guaranteed and return-guaranteed products were subject to harsher regulatory scrutiny in 2019. "Fake structural deposits" with no genuine embedded derivatives products were prohibited even if issued by qualified banks. This prohibition will reduce the number of "deposit products" that solicit customers with guaranteed returns and high interest rates, and is consistent with the intention of stopping the practice of "mandatory repayment".

04

Banking continued to be strictly regulated, with maximum punishment and imposition of responsibilities on head offices and individuals becoming new features

The CBIRC again exercised a policy of strict regulation in 2019. In the first three quarters, the total fines and confiscations of illegal gains from banking institutions amounted to CNY680 million. Enforcement mainly focused on shadow banking, inter-bank business, provision of guarantees and lending in violation of rules, especially in real estate lending. Under the accountability system, in the first three quarters, 1,223 people were punished, 62 of whom were disqualified from holding senior management positions, and 37 were subject to the maximum punishment of a lifetime ban on working in banking. In respect of the violation in lending by Pudong Development Bank's and Guangfa Bank's branches in 2017 and 2018, severe punishments were imposed on each bank's chairman of the board and its senior executives in its head office in October 2019. Each bank eventually replaced its board chairman and president.

05

Capital replenishment channels were broadened for banks and establishment of a long term mechanism for banks' capital replenishment was accelerated

In December 2018, the Financial Stability and Development Commission of the State Council announced that it would support commercial banks in replenishing capital through multiple channels. This policy led to substantial breakthroughs in perpetual bonds and preferred shares in 2019. It took less than a year from the preliminary framework set-up for perpetual bonds at the beginning of 2019 to its normalization - 15 banks of different types have in total issued more than CNY500 billion in perpetual bonds. Regulators also lowered the threshold for insurance funds investing in perpetual bonds and strengthened the financing capability of perpetual bonds (e.g., the PBOC announced the establishment of the Central Bank Bill Swap (CBS) enabling primary dealers on the open market to exchange their perpetual bonds for central bank bills). In addition, the regulators removed the requirement that only the banks listed on A-share exchanges or the new third board may issue preferred shares. This would facilitate small and medium-sized banks to supplement their tier-one capital by issuing perpetual bonds. Expanding capital replenishment channels available to banks constitutes an important part of the measures for "accelerating development for risk prevention" and is critical for the reform, development and risk prevention of small and medium-sized banks.

06

Disposal of at-risk banks happened through a combination of policy rescue and market measures

In the first half of 2019, the PBOC and the CBIRC jointly announced the takeover of Baoshang Bank, which was later entrusted to China Construction Bank. The takeover was the first of its kind in the past 20 years. During the takeover, the regulators applied a partial discount to the external inter-bank debts of Baoshang Bank on a case-by-case basis, which broke "mandatory repayment" in the interbank business and thus caused market shock to some extent (see 03, above). In the second half of 2019, Hengfeng Bank issued 100 billion shares by a private offering. This took the form of capital raising on the market but, in fact, approximately 60% of the shares were subscribed by Central Huijin Investment Company, which invests in critical central financial institutions on behalf of the state, and over 30% of the shares were subscribed by local state-owned enterprises.

These two cases are typical cases on the disposal of at-risk banks in recent years where the regulators have used both administrative measures and market-based mechanisms to dispose of at-risk financial institutions. Under the premise of maintaining stability in the financial sector while conducting these disposals, market participants, mainly participants in the inter-bank market, were required to bear part of the risk, and local governments were required to actively participate in defusing the relevant risks. The cases also serve as an exploratory basis for the future establishment of a bankruptcy system for financial institutions.

07

The CBIRC started to grant key financial licenses as a norm and support the establishment of more privately owned banks and consumer finance companies

In February 2019, the CBIRC proposed promoting the normal development of privately-owned banks by granting a license to any applicant which has met all the eligibility requirements. Shortly thereafter, the CBIRC approved the establishment of two privately-owned banks, Jiangxi Yumin Bank and Xishang Bank. Jiangxi Yumin Bank opened for business at the end of 2019 and became the 18th private bank. Xiaomi and Ping An were approved in 2019 to become the 28th and 29th domestic consumer finance companies.

After no new licenses were issued in 2017 and 2018 for privately-owned banks and consumer finance companies, the new licenses issued in 2019 further reflect the support of the regulators of the financial service providers which have clear development goals and positioning and compliant operations.

08

Regulatory regime governing commercial factoring, pawn brokerage and financial leasing was proactively promoted with regulatory responsibilities between central and local authorities being divided and cooperation being improved

The CBIRC has been empowered to be responsible for formulating regulatory rules governing six types of institutions that were previously regulated by the Ministry of Commerce. These institutions include those doing commercial factoring, pawn brokerage and financial leasing. In performing these responsibilities, the CBIRC promulgated the *Circular on Strengthening the Supervision and Administration over Commercial Factoring Enterprises* in 2019, which prescribes the regulatory guidelines for commercial factoring and the uniform national business operation rules and industry-specific administration requirements. The circular provides that the day-to-day supervision of these institutions rests on the local financial service bureaus. This filled a gap in the national regulations on commercial factoring, and we expect that the same approach will be adopted in the pawn brokerage industry and the financial leasing industry where uniform national rules are lacking. In the meantime, uniform national rules have been in existence to govern three other industries, covering: financial guarantees, small loans, and local asset management. In addition, the CBIRC was contemplating a new administrative licensing system for industries such as financial leasing and commercial factoring and how to supplement those uniform national rules with industry-specific regulatory provisions, such as in financial guarantee. The CBIRC was also striving to accelerate the promulgation of the *Regulations on Non-deposit-taking Lending Organizations* and other higher-level laws. Finally, the CBIRC was working on improving risk monitoring indicators and categorized regulation, and applying differentiated regulation of the relevant institutions. The regulatory regime governing the division of responsibilities and cooperation between central and local authorities, with the CBIRC being in charge of making regulatory rules and local financial services bureaus being in charge of day-to-day supervision is gradually being improved.

2020 Regulatory Outlook

01

The opening-up may lead to market restructuring and bring new challenges for regulation

Throughout 2019, we saw unexpectedly far-reaching and fast-moving changes in China's opening-up of its financial markets. As a result, in 2020, foreign investors are expected to increase their investments in the banking industry by investing in or controlling domestic banks, setting up joint venture banks with domestic non-financial institutions, setting up or controlling joint venture wealth management companies in the banking industry, or even acquiring financial holding companies. This expanded investment and business access for foreign banks, coupled with the series of policies recently issued by the CBIRC on guiding and encouraging foreign-funded banks to cooperate with their overseas parent banks in helping Chinese enterprises "go global", as well as the opening-up of other financial industries to foreign institutions, will allow foreign-funded financial institutions to leverage their group's integrated advantages and share such advantages and resources between onshore and offshore affiliates, and may also lead to restructuring and mergers and acquisitions in the domestic banking industry. In connection with this development, many new regulatory issues may arise, such as cross-border and cross-industry regulatory issues, potential competition in the same industry and related-party transactions.

02

Banking and non-banking financial institutions will be encouraged to differentiate their development based on their core business

According to the *CBIRC Guiding Opinions on Promoting the High-quality Development of the Banking and Insurance Sectors* issued in late 2019, regulatory authorities are aiming within the next five to six years to "form a multi-level, wide-coverage and differentiated banking and insurance system", "form a financial products system with significantly enhanced ability to develop personalized, differentiated and customized products" and "further improve and perfect the credit market, insurance market, trust market, financial leasing market and non-performing asset market". The guiding opinions also contained suggestions on the positioning and differentiated development for medium and large banks, small and medium-sized banks, foreign-funded banks and non-banking financial institutions. In 2020, we can expect more regulatory support will be granted to, and new opportunities for, all types of banking institutions targeted at their development needs based on their core business areas. Such development needs could be in the form of innovative new organizational structures, product design, business and operational models, science and technology applications, and incentive mechanisms.

03

Strict regulation will become the new norm, while the regulatory focus will be on defusing risks in the banking system

Strict in-process and ex-post regulation are necessary for market-oriented regulation. This, together with the shift from institution-based regulation to function - and conduct-based regulation, means that the banking industry is more likely to face investigations or sanctions from multiple governmental and regulatory authorities. For example, the Cyberspace Administration of China and the public security bureau both have the power to regulate data and personal privacy. In 2020, we expect strict regulation to become the norm. We also expect regulations directly targeting core risk control and compliance issues to be more diverse and effective. Furthermore, we don't expect the regulation of shadow banking to be relaxed, while the regulation of inter-bank businesses will be increasingly tightened. Finally, we expect the policies to "break mandatory repayment" to be strictly implemented.

In addition, according to regulatory stress tests and thorough examinations, among the 4,588 banks in China, more than 600 small and medium-sized banks are at high risk. It is reported that the regulators have plans to deal with these high-risk small and medium-sized banks. The overall plan is to: (1) intervene with banks with lower risks as soon as possible by introducing corrective programs to defuse risks; and (2) eliminate the crisis in banks with higher risks through such means as self-help within a prescribed time period, timely capital replenishment and reduction in non-performing assets, complemented by such ways as holding senior management in charge accountable, capital increases and reorganization, and assessing whether to save or dissolve such banks on a case-by-case basis depending on its systemic importance. In 2020, it is expected that the regulators will more regularly and more leisurely dispose of the risks in small and medium-sized banks. Separately, the drafting of the Bank Bankruptcy Law is also on the agenda of the regulators.

04

New policies to regulate financial derivatives are expected

We expect that banks and financial institutions will expand their scope of use of and size of financial derivatives for a number of reasons. First, interest rate risks increased after the reform of the LPR mechanism, and thus banks and financial institutions will be seeking to reduce this interest rate risk by using interest rate derivatives. Second, as structural deposits increase in size and face stricter regulation, financial institutions are using derivatives to hedge the risks associated with those structural deposits. Finally, with the financial sector opening up, there is higher demand and stronger investment capability for derivatives among foreign institutions. In light of this and given the lack of systemic regulatory rules covering financial derivatives, we expect that a number of new policies will be introduced to fill the gaps in the current derivatives regulatory regime.

05

Financial consumer protections will continue to be tightened

The "CCB fund distribution case" set a precedent that banks are fully liable to investors for their losses due to their failure to fulfill their duties to sell products to "suitable investors" in their distribution of financial products. In addition, the *Minutes of the National Courts' Ninth Civil and Commercial Trial Work Conference* established the principle that caveat emptor should be based on "sellers having fulfilled all their duties owed to the buyers", and according to the PBOC's consultation draft for the Implementation Measures for the Protection of Financial Consumers Rights, financial consumers should soon be provided with more comprehensive protection in such areas as financial institutions' conduct, information protection, and dispute resolution. In addition, the Notice on Further Regulating Financial Promotions further unifies the supervision standards over financial products' promotions by various institutions to further protect the interests of financial consumers. In 2020, we foresee that the regulatory authorities will more closely scrutinize commercial banks to ensure they fulfill their investor suitability duties in issuing and distributing products, establish the right process and procedures and retain the relevant records. Moreover, the regulatory authorities will also likely increase the frequency and severity of regulatory sanctions against those in breach of violations.

PRC Financial Regulation: Annual Report (2020) Securities

2019 Key Dates

February

AIA Beijing Branch was approved to participate in the pilot program for integrated operations in Beijing-Tianjin-Hebei region

March 13

The CSRC approved the establishment of Nomura Orient International Securities Co., Ltd. and J.P. Morgan Securities (China) Company Limited

June 1

The *Measures for the Administration of Information Technology Management of Securities Fund Trading Institutions came* into effect

June 4

The amended *Measures for the Supervision and Administration of Futures Companies* was promulgated

June 13

Shanghai Stock Exchange Science and Technology Innovation Board (STAR Market) began its trading, and piloted the IPO registration system

June 17

Shanghai-London Stock Connect was officially launched

July 5

The CSRC issued the *Provisions on the Administration of Equities of Securities Companies*

September 10

The SAFE removed QFII and RQFII investment quota

October 11

The CSRC specified the time point at which foreign shareholding limit for securities companies, fund management companies, and futures companies would be lifted

November 15

The CSRC revoked all business licenses of CEFC Shanghai Securities Co

Nov – Dec

Nomura Orient International Securities Co., Ltd. and J.P. Morgan Securities (China) Company Limited obtained securities business permits, becoming the first two newly established joint venture securities companies to obtain such permits after the foreign investor's shareholding limit was raised to 51%

December 28

The amended *Securities Law* was adopted

2019 Regulatory Observations

01

The amended Securities Law was adopted, signaling the philosophies and future direction of securities regulation

The amended *Securities Law*, after more than four years and undergoing four readings, was adopted at the 15th Session of the Standing Committee of the 13th National People's Congress on December 28, 2019. The amended *Securities Law* modified the current securities regulatory system in many aspects, such as the structure, concepts, principles and core of securities regulation. Notable changes include: (1) expanding the scope of securities to asset management products, reflecting the transition of financial regulation from purely institution-based regulation to the combination of function-based regulation, conduct-based regulation and institution-based regulation; (2) strengthening interim regulation (e.g. the establishment of an -extensive information disclosure system) and ex-post regulation (e.g. substantially increasing penalty amounts and expanded regulatory scope) and relaxing ex-ante regulation (e.g. the introduction of the IPO registration system), as opposed to the previous heavy reliance on ex-ante regulation; and (3) improving investor protection through the introduction of innovative systems such as "class action".

At the same time, the amended *Securities Law* grants more regulatory power to the securities regulatory authorities. This will give the judiciary more room to make decisions based on the departmental rules of the securities regulatory authorities. In addition, the introduction of the extraterritorial jurisdiction principle makes statutory preparations for the Chinese regulatory authorities to regulate certain overseas securities issuance and trading.

02

Regulatory environment becomes more market-oriented

The registration system for the initial public offerings made by companies on the STAR market launched on June 13, 2019, marking the official introduction of the registration system for the public offerings of securities that the industry has been waiting for years. The revised *Administrative Measures on Significant Asset Restructuring of Listed Companies*, which took effect on October 18, 2019, further adapts the regulatory environment to the market, removing the 'net profit' indicator in the criteria for approving listing by way of restructuring, resuming the provision of financing support for listing by way of restructuring, and allowing the relevant assets of high-tech industries and strategic emerging industries that meet the national strategy to be restructured and listed on the Growth Enterprise Board.

On November 15, 2019, the CSRC made an administrative decision to revoke all business licenses and permits of Huaxin Securities, to conduct the administrative liquidation and entrustment of Huaxin Securities, and to bring the remaining assets and liabilities of Huaxin Securities into Huaxin Group to be disposed of as part of the group assets and liabilities. In this way, it took an important step in defusing the risk of securities companies by using a market approach. In terms of regulatory enforcement, the introduction of the system of administrative settlement and the announcement of the first administrative settlement case tested the water for introducing market-oriented approach in regulatory enforcement, which should help achieve more efficiency in regulatory enforcement.

03

CSRC aimed to promote more competition in the securities and futures industries at the same time as imposing more restrictions on shareholders and equities

While approving the establishment of Nomura Orient International Securities Co., Ltd. and J.P. Morgan Securities (China) Company Limited, and accepting applications for establishment or increase in capital of several securities joint ventures, the CSRC announced that it would restart the examination and approval of the establishment of domestic securities companies after 12 years and to accept applications from foreign investors to invest in futures companies after several years. Obviously, the regulatory authorities intend to introduce more high-quality shareholders and market players into the market and to promote full competition in the securities and futures industries.

Meanwhile, the *Administrative Provisions on Equities of Securities Companies* issued by the CSRC on July 5, 2019 put forward more stringent requirements for the shareholders, especially the controlling shareholders, of securities companies in terms of qualifications and equity management. For example, a new requirement is added that the main shareholders of a securities company shall have good financial status, appropriate asset liability and leverage levels, and shall have the capacity to increase capital of the securities company to match its business. In addition, the new regulation also imposed restrictions on shareholders of securities companies topledge their equity. On June 4, 2019, the CSRC issued the revised *Administrative Measures on Supervision of Futures Companies*, which imposes more strict qualification requirements for the major shareholders and controlling shareholders of futures companies, strengthens the management of shareholders of futures companies and tightens the examination and approval of shareholder qualifications.

04

A differentiated management system was introduced and the principle of tiered regulation was specified for securities companies

The *Administrative Provisions on Equities of Securities Companies* officially put forward the policies of tiered and differentiated regulation of securities companies further to the implementation of a rating system and different regulatory polies for securities companies. Securities companies will be divided into specialized securities companies and comprehensive securities companies. The main businesses of specialized securities companies are regular intermediary services, i.e. not involving large liabilities and large capital intermediary services and the risk of externality being low, ad including services such as securities brokerage, securities investment advisory, financial advisory, securities underwriting and sponsoring, and securities proprietary trading. The main businesses of comprehensive securities companies include market-making of stock options, OTC derivatives, stock pledge repurchase and other complex business, in addition to traditional securities businesses, involving significant leverage and cross-risks between various businesses. The two different types of securities companies will be subject to different requirements in terms of shareholder qualifications and scope of business, among others. In particular, there will be higher qualification requirements for the main and controlling shareholders of comprehensive securities companies. The specific differentiation methods, conversion between different types, and differentiated business policies and capital policies of different types of securities companies are subject to further interpretation or issuance of the corresponding implementation rules by the competent authorities.

05

The integrity of the capital market was emphasized and credit-based regulation was promoted

Integrity has increasingly become an important foundation of the capital market, and credit-based regulation has also played an important role. With the *Measures for the Supervision and Administration of Integrity of Securities and Futures Markets* coming into force on July 1, 2018, the regulators stepped up their efforts in 2019 to investigate into, and punish instances of, bad credit, imposing heavier punishments. The CSRC worked closely with the NDRC, the Civil Aviation Administration of China, the China Railway Group and other regulators to restrict dishonest individuals. As a result, the CSRC publicized a total of 191 seriously dishonest individuals.

Different departments of the CSRC took 151 actions against high-risk and dishonest market players in 2019. As a result of comparisons made by batches between the integrity database and more than 10,000 listed companies and nearly 239,000 practitioners, 157 dishonest entities/persons were found through screening. 545 dishonest private equity institutions were put on public notice for dishonesty.

The CSRC also built integrity into daily regulation. In 2019, the CSRC paid special attention to the credit records of applicants during the process of examination and approval of shareholders' qualifications, being significantly stricter in the requirement of supporting documents. In 2019, the CSRC provided 13 batches of verification services for the selection of members of the STAR Listing Committee, and provided 184 batches of special inquiry services for the listing of enterprises on STAR. By the end of November 2019, departments (agencies) of the CSRC had asked for credit information in more than 39,000 batches in their review of administrative licensing, classified inspection and law enforcement, and risk monitoring. Meanwhile, the CSRC actively urged securities and fund operating institutions to establish integrity management systems and verify the credit of clients in their business.

06

Securities and futures business opened up to more foreign capital and restrictions on cross-border securities transactions were largely relaxed

In 2019, China accelerated the pace of opening-up in the securities and futures industry, which is mainly reflected in commercial presence and cross-border transactions. On July 20, 2019, the Financial Stability and Development Commission promulgated the *Relevant Measures for Further Opening-up of the Financial Industry*, putting forward 11 measures for the opening-up of the financial services sector, bringing forward the date to lift restrictions on the foreign equity ratio of securities companies, fund management companies and futures companies from 2021 to 2020.

As the follow-up to such policy, on October 11, 2019, the CSRC clarified the specific times to lift the restrictions on the foreign equity ratio as follows: the restrictions on the foreign equity ratio of futures companies would be lifted on January 1, 2020; the restrictions on the foreign equity ratio of fund management companies would be lifted on April 1, 2020; and the restrictions on the foreign equity ratio of securities companies would be lifted on December 1, 2020. At present, Nomura Orient International Securities Co., Ltd. and J.P. Morgan Securities (China) Company Limited have already obtained licenses/permits to operate a securities business, and many joint venture securities companies, including Credit Suisse, Daiwa Securities and DBS Bank, are applying to set up or to increase capital.

The Shanghai-London Stock Connect was officially launched on June 17, 2019, starting the interconnection between the Shanghai Stock Exchange and the London Stock Exchange. Domestic Chinese enterprises may list on the London Stock Exchange through issuing global depositary receipts (GDRs), and enterprises listed on the London Stock Exchange may list on Shanghai Stock Exchange by issuing Chinese depositary receipts (CDRs). With respect to cross-border investment in domestic markets, SAFE has canceled the restrictions on investment for QFIIs and RQFIIs, and introduced the draft of the new QFII policy to give foreign institutions more scope in terms of eligible investors and permissible products in which to invest, among others. While broadening the channels and scope of permissible products for foreign capital, foreign institutions were allowed to enter into more types of derivatives transactions, to help manage the risks generated from cross-border transactions.

07

Insider trading and intermediary institutions were the focus of regulatory actions

In 2019, the CSRC and its local bureaus continued to keep the pressure on those found to be in violation of securities laws and regulations. Sanctions for more than 300 cases were imposed during the year, with insider trading being the main target of regulatory actions and accounting for about 40% of the total.

Regulatory actions also focused on intermediary institutions. In 2019, the CSRC imposed sanctions on four securities companies. The most severe sanction was imposed on Shanghai Huaxin Securities Co., Ltd., which had its business license revoked after it had been found to provide financing to its shareholders in violation of the relevant laws and regulations; and the other three securities companies were punished because of their failure to act diligently and responsibly as financial advisors/underwriters.

On June 28, 2019, in order to further punish violations in the securities and futures markets, the Supreme Court and the Supreme Procuratorate promulgated the *Interpretations of the Supreme People's Court and the Supreme People's Procuratorate on Several Issues concerning the Application of Law in Handling Criminal Cases of Manipulation of the Securities and Futures Markets and the Interpretations of the Supreme People's Court* and the Supreme People's Procuratorate on Several Issues concerning the Application of Law in Handling Criminal Cases of Transactions by Using Undisclosed Information. The CSRC also released the Provisions for "Other Activities of Manipulating Futures Price" under Item 5, Article 70 of the Administrative Regulations on Futures Transactions. Both broaden the scope of market manipulation by including new types of market manipulations (such as manipulation by false information, manipulation by scalping (i.e. manipulation by using vicious KOL to recommend shares), manipulation by using major events, manipulation by abusing information advantages, manipulation by false orders, cross-period manipulation or manipulation in spot market).

08

The first model securities case was heard, providing guidance in future investor protection cases

On November 13, 2018, the Supreme Court and the CSRC issued *Opinions on Comprehensively Promoting the Construction of a Diversified Resolution Mechanism for Securities and Futures Disputes*, proposing the establishment of a model judgment mechanism for the handling of securities and futures disputes.

On August 7, 2019, the Shanghai High Court heard China's first model case of securities disputes involving multiple investors. The final judgment rejected the appeal and upheld the original judgment. This case was selected as a model case by the *Shanghai Financial Court in accordance with the Shanghai Financial Court's Provisions on the Model for the Modeling of Securities Disputes (Trial)*. This case was one of a series of cases in which Founder Technology Corporation was alleged to have made misrepresentations to investors. The judgment finally resolved the dispute through mediation, and provided sufficient litigation expectations for litigants (investors) in parallel cases involving thousands of investors (referencing cases with common factual and legal issues with the one model case), as well as enhancing judicial efficiency. This model case mechanism, together with the new dispute resolution mechanisms stipulated in the *Securities Law* (such as class actions), will provide investors with more diversified, convenient, and predictable measures in respect of the approaches and effects of investors' protection.

2020 Regulatory Outlook

01

China broadened access of foreign capital to securities and futures business and substantially relaxed restrictions on cross-border securities transactions

2020 is a vital year for deepening capital market reforms, and various reform policies are expected to be issued and implemented. With the promulgation and implementation of the new Securities Law, based on the STAR practice in which securities issuances were examined by the Exchange and registered by the CSRC, it is expected that in 2020 the review authority by the CSRC over the public issuance of all securities will be delegated to the exchanges, the CSRC's Committee for Examining Securities Issuance will be abolished, and the role of the CSRC in securities issuance will be changed from "approval" to "registration". In addition to the STAR, the listing requirements for the SME board are also expected to be more flexible to accommodate different types of businesses.

At the same time, the information disclosure system of listed companies will be further strengthened. The main focus of supervision will be on disclosure by different entities, how well they are deemed to have met their disclosure obligations, and responsibilities of securities intermediaries.

02

The opening up of the securities market will be centered on the two-way opening of cross-border transactions

On top of allowing wholly foreign-owned futures companies and securities companies, more open policies are expected to allow foreign financial institutions to enter into China's securities market in 2020:

- The new QFII policy will be officially launched, which will grant the QFII license to more foreign institutions, and expand QFII's tradeable product range to commodities futures, wealth management products issued by financial institutions, and privately-offered products;
- "Wealth Management Connect" will officially launch in the Greater Bay Area and Hong Kong, and will also expand to regions such as Shanghai;
- Mechanisms such as those used in "Shanghai-London Stock Connect" (such as global depositary receipts (GDR) and Chinese depositary receipts (CDR)) will be established between China and more countries and regions;
- More foreign companies will be allowed to be listed on the STAR;
- More foreign-invested companies will be listed in China;
- Asset securitization products (such as asset-backed securities (ABS)) will be allowed to be issued on a cross-border basis.

Correspondingly, we expect that the supervision of domestic securities companies' cross-border transactions will also be relaxed. More domestic securities companies will be permitted to conduct overseas investments and cross-border derivatives transactions, and the pace of internationalization of domestic securities firms will also be accelerated.

03

While encouraging securities companies to grow, regulators continue to prioritize risk control and compliance management

In order to build securities companies the size of "aircraft carriers", it is expected that the regulators will allow more diversified market players to invest in securities companies when these companies need to replenish their capital. Securities companies may be allowed to issue a wider variety of products, such as preferred shares, convertible bonds and subordinated debts, as more innovation is introduced into the market. However, we believe that the regulatory authorities will continue to take a strict approach when reviewing shareholders' qualifications. In particular, they will strictly implement the shareholder eligibility requirements provided in relevant laws and regulators in respect of controlling shareholders and major shareholders of comprehensive securities companies. In addition, risk prevention and compliance will remain the focus of regulation. We expect that the classified supervision of securities companies will be enhanced in 2020, by further applying differentiated regulatory requirements in terms of the capital, business scale, personnel and IT system setup of securities companies of different categories. Following the publication of *Minutes of Forum on Nationwide Bond Disputes Trial Hearing and the Notice of Matters in Relation to Dealing with Defaults in Corporate Credit Bonds (Consultation Draft)* for public comments, the prevention and diffusion of risks and the strengthening of risk management in key areas such as stock pledges and bond defaults will be carried out at multiple levels. Meanwhile, the fact that seven securities companies have been fined for compliance failures since the end of 2019 signals more tightened regulation of compliance on securities companies in 2020, which may focus on the establishment of compliance system, compliance department staffing, compliance control, compliance responsibility and corporate governance.

04

The application of fintech in securities and futures industry will become the regulatory focus

While the two traditional industries of securities and futures are encouraged to make more use of technology to support investor services, diverse trading and security, the new Securities Law for the first time requires program trading to be regulated, and a regulatory system is expected to be in place in 2020 for regulating program trading. The *Administrative Measures for Programmatic Trading in Securities and Futures Market* or related provisions may be promulgated to give institutional recognition to program trading and to provide express parameters for use and reporting. In conjunction with this, we look forward to the formal promulgation of the *Interim Provisions on External Access Management of Trading Information System of Securities Companies (Consultation Draft)* which was issued by the CSRC on January 31, 2019. It is expected that the regulation will impose strict requirements on the external connectivity of the trading information system of securities companies both in terms of the qualification of such securities companies and the qualification of the external counterparties.

05

The CSRC will maintain tightened regulation on violations in securities industry

On January 2, 2020, the Beijing CSRC and Shanxi CSRC announced decisions of regulatory actions; on January 3, a material case of market manipulation was reported at the CSRC's first news conference of the new year. The occurrence of several events at the beginning of the new year may set the tone of tightened regulation in 2020. In conjunction with the newly-revised Securities Law and the judicial interpretations on securities and futures manipulation and insider trading issued by the Supreme Court and the Supreme Procuratorate, respectively, it is expected that the CSRC's law enforcement will focus on market manipulation and continue to crack down on insider trading in 2020. In addition, with the implementation of the pilot registration-based IPO regime, information disclosure of listed companies and due diligence duties of intermediaries will also become the focus of law enforcement. We believe that the severity of sanctions to be imposed against violations, especially the level of monetary penalties, will be significantly enhanced after the Securities Law becomes formally implemented on March 1, 2020. This trend in the severity of regulatory punishment has been revealed in the disclosed regulatory action early this year - the CSRC stopped Chinalin Securities (华林证券) from increasing its business size across all business lines for its compliance defects, an action which is more severe than those taken in the past. In the meantime, the judiciary and the investor protection institution will more actively and widely invoke the "class action system" and the "model case and parallel case hearing system" to protect investors when making civil claims, and thereby increase the cost of violating securities laws and regulations and the severity of penalty severity for such violations. In addition, based on the success achieved in applying the pilot scheme in 2019, we expect that the CSRC will use the administrative settlement mechanism in a wider range in 2020 to deal with violations of securities laws and regulations.

PRC Financial Regulation: Annual Report (2020) Asset Management

2019 Key Dates

February 22

The CSRC published the *Measures for the Supervision and Administration of Sales Agencies for Publicly-offered Securities Investment Fund (Consultation Draft)*. Under the measures, independent fund distribution institutions would be regulated as licensed securities and futures business institutions

March 18

The China Banking Association (CBA) published the *Guidelines on Asset Custody Services of Commercial Banks*. Once again, there was passionate discussion concerning the extent of the custodian's responsibility

May 22

The first batch of wealth management subsidiaries ("WMS") of commercial banks opened for business

June 3

The CSRC updated the *Guidelines on the Examination and Approval of Fund of Funds (FOF) (Publicly-offered)*, encouraging the development of FOF as well as strengthening regulation

July 20

The Financial Stability and Development Commission announced 11 new policies to open up the financial sector, encouraging foreign institutions to engage in onshore wealth management and asset management businesses

October 12

The PBOC published the *Recognition Rules on the Standardized Debt Assets (Consultation Draft)*, confirming the criteria for "non-standard assets" in asset management

October 25

Five public fund institutions were approved to conduct consulting business for investment in mutual funds on a pilot basis. The asset management sector is gradually entering the buyer-side investment advisory era

November 8

The Supreme People's Court issued the *Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work*, addressing important legal issues in the asset management sector, such as the effectiveness of guaranteed returns and the obligations regarding *caveat venditor*. (In a related event, on August 7, China Construction Bank (CCB) was ordered to compensate investors for all losses suffered resulting from the sale of fund products where the bank had failed to fulfil obligations to check the suitability of investors.)

December 6

The CSRC published the *Interim Guidelines for Manager of Managers (MOM) Products of Securities and Futures Business Institutions*, providing channels for professional cooperation between different managers

December 20

The first foreign-controlled wealth management company (the joint venture company between Amundi Asset Management and the WMS of Bank of China) received approval for establishment in Shanghai

December 23

The AMAC updated the *Instructions for the Filing of Privately-offered Investment Funds*, which are the comprehensive operational guidelines for the filing of private funds

December 25

The PBOC, the CBIRC, the CSRC and the SAFE jointly published the *Notice on Further Regulating Financial Marketing and Promotional Activities*

2019 Regulatory Observations

01

The Assets Management New Rules were being fully implemented, a comprehensive regulatory regime over assets management industry was being established centering the Assets Management New Rules; institution-based regulation and function-based regulation have advanced, complementing each other, and a "two-pillar" regulatory regime has been formally established under which the CBIRC and the CSRC separately regulate the asset management market.

To implement the principles in the *Assets Management New Rules*, the CBIRC and the CSRC (as well as the AMAC) issued or implemented several rules and measures in 2019. These rules and measures have perfected the regulatory regime established by the *Assets Management New Rules*.

- The WMSs of nine commercial banks opened for business in 2019. More WMSs and one Sino-foreign wealth management joint venture established by such WMS were also approved.
- The CBIRC and the PBOC sought public opinion on the *Circular of Matters Related to the Regulation of the Management of Cash Management Products*, following which they refined the rules governing cash management products.
- Securities companies were requested to remove any "channel business" (under which one financial institution acts as conduit for making investments by asset management products managed by another financial institutions) that they were doing. "Red East VII" indicated that "big collective products (大集合)" launched by securities companies and worth more than CNY700 billion were to be made available for the public to buy.
- The AMAC has updated the *Introductions for the Filing of Privately-offered Investment Funds*, reiterating the idea that private funds "are not subject to licensing requirement(s) but cannot be unregulated".
- The CBIRC sought opinions from the industry on the *Administrative Measures for Cash Trust of Trust Companies* and from the public on the *Interim Measures for Insurance Assets Management Products*.

With the above rules and practices, a "two-pillar" regulatory regime under which the CBIRC and the CSRC separately regulate the asset management market was formally established. This was confirmed by the fact that WMSs of commercial banks now enjoy regulatory treatment that is equal to, or more preferential than, that governing mutual fund management companies.

Function-based regulation still applies in many cases. These regulations still classify asset management products by how they are publicly or privately offered rather than according to the launching institution. This new classification system follows the principle established in the *Assets Management New Rules*, including, for example, which institutions meet the standards to become qualified investors. Added to that, invested assets will need to meet the criteria set out in the *Rules of Validating Standardized Debts Related Assets*, currently in draft form for consultation, to be published by the PBOC. The amended *Securities Law* in late 2019 classified asset management products as "securities", to be subject to the unified regulatory scheme now governing securities. The amended *Securities Law* will make function-based regulation at the level of law (instead of merely at the level of administrative regulations, which rank under the law in the legal framework of China).

02

The regulatory and judicial authorities shared the view that asset managers had a relationship with clients based on trust, according to which managers owed fiduciary duties to clients; however, it remained unclear the extent of custodians' responsibilities.

Historically, it was generally understood that only businesses conducted by trust companies and mutual funds were based on a trust relationship with clients. This understanding was later extended to private fund business and asset management businesses of securities companies, both subject to the supervision of the CSRC. Although the *Assets Management New Rules* emphasized managers must be diligent and responsible, it failed to clarify specifically whether managers were trustees owing a fiduciary duty to asset management clients. In December 2018, at a press conference announcing the *Administrative Measures for Wealth Management Subsidiaries of Commercial Banks*, the CBIRC explicitly recognized that commercial banks and their subsidiaries' wealth management businesses had trust relationship. In 2019, the *Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work* also expressed inclination to acknowledge such an understanding.

In light of the above, a consensus has been reached at both the regulatory and judicial level that the legal relationship between an asset management client and the manager was one of trust. Having reached this consensus, the regulatory system now reflects the managers' fiduciary duties, including detailed provisions of the trustee's responsibilities under asset management contracts, internal governance and information disclosure requirements, and prohibitions and restrictions on related-party transactions and conflicts of interest.

However, the regulations remain unclear about the extent of a custodian's responsibilities for asset management products other than securities investment funds (including public and private funds). The issues surrounding Fuxing in 2018 (when managers of private funds launched by Fuxing group were not contactable and investors requested the custodian Shanghai Bank to take responsibility) triggered extensive discussions about the responsibilities of custodians in the assets management business. However, even after the *Guidance for Commercial Banks' Custodian Business was issued by the CBA in March 2019, and the updated Introduction for Filing of Private-offering Investment Funds* was issued by the AMAC in late 2019, the opinions of the CBA and the AMAC on custodians' responsibilities remained divided. There was no consensus about how custodians should exercise their responsibilities and if and how custodians should take over responsibility in situations where managers were incapable of carrying out their duties. Nor is there any clear determination on whether the custodians' responsibilities would differ when supervising the managers' activities in managing different products.

On 23 October 2019, the first-hearing court issued a decision in a contract dispute involving the China Aviation Industry Park Fund. According to that decision, the comprehensive custodian, Pacific Securities, was liable for 15% of investors' losses. This case further pushed the regulators and market players to seek clarification over the distinction between "custodian" and "comprehensive custodian". The case also forced the judiciary to consider whether custodians of asset management products (not investing in securities) should have joint liability with managers.

03

Regulators strengthened protections for financial consumers and emphasized *caveat venditor ("seller beware").*

In 2019, the idea to protect interests of financial consumers was fully reflected at regulatory and judiciary levels.

- The commitment to protecting financial consumers was demonstrated the *Notice on Further Regulating Financial Marketing and Advertising Activities* jointly issued by the PBOC, the CSRC, the CBIRC and the SAFE, and the *Implementing Measures for the Protection of Financial Consumer Rights and Interests (consultation draft)* published by the PBOC.

- The *Administrative Measures for the Information Disclosure of Publicly Offered Securities Investment Funds* have been revised and renamed for the first time since 2004. The revised measures were supplemented with disclosure principles, such as "timeliness", "simplicity" and "accessibility". Added to that, the *Guidelines on the Record-filing of Private Investment Funds* have also been updated. The update supplemented and strengthened the requirements for disclosing key information, such as the arrangements for fund dissolution and liquidation.

- The *Securities Law*, revised at the end of 2019, included a specific chapter titled "Investor Protection" to strengthen investor protection from both administrative and judicial perspectives. As asset management products also fell within the scope of the jurisdiction of the *Securities Law*, these provisions apply in the same way to investors who purchase asset management products.

- From the judicial perspective, as indicated by the CCB case, more stringent requirements were set on sellers of financial products. Furthermore, the *Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work* included a chapter to specify obligations of suitability and explanation of financial institutions.

Based on these regulatory and judicial actions, financial consumer protection in the asset management industry has moved beyond being a superficial slogan. The courts and regulatory authorities have imposed substantial requirements in terms of *caveat venditor*, which has raised challenges for all institutions selling to financial consumers both directly and indirectly. It is fair to say that in order to implement the general principle of *caveat emptor* ("buyer beware"), the regulatory and judicial authorities have strengthened the formulation, supervision and implementation of the standards for *caveat venditor*.

04

Regulators implemented the principle of "buyer beware" and took further steps to stop the practice of "mandatory repayment".

Various default events in 2019 posed challenges for the regulators to tackle the expectation of "mandatory repayment". Although the *Asset Management New Rules* specified that principal and investment returns of asset management products must not be guaranteed, in practice it has been difficult to balance the implementation of this principle and the stability of financial markets at a time when economic growth slowed down and there were frequent risk events.

Nonetheless, the *Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work* expressly stated that any mandatory repayment undertaking provided by a trust company, commercial bank or other financial institution in the asset management business should be invalid. The minutes showed strong judiciary support for implementing the policy, promoting instead the principle of "buyer beware". The minutes also provided a basis for the asset management sector to move away from "mandatory repayment" towards a Net Asset Value (NAV) model, ensuring transparency of risks, liabilities and value of asset management products. The courts still had a wide discretion in deciding, in invalid contracts, which among the parties should bear responsibility.

As for the banking sector's asset management business, the past year saw some significant events in moving away from mandatory repayment. Banks established WMSs, which would be completely separate from banks and move "shadow" banks to be truly off-balance sheet. In addition, the CBIRC publicly commented that the wealth management services provided by commercial banks and their WMSs created a trust relationship with the clients, which, from a regulation perspective, prevented mandatory repayment in banks' wealth management business.

05

A combination of regulatory and judicial efforts promoted the transition from passive to active asset management.

The *Assets Management New Rules* aimed to require asset management companies to return to their original purpose (that is, active management) and to require financial institutions to adopt the NAV asset management model. The rules have had the desired effect, in part, 2019 saw an increase in the number of NAV-type products in commercial banks' wealth management business. There was also a notable lessening of the passive management ("channel") business of securities companies.

In addition, the CBIRC, the CSRC and other regulatory bodies issued guidance about product valuation. In terms of public funds, it has been proposed to include "side pocket" investments (a practice adopted by some asset management funds to book illiquid and highly risky assets separate from other investments) in the overall valuations of asset management funds.

The *Minutes of the National Courts' Ninth Conference on Civil and Commercial Trial Work* stated that "illegal channel business" conducted during the "transition period" of asset management contracts should not be deemed invalid in the absence of other factors which might invalidate the contracts. Such opinion implied that the courts might hold "illegal channel business" invalid after the "transition period". Also, the minutes distinguished between active management and passive management, indicating that different standards for determining fiduciary duties for different types of asset management business may be adopted.

06

Regulators went to great lengths to encourage greater professionalism in the asset management sector.

Since the implementation of the regulations on WMSs of commercial banks, many commercial banks with WMSs have transferred existing wealth management businesses to these subsidiaries. These transfers are part of a trend for parent banks to focus on lending and to have their WMS specialize in wealth management. Added to this, some WMSs have set up subsidiaries focusing on asset management, separate from WMSs focusing on wealth management.

Since the *Guidelines for Manager of Manager (MOM) Products of Securities and Futures Business Institutions (Trial)* were implemented, managers (i.e. parent managers) of both public funds and asset management schemes launched by securities firms have been permitted to entrust management of assets to multiple Investment advisors (i.e., sub-managers). In this way, parent managers can efficiently manage assets by entrusting different asset classes to different sub-managers. By the end of December 2019, several MOM products had been registered with the CSRC.

The first batch of private asset allocation managers completed their registrations with the SAC. Private asset funds were mainly in the form of FOFs, which had a broad range of underlying investment assets. The existence of private asset allocation managers also expanded the range of private fund managers.

The era of "buyer-side" investment advisory services relating to public funds commenced with several fund management companies and independent fund distribution companies being granted pilot business permits. The buyer-side investment advisory service thus separated fund distribution and investment advisory services. This separation not only settled the conflict of interest for fund distributors but also promoted the specialization of different services.

In sum, the asset management sector has adopted a more precise regulatory approach, and this helped create specialization and intra-sector cooperation, as well as improving efficiency generally.

07

The asset management sector fully opened up.

The opening-up of the asset management sector in 2019 went further than ever before, as exemplified by:

- Foreign investors were permitted to hold more than 25% of insurance asset management companies. This change followed the removal of restrictions on the shareholding percentage in the Big 4 AMCs and trust companies.

- The timetable was brought forward by one year to 2020 from 2021 for removing the foreign ownership cap on securities companies, fund management companies (FMC), and futures companies.

- Nomura established a Nomura-controlled securities company to engage in asset management. Meanwhile, Morgan Stanley and JP Morgan have applied to acquire a certain percentage of shares in their FMCs, by which the Morgan Stanley FMC and the JP Morgan FMC would become the first foreign-invested FMC in which the foreign shareholder would hold interest higher than the biggest Chinese shareholder and the first majority foreign-controlled FMC, respectively, upon approval.

- Foreign asset management companies were allowed to partner with subsidiaries of domestic banks or insurance companies to set up foreign-controlled wealth management companies. One example would be the joint venture between Amundi Asset Management and the WMS of Bank of China, which has been approved for establishment in Shanghai.

- Lubrizol and Fullerton became the first PFMs to obtain private investment advisory licenses in early 2019, while Qingdao Yitsai became the first wholly-owned subsidiary of a foreign bank to obtain an independent fund distribution license.

- The CSRC intended to further expand investment by QFII/RQFII in domestic products, including commodity futures and private equity funds.

- The concept of "Wealth Management Connect" for the Guangdong-Hong Kong-Macao Greater Bay Area was proposed and discussed, which may allow mainland individuals to purchase Hong Kong wealth management products through onshore institutions, and vice-versa.

With the growth in demand among Chinese citizens for asset management services and with the overall trend in more active asset management, foreign capital would focus on and seek opportunities in China's asset management industry. However, as things stand, it will still be difficult for foreign investors to choose between multiple domestic asset management platforms and arrange intra-group resource sharing both domestically and with overseas headquarters.

08

Regulators strengthened sanctions against those businesses failing to comply.

There was more enforcement in 2019, with a focus on asset management companies. Taking trust companies and securities asset management companies as examples:

- In the trust sector, 29 trust companies received 42 fines in 2019, amounting to close to CNY200million. The number and amounts of fines increased compared to the previous year. Of those companies fined for breaches, the investigations and punishments targeted real estate and trust-insurance channel businesses, post-lending management, and information disclosure.

- As for asset management by securities companies, the CSRC suspended the securities business license of one securities company for six months, and found others in breach of regulations covering a wide array of offenses, including information disclosure delays, non-compliant sales, the omission of mandatory contract provisions, excessive investment ratios, inadequate internal controls, guaranteed returns, and violation of Chinese Wall rules.

2020 Regulatory Outlook

01

It is not clear whether there will be significant changes in the top-level system design and regulatory framework covering asset management.

Since 2018, the *Assets Management New Rules* and supporting measures have proposed a series of measures to revert asset management to the way it was originally intended to operate. Those measures include: removing "channel business", prohibiting mandatory repayment, and clarifying the legal relationship in asset management business between managers and investors.

However, many questions remain about how regulators will promote the long-term development of the market. How can institution-based regulation and function-based regulation be effectively integrated? How can day-to-day asset management activities be more closely regulated? How will the specific Securities Law provisions on securities issuance, trading and investor protection be applied to asset management? Should the regulatory regime established by the Assets Management New Rules be updated?

The WMSs of commercial banks under the CBIRC's regulation enjoy preferential policies similar to public funds. Those preferential policies touch on product investment scope, fundraising methods, and other aspects. However, at the same time, these WMSs operate under a much looser code of conduct and with fewer restrictions. This has raised questions as to whether it would lead to inconsistent regulations again, and how the implementation of function-based regulation will be impacted. We expect that the legislative calendar will soon contain plans for a refined and unified regulatory regime, making reference to foreign regulations on collective asset management products, under which all market players have one asset management regulatory regime, which they manage. In addition, regulators will likely further clarify the distinction between asset management and wealth management, and promote professional services.

02

Regulators may, from a macro-economic viewpoint, extend the transition period for existing products under the Assets Management New Rules, allowing new and old products as well as new and existing asset management methodology to coexist for an extended period, which will create opportunities in the non-performing asset management business.

The Assets Management New Rules provide a transition period until the end of 2020 for existing asset management products to be corrected or replaced with new products to comply with the provisions of the Assets Management New Rules. After the transition period, financial institutions may not issue or manage any asset management product in violation of the *Assets Management New Rules*.

However, as of the end of 2019, the correction of existing products is behind schedule. Specifically, commercial banks, who (among all types of asset managers) have the largest amounts of existing asset management products, most of which are invested in non-standard assets, have corrected only about one-quarter of them by the end of 2019. Thus, it is likely that the full-scale correction will not be completed by the end of 2020.

In response, regulators have indicated that they may extend the transition period, potentially by three years, for individual banks on a case-by-case basis. It is unclear whether all banks will be treated equally and whether other financial institutions will be treated similarly. It is also unclear what actions will be taken to substantially remove existing products that do not comply with the Assets Management New Rules, especially those products investing in non-standard assets. Any radical acceleration in their reduction could lead to pressure for assets disposal or for transferring assets back to financial institutions' balance sheets. Also, there is potential issue as to whether investors should be repaid on the basis of the rate of return they had expected to make on their investments or on the likely lower rate of return in the scenario where invested assets are locked while revolving issuance of asset management products continues on the funding side.

During the transition period, it is not clear how quickly asset management products that do not comply with the Assets Management New Rules will be phased out. The likelihood, therefore, is that there will continue to be a mix of new and old asset management products, as well as new and old asset management methodology, for some time to come. In the meantime, to incentivize the reduction of existing products, regulators may, in approving/supporting an asset manager's new business, take into account progress made in addressing aspects of existing products that do not comply with the new rules. Asset managers that wish to take the lead in developing new products should be proactive in disposing of assets that do not meet the new standards. This way, asset disposal and non-performing asset management business may also be promoted to certain extent.

03

To encourage the transformation of the asset management sector, regulators may tolerate and even encourage innovation by and cooperation between various competing businesses.

The transformation of the asset management sector has been an important theme in recent years. Various asset management institutions, such as commercial banks, securities companies, FMCs, private funds, insurance asset managers, trusts and futures brokers compete with each other under generally similar rules. From 2020, the asset management market will be fully open to foreign investors, who will be allowed to establish or acquire different types of asset management platforms and invest in various products. Market players and regulators will face shared challenges in how institutions can differentiate and develop themselves in a regulatory environment that is aimed at returning asset management to its original objectives.

Given that asset management in China is still in its infancy, we expect regulators to tolerate and encourage innovation in products, internal governance, business models and other aspects provided market players demonstrate adequate risk control and fiduciary duty. Regulators will also support cooperation among different institutions (including Sino-foreign cooperation) to improve domestic asset managers' technical capabilities (including know how covering asset allocation, customer demand analysis and exploration, artificial intelligence and product design) and management culture, to educate and foster sophisticated and honest institutional investors and to serve the development of the capital market and the real economy.

04

Compliance and risk control will continue to be emphasized.

In 2020, we expect that strong regulation will become the norm for asset managers. We also expect that regulators will take a "look-through" approach in the regulation, emphasizing substance over form and will focus on inspection of, and sanctions resulting from, non-compliance in futures asset management.

Moreover, returning to asset management's origins as well as transforming and upgrading the asset management business have also raised new compliance and risk control requirements. Regulators may encourage improvements on compliance and risk control capacities in system design. For example, regulators may implement a grading system for FMCs referring to the similar system for securities companies. The grading system will factor in compliance and risk control conditions into ratings to indirectly affect regulatory resources allocation to, and customer acquisition by, FMCs. Strengthening the risk control, internal governance, information disclosure, risk disclosure and conflict prevention will be key to compliance and risk control.

05

Regulators will focus on fintech.

Technology is widely used in the asset management sector, including middle and back office services to funds, automated investment advisory services, hedge funds and internal governance of FMCs. The development of fintech in the asset management sector will be driven on one hand by domestic asset managers identifying global assets in which to and on the other hand by international asset managers entering into and competing in the Chinese market. We expect that in 2020 regulators will focus on the opportunities of fintech in the asset management sector and its risk control. The *Administrative Measures for Program Trading in the Securities and Futures Market* or other relevant rules may be published in 2020, enabling institutions such as hedge funds to conduct program trading and at the same time set specific restrictions on the use of program trading and reporting. The consultation draft of the *Interim Provisions on the Administration of External Access to the Trading Information Systems of Securities Companies* also sets many strict requirements for investors eligible for direct market access service and their conduct. Regulators will also focus their attention on automated investment advisory services. We also expect that "regulatory sandbox" will be applied to fintech.

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2019 Key Dates

January 21

The FinTech Regulation and Rectification Steering Team and the Online Lending Steering Team issued the *Opinion on the Classification and Treatment of Online Lenders and Risk Prevention*

February 2

The PBOC issued the *Regulation on Functions, Divisions and Headcounts of the PBOC*, which made clear that the PBOC will be in charge of regulating internet finance and assessing FinTech innovation

May 13

SAMR and the National Standardization Administration Committee published national standards 2.0 for multi-level cybersecurity protection

May 28 and June 13

The CAC published the consultation draft of the *Administrative Measures on Data Security* and the consultation draft of the *Measures for Security Evaluation on Outbound Transfers of Personal Information*

August 23

The PBOC published the *FinTech Development Plan (2019-2021)*

September 6

The managers of two start-ups, 91Moxie and Xinyan Technology, were investigated by the police, marking the start of the "rectification" of the web-crawling business and the big data sector

September 30

The PBOC approved PayPal's acquisition of 70% equity in GoPay, resulting in the formation of the first foreign-controlled payment institution

October 9

The PBOC distributed the draft of the *Pilot Measures for the Protection of Personal Financial Information (Data)* to commercial banks for comment

October 9

Nine ministries and departments of the central government jointly published the *Notice on Issuing Supplementary Provisions for the Supervision and Administration of Financing Guarantee Companies*, prohibiting non-licensed institutions from providing financing guarantee services

October 24

President Xi issued instructions that blockchain should be treated as the breakthrough point of independent innovation in core technologies and that the development of blockchain technology and the blockchain sector should be accelerated

October 29

The PBOC and SAMR jointly announced that FinTech products would fall within a national certification system

December 5

The PBOC initiated a pilot program to mark China's first step in the regulatory sandbox

2019 Regulatory Observations

01

FinTech regulatory framework is largely in place.

With the issuance of the *FinTech Development Plan (2019-2021)* by the PBOC in 2019, the long-awaited FinTech regulatory framework has largely been completed.

The PBOC listed licensed financial institutions as addressees in its public notice on issuance of the Plan, which showed the regulatory authorities' recognition of the "financial" nature of FinTech. This also represented the regulatory authorities' intention that licensed financial institutions should be considered the main players when planning the future development of FinTech, and that FinTech should to become "compliant, innovative, safe and controllable". During 2019, the PBOC coordinated the design of the regulatory framework and issued policies or consultation drafts on data regulation, FinTech product standardization, and the regulatory sandbox.

Regulatory experience obtained from governing internet finance is underpinning FinTech regulation. Such experience includes strengthening the PBOC's overall coordination, introducing self-regulation by industry associations and encouraging the central and local FinTech regulatory authorities to conduct behavior- and function-based regulation in addition to institution-based regulation. We have yet to observe what impact the cybersecurity authorities, such as the CAC, will have on financial regulation.

02

License-based regulation has been reinforced to reduce risk, while regulators are exploring "soft" regulation.

In 2019, regulators continued to focus on license-based regulation of FinTech. For example, regulators have strengthened regulation of banks cooperating with, and outsourcing to, technology and data companies (which are unlicensed) by prohibiting them from outsourcing core risk control functions to unlicensed organizations.

There are new regulations governing provision of fallback guarantees by FinTech companies for financial products such as cash loans. Multiple ministries and departments of the central government have jointly issued the *Supplementary Administrative Regulations on Financing Guarantee Companies*, prohibiting companies from providing financing guarantee services in actual or disguised form without approval. Any FinTech company that adopts this guarantee model in its lending assisting business should make sure that it is complying with the new regulations.

The peer to peer (P2P) sector has been completely overhauled. All institutions engaging in such business are required to make a filing with local financial regulators or to convert themselves into lending assisting institutions, consumer finance companies or small loan companies, unless regulators decree they should be dissolved.

Meanwhile, to encourage FinTech companies to be both innovative and compliant – and to learn from best practice internationally - the PBOC has, for the first time, proposed as part of the *FinTech Development Plan (2019-2021)* applying a review mechanism focusing on the substance and overall structure of, and setting unified minimum regulatory requirements for FinTech businesses. At the same time, the PBOC is exploring "soft" regulation such as imposing requirements for information and disclosure, as well as public supervision.

The FinTech pilot project is ongoing in many cities, and a regulatory sandbox is rapidly developing. The regulators are showing a certain level of tolerance for risks brought about by technological innovation, which reflects their determination to actively explore "soft" regulation.

03

Regulatory authorities tighten regulation of data management and use.

2019 was an important year for data protection. Given data is linked to myriad interests, such as individual privacy, social and economic security and national security, and considering China has long adopted a tolerant attitude towards the development of the data sector, regulating data and the use of data needs to catch up, to solve practical problems and to formulate appropriate forward-looking rules. Regulatory authorities have introduced a number of measures operating at different levels, including:

- Cleaning up the web crawler (spider-bot) practice that originally operated under the name of big data. More than 10 companies were investigated, and senior executives of those companies were interrogated or detained by the police; as a result, the top data companies announced they would stop their web crawler business.

- More than 50 financial apps (including those operated by large state-owned banks) were criticized for the failings of their privacy policies, including exceeding their authority when collecting personal information.

- In the second half of 2019, the regulatory authorities began a process requiring companies to register any financial apps, with the aim of standardizing regulation of such apps. Twenty-three operators participated in the first pilot filing.

- In addition to protecting the privacy rights of individuals, the regulatory authorities also increased protection of the use of important data such as transaction data. After the *Measures for the Information Technology Management of Securities and Fund Operators* took effect, the CSRC has increasingly focused on data protection when conducting compliance inspections of securities companies. The CSRC has also set regulatory requirements on data held by securities companies' overseas branches.

- The sharing of data between domestic financial platforms and their overseas parent companies or domestic affiliated companies became a key focus of attention by the regulatory authorities when approving the establishment of foreign-invested financial institutions.

04

Payments will be more strictly regulated, as well as being opened further to foreign investment.

The payments sector has hitherto been well regulated, and that trend continued in 2019.

- The process of disconnecting payment institutions from banks accelerated, with payment institutions achieving turning in 100% of "customer provision funds".

- Some Illegal practices were banned. These included banning point of sale (POS) machines linked to multiple merchants and "allowing selection of merchants on the POS machine". In 2019, the authorities handed down more than 100 sanctions imposed on those carrying out illegal activities, resulting in total fines of RMB150 million. One company, IPS, was fined nearly RMB60 million by the PBOC Shanghai Branch, the largest fine levied in the third-party payment sector.

- The PBOC rejected renewal of licenses for several companies in the payment sector.

Although regulation was tightened in order to reduce risks in payments, at the same time, the authorities took a number of steps to help open up the sector. For example, the PBOC approved PayPal's acquisition of a 70% equity stake in GoPay on September 30, 2019, making PayPal the first foreign payment institution to enter the Chinese market. American Express received approval to establish a joint venture to engage in bank card clearing. This joint venture will be the first Sino-foreign bank card clearing joint venture in China.

On top of this, the regulatory authorities supported cross-border payments. In April 2019, the State Administration of Foreign Exchange issued the *Administrative Measures for the Foreign Exchange Business of Payment Institutions,* allowing the original pilot program in cross-border payments by payment institutions in the foreign trade, study abroad, and tourism sectors be implemented in full across the country under the supervision of banks partnering with such payment institutions in such business. Further innovation in the payments sector is to be encouraged, involving cooperation with international partners and the utilization of new technology such as blockchain.

05

Regulators scrutinized and cleaned up peer to peer (P2P) online lending platforms.

The regulators' efforts to control internet finance-related risks continued in 2019. After the issuance of *Opinions on the Classified Disposal and Risk Prevention of P2P Lending Institutions* at the end of 2018, local financial regulatory authorities started classifying P2P lending institutions by risk status and preparing an action list for institutions considered to be high risk.

Other than the few institutions which were identified to be compliant and qualified, most P2P institutions were closed down by regulators. As a result, there were some two-thirds fewer P2P lending institutions at the end of 2019. Hunan and Shandong provinces were among those announcing province-wide bans on all P2P lending services. Nearly all P2P lending institutions suspected of being in breach of contract or illegal fund-raising, among other crimes, were investigated by the authorities, and anyone (whether managers or employees) found guilty of illegal fund-raising were required by the police to hand over their salary and commissions.

The financial regulators required the remaining qualified P2P lending institutions to complete a filing process to continue in the same business or to convert into consumer finance companies or small loan companies. A distinction was drawn between information intermediaries and lenders, who are regulated differently. The regulation of P2P online loans set a precedent for the regulation of other quasi-financial institutions, such as finance guarantee companies and commercial factoring businesses.

06

Virtual currency trading platforms and initial coin offerings (ICOs) are highly regulated; regulators supported compliant commercial blockchain applications.

In 2019, the regulatory authorities kept up tough regulatory pressure on blockchain assets, virtual currency trading platforms and ICOs.

The PBOC, the National Internet Finance Association of China and local finance regulatory authorities issued a succession of announcements and monitored virtual currencies, as well as instituting regulatory measures applying to institutions engaged in virtual currency operations. Regulators prohibited domestic institutions from the advertising of, or redirecting clients to, cross-border virtual currency trading services provided to onshore residents, as well as imposing restrictions on payment and settlement. In 2019, six virtual currency trading platforms newly founded within China were closed down, 203 overseas virtual currency trading platforms were blocked from domestic users, nearly 10,000 related WeChat and Alipay payment accounts were closed, and several overseas virtual currency exchanges announced that they would not provide services to Chinese residents.

At the same time, regulators and reputable financial institutions and FinTech companies indicated they supported the development of blockchain technology and its legitimate commercial applications. In 2019, the CAC issued a list of 500 domestic blockchain information service providers which had completed filing. Based on information published for these filings, it is the financial sector that makes most use of blockchain technology, particularly in supply chain finance (including the platforms established by banks or FinTech companies) and electronic depository receipts.

The PBOC also expanded the scope of its trade finance blockchain platform from the Bay Area (Guangdong, Hong Kong and Macao) to the whole country. It is possible that the PBOC will link this platform with similar platforms of overseas regulators to establish a public financing infrastructure for cross-border trade.

07

Higher FinTech standards adopted to facilitate advancement and control of FinTech applications.

The PBOC issued the 2019 FinTech Product Certification Rules both to implement the State Council's requirements on product quality certification and to follow the requirements of the *Cyber Security Law* in 2017 on cybersecurity. These latter requirements extended certification requirements from payment technology products to all FinTech products, which may be enhanced to compulsory certification requirements for all Fintech products. In 2019, the PBOC and SAMR released the *Catalogue of FinTech Products Subject to Certification (First Batch)*, which covered client software, voiceprint recognition systems, and cloud computing platforms.

In addition, the PBOC issued the *Security Management Specifications for Mobile Finance APPs* in 2019 as recommended standards for the financial sector. The PBOC specifications include specific requirements for mobile finance apps in terms of risk prevention, information protection, filing on real-name basis, supervision and administration. The National FinTech Evaluation Center, established in Shenzhen, carries out evaluations, risk monitoring, and development of RegTech and compliance technology for finance apps. The certification of FinTech products will help to achieve the regulator's goal of "application of advanced and controllable FinTech technology" by verifying and standardizing FinTech products.

08

Regulators combated chaos in consumer finance and cracked down on "trap loans".

In 2019, the consumer finance sector faced significant compliance challenges as regulators tackled the issue of internet financing-related risks. Following the focus on cash loans businesses in 2017, regulations have since been introduced to all stages of consumer finance, from customer acquisition and risk control through to management and debt collection.

- Some leading "loan supermarkets" (such as Sina Aipuhui, Baicheng FinTech, and Credit Manager) were investigated by the public security bodies for marketing for unlicensed business partners or aggressive debt collection by their partners.

- Four consumer finance companies were fined by the PBOC or the CBIRC for violating credit investigation and loan management regulations. Huarong Consumer Finance received multiple fines simultaneously from both the PBOC and the CBIRC.

- Many banks were punished for providing consumer loans for investments or real estate purchases. As a result, a number of banks chose to reduce or even suspend personal consumer loans.

- The Ministry of Public Security made criminal "trap loans" under which the lenders induced or forced borrowers to sign loan agreements, then deliberately said they were in default and then aggressively collected these debts. As part of the special national campaign to "combat crime and eliminate evil", the Supreme People's Court and the Supreme People's Procuratorate issued the *Opinions on Several Issues Concerning the Handling of "Trap Loan" Criminal Cases*, the *Opinions on Several Issues Concerning Handling Criminal Cases relating to "Soft Violence"*, the *Opinions on Several Issues in Handling Criminal Cases of Illegal Lending* and several other documents, all of which provide specific legal grounds for making "trap loans" criminal.

In a debt recovery case brought by Ping An Puhui, the court found that Ping An Puhui and a third party small loan company had extended many loans through affiliated companies in order to obtain interest payments illegally and that their behavior constituted economic crimes. This case gave rise to the discussion as to whether the fees charged to borrowers in the form of loan assistance/financing guarantee service fees were a disguised form of high interest.

2020 Regulatory Outlook

01

Multiple relationships will develop dynamically as the "four beams and eight pillars" of FinTech are set up. The main focus of the policies will be on bringing about cooperation between finance and technology businesses, while clarifying the boundary between them, and encouraging initiatives by local governments, the market and industry organizations as coordinated by the PBOC. All of these are aimed at providing clear financial regulation, while stimulating the market.

The regulatory authorities will continue to adhere to the principle of "regulating as finance what is finance and regulating as technology what is technology", and to have licensed-based regulation applying to financial businesses. We expect that regulators will adopt a more targeted approach in regulating the cooperation between financial institutions and FinTech/internet companies once regulators have identified and apportioned legal risks in complex relationships: for example, commercial banks will be required to refrain from outsourcing core functions and to have in place enhanced risk controls for any outsourced non-core functions such as marketing, data security or use of loans, while restrictions may be loosened in some other areas, such as on the joint lending ratio.

To date, various cities such as Beijing and Shanghai have launched high-profile policies and measures to promote the local development of FinTech, and Beijing has launched its regulatory sandbox. The regulatory sandbox is designed to bring together many interested parties from far afield, but implementation will be conducted at a local level. As a result, local governments will be in charge of implementation of regulations (under the guidance of the PBOC). Since the main players falling within the regulatory sandbox are financial institutions (though technology companies can act as service providers), the local regulators will be given more power, as opposed to have a coordination role. The regulatory sandbox provides soft regulation over the whole life cycle of a FinTech product, which, we believe, if operated properly, will stimulate the healthy development of the FinTech sector generally

02

The development of core technologies that improve financial services will be supported by regulators, and foreign-invested technology companies and FinTech companies will be encouraged.

Under the principle of “regulating as finance what is finance and regulating as technology what is technology", the Chinese regulatory authorities will continue to support the development of core technologies that improve financial services. These technologies include AI, cloud computing, big data, and blockchain, among others. Also, there is expected to be a filing system comprising a "white list" of FinTech companies. Such a welcoming environment, combined with the post-2018 opening-up of the financial sector, should encourage more foreign technology companies to export their products to China and establish businesses, including FinTech companies, in China.

The Cryptography Law and the Foreign Investment Law issued in 2019 was a response to foreign investors’ long-held concerns about technical and intellectual property issues, reflecting the Chinese government's protection of intellectual property and the national treatment for foreign investors in procurement and in other areas. We have also noticed that many foreign-invested FinTech companies in infrastructure for the financial industry and financial services have been set up or approved. These companies include payment companies, payment clearing companies and AI investment advisory businesses. Furthermore, it has been made clear that Beijing's regulatory sandbox will be opened to overseas investors.

This overall encouraging environment will not change in 2020. However, given that FinTech is likely to be the core of the financial sector in the future and assessing FinTech risks will determine how far and how fast the FinTech sector will be opened up, regulators will likely expect more transparent communication with the market players, which will assist the regulators to acknowledge the emerging technology or technological applications. This point is likely to be reflected in high-frequency trading, AI investment advisory services and other areas. The regulatory sandbox may become a vital space for all parties to balance the interests of different parties and create accurate risk measurement.

03

The development of regulatory technology (RegTech) will enhance "look-through" regulatory capability and coordination, creating more space for FinTech innovation.

In 2020, we expect the regulatory authorities to continue to develop and apply RegTech. For example, technology facilitating system embedding, application programing interfaces (APIs) and other data collection methods will not only reduce the burden on companies to comply with data reporting but also help to ensure the accuracy of the data and give regulators timely information. RegTech will also make possible "look-through" regulation through the whole business process by comparing data from different systems.

In August 2018, the CSRC issued the *Overall Technological Development Program of the CSRC*, which stated the goal of "Regulatory Technology (RegTech) 3.0" to be a highly efficient regulatory big data platform. The CSRC also called for the FinTech Regulation Bureau to be established as a new department. In 2020, we expect the CSRC, its subsidiary China Securities Information Technology Service Co., Ltd., and other capital market regulatory agencies and associations to further explore the application of technologies such as big data, cloud computing and AI, in their regulation activities, in order to achieve real-time monitoring of the sector and to adopt more RegTech in law enforcement. Further, we expect the PBOC to lead the establishment of a comprehensive statistical system for the financial sector covering different financial regulatory authorities, financial infrastructure and financial activities, including innovative FinTech products. Data sharing in this way will help promote regulatory coordination.

Enhancing RegTech capability should allow for FinTech innovation. For example, cross-border payments will be made easier by connecting SAFE, customs, banking, payment, and cross-border e-commerce systems as data are shared between businesses and regulatory authorities.

04

FinTech regulation will be broadened, with the main focuses being on consumer protection, information/data regulation, and secure identity authentication.

2020 is the second year of the FinTech development plan, and we expect more far-reaching changes in the regulation of FinTech. In addition to the *Certification Rules for FinTech Products* and the *Catalogue of Certification of FinTech Products (First Batch)*, we expect that the *Regulatory Rules for Financial Innovative Products* will be issued. These rules will set minimum standards and flexible administration requirements for FinTech products. We also expect new rules covering the scope of financial innovative products, open banking and the financial information (data) protection, and guidelines on the usage of identity authentication technology, such as facial recognition, in the financial sector. In addition, it is also possible that the regulators will promulgate regulations applying to cybersecurity and system stability.

With the *Personal Information Protection Law*, the *Data Security Law and the Draft of Trial Measures for the Protection of Personal Financial Information (Data)* all expected to be issued this year, there are still outstanding theoretical and practical issues that need to be discussed and resolved:

- data regulation: fundamental issues to be clarified include balancing data flow needs with privacy/national security protection, data ownership, data use and management rights.

- sector development: how will the sector develop after the crackdown on illegal activities in 2019?

- information islands: it is not certain whether the *Interim Measures for the Regulation of Financial Holding Companies (Consultation Draft)* will resolve the issue of information islands within financial groups.

- monopolies: regulators will still need to address data monopoly and technology monopoly.

05

Regulators will continue to work to reduce or eliminate existing risks, and enforcement will focus on compliance by internet financial institutions when delivering financial services.

While rolling out licensing requirements on FinTech businesses, regulators will set their sights on shutting down non-licensed financial businesses and other illegal financial activities. Meanwhile, so far as license conditions for FinTech companies are concerned, we expect that regulatory enforcement will focus on compliance issues in the companies' business operations, such as anti-money laundering (AML), IT security, corporate governance, and inter-company cooperation. There should also be increased regulatory attention on the wide use of blockchain in the financial sector.

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2019 Key Dates

February

AIA Beijing Branch was approved to participate in the pilot program for integrated operations in Beijing-Tianjin-Hebei region

March 15

The first foreign-invested endowment insurance company, Heng An Standard Endowment Insurance Co., Ltd., was approved to be established by the CBIRC

April 28

The first foreign-invested insurance assets management company, ICBC-AXA Assets Management Co., Ltd., was approved to commence its business operation

May 1

The CBIRC Chairman revealed 12 proposed new opening-up measures for the banking and insurance industries, including 5 measures for the opening-up of the insurance industry

July 11

Dajia Insurance was established to acquire the equity, business, assets and liabilities of certain licensed entities of Anbang

July 20

As a milestone in the opening-up of the insurance industry, the Office of the Financial Stability and Development Committee under the State Council announced 11 policies on the further opening-up of the financial sectors, and the CBIRC issued 7 new opening-up policies

August 25

The *Measures for the Administration of Related-Party Transactions of Insurance Companies*, "the harshest-ever" measures, was issued, which expanded the scope of related parties and further clarified the specific criteria for making such determination

October 1

The *Measures for the Administration of the Bancassurance Business of Commercial Banks* took effect to unify the regulation process of the bancassurance business

October 15

The *Regulation of the People's Republic of China on the Administration of Foreign-Invested Insurance Companies* was amended by the State Council to relax the relevant entry restrictions and qualification requirements for investors

October 30

Huatai Insurance Group Co., Ltd. was approved by the CBIRC to become the first Sino-foreign joint venture insurance group in China

November 11

The first foreign-invested insurance holding company, Allianz (China) Insurance Holding Company Limited, was approved by the CBIRC to commence its business operation

November 29

The amended *Detailed Rules for the Implementation of the Regulation of the People's Republic of China on the Administration of Foreign-Invested Insurance Companies* was issued by CBIRC, relaxing the entry requirements for foreign-invested insurance companies, clarifying the responsibilities and obligations of majority shareholders, and further aligning the regulatory regimes for foreign-invested and domestic insurance companies

December 1

The amended *Measures for the Administration of Health Insurance* took effect

December 6

The *Notice concerning Clarification of the Timetable for the Removal of Foreign Ownership Restrictions on Joint Venture Insurance Companies* was issued by CBIRC, announcing that the foreign ownership restrictions on joint venture insurance companies engaged in life insurance business would be formally removed from January 1, 2020 and foreign investors may hold up to 100% equity in joint venture life insurance companies from that date

December 13

The *Measures for the Regulation of Internet Insurance Business (consultation draft)* was issued

2019 Regulatory Observations

01

Unified regulation of the banking and insurance industries was in large part implemented

Following the merger of the former CBRC and CIRC in 2018, the CBIRC took several actions and issued a number of regulations in 2019 to unify the regulation of the banking and insurance industries. After the merger, the CBIRC established a new Corporate Governance Regulation Department, which is designated to be responsible for formulating corporate governance rules for banking and insurance institutions and coordinating regulatory supervision of the two industries. In November 2019, the *Measures for the Regulatory Assessment of Corporate Governance of Banking and Insurance Institutions (for trial implementation)* was issued by the CBIRC to establish a set of regulatory assessment indicators for corporate governance of banking and insurance institutions. These are tailored for the Chinese market while drawing on international rules and practice. While emphasizing the importance of corporate governance in future regulation, it was made clear by the regulators that a unified regulation regime would be applied to the corporate governance of both commercial banks and commercial insurance institutions. Despite the differences in specific assessment indicators, commercial banks and commercial insurance institutions will be subject to the same set of regulatory systems in terms of assessment procedures, rating methods and regulatory actions. Given the similarity in the regulatory philosophies, rules and tools for both the banking and insurance industries, the trial implementation of unified regulation in corporate governance was an attempt to apply comprehensive regulation within the financial sectors.

Also, as the first step in the unification of regulatory policies for specific banking and insurance products, in mid-2019 the CBIRC issued the *Notice of the General Office of China Banking and Insurance Regulatory Commission on Relevant Matters concerning the Registration of Asset-Backed Plans* to apply a registration management system for asset-backed programs issued by insurance assets management institutions following the issuance of their first asset-backed program. This system aligned the relevant regulatory practices in the banking and insurance industries in this area. At the end of 2019, the CBIRC unified the supervision and inspection of operations of banking and insurance institutions by issuing the *Measures of China Banking and Insurance Regulatory Commission for On-Site Inspection (for trial implementation)*. All of this indicates a steady progress in the process of unified regulation.

02

Insurance industry moved towards a full opening-up

As part of the continuing efforts for the opening-up of the financial sectors, regulators introduced new initiatives in 2019 including the "11 Measures" and the "New 12 Measures of the CBIRC", which undoubtedly benefited the insurance industry. A number of high-profile applications for entering the market were approved, including the establishment of the first foreign-invested insurance holding company by Allianz, the establishment of the first foreign-invested endowment insurance company by Heng An Standard Life Insurance (a Sino-British joint venture), and the further acquisition of shares of Huatai Insurance by ACE to convert it into the first Sino-foreign joint venture insurance group.

In 2018, the CBIRC relaxed the ownership restrictions on foreign-invested life insurance companies to allow foreign investors to hold up to 51% equity interest. A further notice was issued by the CBIRC at the end of 2019 to formally remove foreign ownership restrictions from January 1, 2020. With the amendment to the *Regulation on the Administration of Foreign-Invested Insurance Companies* and its implementation rules in the second half of 2019 by the State Council and the CBIRC respectively, the entry restrictions on foreign-invested insurance companies were also relaxed. In particular, substantial progress was made in the reduction of "quantitative conditions" for foreign investors. These measures include removing the rigid requirements for foreign investors of foreign-invested insurance companies that they be insurance companies, have been engaged in the insurance business for over 30 years, and have a representative office in China for over 2 years, allowing all types of foreign financial institutions to have a stake in foreign-invested insurance companies (previously, only foreign insurance companies were allowed), and permitting foreign insurance group companies to establish foreign-invested insurance companies in China. Opportunities were offered to a wider range of foreign investors, and those with their own unique features, expertise and resources were encouraged to make investments in the Chinese insurance market to expand the diversity of market offerings. Insurance brokerage companies, insurance assets management companies and other licensed insurance institutions were also covered by these opening-up measures, though further clarification and implementation of the specific measures would be required in the coming year.

03

The exit of Anbang and establishment of Dajia marks the first attempt of the "takeover by newly established company" model in the insurance industry to deal with problem insurance companies

Since the takeover of high-profile insurance company Anbang, a series of actions had been taken, including capital injection by the China Insurance Security Fund, removal of non-compliant shareholders, reduction of registered capital, spin-off of assets, and business re-focusing. As an important step of the takeover, three shareholders of Anbang were approved by the CBIRC in July 2019 to establish Dajia Insurance Group Co., Ltd. with a registered capital of RMB20.36 billion, which was exactly equivalent to the amount of Anbang's decreased capital. Under the restructuring plan, Dajia Insurance acquired 100% of the equity interest in Anbang Life Insurance, Anbang Endowment Insurance and Anbang Assets Management from Anbang; Dajia Property Insurance, which is a subsidiary of Dajia Insurance Group and opened for business in December 2019, took over certain business, assets and liabilities of Anbang Property Insurance. Upon the completion of the restructuring, Anbang will not carry on any new insurance business, but its payment obligations under the existing policies will remain, and it will continue to fully perform its contractual obligations under the relevant insurance contracts.

Anbang was not the first problem insurance company that underwent such restructuring. In the wake of the approach applied in dealing with New China Life Insurance and China United Insurance, it is common for the China Insurance Security Fund to take over and dispose of such companies. However, in the case of Anbang, the relevant investors did not directly inject capital into Anbang, but instead established a new company, Dajia Insurance Group, to take over certain assets of Anbang Group. This model of "takeover by newly established company" differentiated it from the other cases. In particular, Dajia did not acquire all the equity interest in the licensed Anbang Property Insurance, but chose to establish Dajia Property Insurance to acquire certain business and assets from Anbang Property Insurance. Although this model had been repeatedly applied in the restructuring of problematic securities companies, it was first applied in the insurance industry in the Anbang case. This would provide effective protection to Dajia Insurance against the legacy liabilities of Anbang after the completion of the restructuring. However, this would mean that the liabilities remaining with Anbang upon the completion of the restructuring would be handled by the market, and certain policyholders (especially large institutions) or ordinary creditors might not be able to receive timely and adequate remedy as a result of Anbang's insolvency.

04

The "look-through" regulation was adopted over shareholding and related transactions

The *Measures for the Administration of Equity Interests in Insurance Companies* enacted last year explicitly put forward the concept of "look-through" as a regulatory approach, and established the "substance over form" principle in regulation and examination while differentiating different types of shareholders of insurance companies. The *Measures for the Administration of Related-Party Transactions of Insurance Companies*, "the harshest-ever" measures, enacted in 2019, echoes this regulatory approach.

With respect to the determination of a related party, the new rules extend the scope of related parties to address such market irregularities as multi-layer nesting and "insurance companies serving as the ATMs of their shareholders". Although insurance companies still retain certain discretion and room for making their own judgment in determining their related parties, the new rules require the determination of related parties to be made from related individuals, subsidiaries of insurance companies and other perspectives by taking the "look-through" approach, which was absent in the previous rules.

Furthermore, the new rules provide for a number of quantitative standards for determining the limit on related party transactions and the amount of relevant capital employed for such transactions. This reflects the resolution of the regulatory authorities to examine more closely related party transactions, and impose stricter requirements on insurance companies in respect of their day-to-day information collection and management of related-party transactions.

However, the compositions of shareholders of different insurance companies vary markedly, and many existing investors of insurance companies are subject to complicated shareholding arrangements and hold numerous investment portfolios. Since the implementation of the new rules, various problems have arisen in the implementation of the specific standards. It is advised that insurance companies, in determining their own actual controller, persons acting in concert, ultimate beneficiaries of financial products and other relevant persons, always focus on the transfer of relevant obligations and resources and adopt the "substance over form" principle so as to reduce compliance risk. At the same time, we also hope that regulatory authorities will provide specific guidance in respect of certain specific types of shareholders, such as funds.

05

Regulation of intermediaries and sales channels was tightened

"Irregularities of intermediaries" has always been a top priority for regulation, and falsified intermediary business, inflated costs and misleading sales have long been the key non-compliant areas for insurance companies. 2018 was marked as a "big year" of regulation thanks to the more than 1,400 penalty notices with a total amount of fines being approximately RMB240 million issued during the year. According to incomplete statistics, although there were fewer penalty notices and the amount of fines in 2019 were smaller, the proportion of the penalty notices issued against professional intermediaries and part-time insurance agencies remained stubbornly high, and the local counterparts of the CBIRC across China revoked more than 400 licenses for insurance intermediaries in 2019.

In 2019, the CBIRC issued a series of rules to strengthen the regulation of intermediary channels, with a particular focus on such areas as the responsibilities of insurance companies in managing and controlling various types of intermediary channels, compliance in the businesses of insurance intermediaries, and insurance services provided on third party internet platforms. Selling insurance on the internet has gradually developed into another major channel in addition to direct selling, bancassurance and professional intermediaries. The *Measures for the Regulation of Internet Insurance Business (consultation draft)* issued at the end of 2019 are intended to intensify compliance in internet insurance while expanding the scope of products permitted for sale on the internet. This represents the increasing convergence of regulatory philosophies in regulating both online and offline insurance sales.

In addition, stricter rules were enacted for traditional bancassurance in 2019. The *Measures for the Administration of the Bancassurance Business of Commercial Banks* expressly set out the prohibited acts in the provision of insurance agency services by commercial banks and their insurance sales personnel, a breach by a bank of which may directly lead to revocation of the authorization granted to the bank for providing agency services.

06

In products regulation, authorities come down hard on non-compliant products while encouraging other products to the market

In 2019, motor vehicle insurance was still the focus of regulation in the property insurance sector. The Notice on the Matters Relating to Further Enhancing the Regulation of Motor Vehicle Insurance was issued by the CBIRC in January 2019, concentrating on the two major issues: failure to use the applicable contract terms and fee rates in compliance with the regulations; and false business and financial data. Six months later, the CBIRC issued another rule requiring more efforts on law enforcement against violations of laws and regulations in motor vehicle insurance. The scope and level of accountability in the course of implementing the new rules continued to be expanded and intensified, and orders to suspend business and penalties imposed upon both a given institution and the individuals involved often surfaced. Underlying the tough regulation is the original intention to curb cut-throat competition and extensive increase of costs in the motor insurance industry, both objectives that were not completely achieved by the previous fees reforms, and also the deep problems that should be solved by regulators in the future.

With respect to life insurance, the "Major Illness Mutual Aid Program" that was popular at the end of 2018 was determined as a non-insurance product, and a number of red lines remain with the development of online mutual aid insurance in China. The new measures for the administration of health insurance were enacted in the second half of 2019, and the most notable amendment is that insurance companies will be allowed to adjust their fee rates for long-term health insurance products if pre-agreed conditions are triggered. This would encourage insurance companies to provide consumers with more long-term and continuous protection. The new rules also dedicate one chapter to health management raising the ratio of health management costs in the price of a given product from 10% and 2% specified in the *Notice on the Matters Relating to Provision of Health Management Service by Health Insurance Products* issued in 2012 to a unified 20%, with a view to further encouraging the combination of insurance products and health management services.

In addition, the regulatory authorities are also encouraging the re-insurance business, and the regulatory framework governing agricultural insurance and other relevant products has begun to take shape. There is little doubt that the regulatory authorities are doing their utmost to promote the development of insurance products that can meet the development needs of China's market while having zero tolerance over non-compliant products.

07

Use of insurance funds was allowed for multiple purposes and equity investment was supported

At the beginning of 2019, the regulatory authorities issued a series of rules encouraging the "entry of insurance funds into the securities market", which led to the return of insurance funds to the A-share market that had previously been the subject of much criticism. With respect to equity investments, although the consultation draft of the new rule on equity investments that was released in 2018 failed to be officially enacted (even after an extended period), the regulatory authorities signaled that the restriction on the scope of the industries in which insurance funds can be invested would be removed and the "positive list" for use of insurance funds would be converted to a "negative list". In order to support more insurance funds to be used for equity investments, the CBIRC simplified the procedures for registration of equity investment plans and privately offered insurance funds.

With respect to the bond market, the CBIRC issued the *Notice on the Matters Relating to the Investment of Insurance Funds in Capital Supplementary Bonds Issued by Banks* in January 2019, which allows insurance funds to be invested in tier 2 capital bonds and non-fixed-term capital bonds issued by banks. This would add more options for the investment of insurance funds in long-term debts. While there remain many restrictions on the qualification of issuers, it is expected that the relevant threshold would be lowered or cancelled in the future so that more insurance funds are attracted to invest in capital bonds issued by small- and medium-sized banks and to supplement their capital.

Moreover, in 2019, a registration-based system was introduced for asset-backed plans launched by insurance asset managers, and insurance funds were allowed to invest in credit derivatives (subject to certain conditions). With respect to trust investment, the new rules encouraged expanded cooperation between "insurance companies and trust companies", and implemented the regulatory direction of de-channeling, eliminating multi-layer nesting, breaking guaranteed return and encouraging funds to be invested in the real economy. These favorable policies have expanded the areas in which insurance funds can be invested, and according to the relevant statistics, the balance of the utilized insurance funds as of the end of 2019 increased by 12.9%, year-on-year. That being said, there was only a slight change in the percentage of the balance of various assets compared with that at the end of the previous year. This, coupled with the position taken by the regulatory authorities on encouraging higher percentage of equity assets in total assets, indicates that there will be more policy support forthcoming.

08

Tighter regulation of compliance by institutions continued and more "concurrent sanctions" against institutions and individuals were imposed

According to statistics, the CBIRC at all levels issued more than 800 penalty decisions throughout 2019 imposing fines amounting to RMB120 million, and more than 110 penalty decisions were issued in December. While this represents a sharp drop , in terms of number and amount of penalties, from 2018, which is known as the "harshest-ever regulation year", 2019 remained a year of "strict regulation" for the insurance industry relative to the previous few years.

First of all, more areas were subject to sanctions. In addition to intermediaries, as discussed above, a number of property insurance companies were sanctioned due to non-compliance in vehicle insurance business and false accounting of operating expenses. Life insurance companies were penalized largely for mis-selling, cheating insurance applicants and providing false information, but sanctions were also imposed against insurance sales agents advertising insurance products via WeChat and other social media in violation of the applicable regulations. With respect to the types of non-compliance issues, sanctions were mainly imposed on false accounting of operating expenses, provision of false marketing information, offering insured benefits as opposed to insurance benefits or providing untrue client information. In addition, there were some other non-compliance being sanctioned, including failure to cooperate in regulatory investigations.

Secondly, severe sanctions were increasingly imposed. A number of institutions were restricted from carrying out new business and even had their business licenses revoked due to violations. It is worth noting that another notable feature in 2019 is that more sanctions were imposed on individuals or institutions and individuals concurrently. According to the incomplete statistics, in the first half of 2019, approximately 100 decisions were issued against individuals and a number of decisions were against institutions and individuals concurrently. As a result, dozens of management personnel were barred from acquiring the qualification for management personnel of insurance companies and held liable for their institutions' and their own non-compliance.

2020 Regulatory Outlook

01

Focus will be on dealing with high-risk insurance companies and risk management of insurance institutions

2020 is the final year of the uphill battle to prevent and diffuse financial risks, and the insurance industry has a key role to play. We expect that, in addition to Anbang Insurance, the CBIRC will deal with several other high-risk insurance companies focusing on external funds operating on market terms, which will be different from that adopted for Anbang Insurance. In addition, the regulators are expected to maintain consistency in the relevant policies, making every endeavor to strengthen risk management of insurance institutions and focusing on such issues as governance structure, quality of investment assets of insurance institutions. Further, priority will be given to the establishment of a reinsurance market and the improvement of the relevant systems.

02

All-round opening-up is well on the way to be achieved

Although a foreign shareholder was allowed to hold up to 51% equity in a life insurance company as early as 2018, no application for the establishment of foreign-controlled life insurance company has been approved, other than few legacy cases. AIA submitted its application to convert its Shanghai Branch into a wholly owned life insurance subsidiary in 2019 so as to terminate its operation in China as a branch, which had lasted for almost 30 years. The first wholly-owned life insurance company is ready to go. In addition, the timing for opening up the insurance business has now been set on April 1, 2020 under the Sino-US phase-one economic and trade agreement. Therefore, the relevant implementation rules will be issued imminently. We expect that in the coming year several foreign insurance institutions will apply for controlling stake in life insurance companies and other foreign financial institutions and insurance groups may take this opportunity to participate in the insurance business and related business in China. The regulators are expected to adopt an open-door policy to welcome participation from more foreign investors while strictly enforcing the relevant qualification requirements.

03

Strict regulation will continue and protection of insurance consumers will be the focal point for law enforcement

Following a three-year period of strict law enforcement, taking into account the overall economic situation and the outbreak of new coronavirus at the beginning of 2020, we expect that the number and total amount of penalties to be imposed in 2020 will decline while the number of penalties with a fine of more than RMB1 million is likely to increase. In addition, we will likely see a significant increase in the number of cases where the regulators hold institutions and individuals, including the senior management, concurrently responsible for violations. It is likely that an increasing number of sanctions will be imposed on violations in certain areas, such as data, personal information and anti-money laundering, in addition to those areas in which sanctions are commonly seen. Further, protection of insurance product consumers will become the focus of regulatory authorities and the judiciary in law enforcement. Building on the strict regulation of insurance intermediaries in 2019, we expect that this year the regulators will attach more attention to compliance of insurance sales agents in marketing and strict control of licenses of intermediaries, and that a regime regulating all types of players in the intermediary business in respect of all their activities will take shape.

04

Regulating internet insurance business will be on the agenda of regulatory authorities

The unexpected new coronavirus was a setback to the good start of 2020, but it has indirectly resulted in the fast growth of the internet insurance business. The *Measures for the Regulation of Internet Insurance Business (consultation draft)* issued in the middle of December 2019 are expected to be formally issued and implemented in 2020. In consideration of the changes and the emergence of new features in internet insurance business in the past five years, we expect that the new regulation will build on the provisions under the *Interim Measures for the Regulation of Internet Insurance Business* and make further classification or provide for further rules in respect of such aspects as the relevant business participants, licensing management, operating rules, risk control, compliance management, and law enforcement so as to reshape the underlying regulatory framework governing internet insurance business. The regulation of internet insurance business is expected to stick to the bottom-line requirement for any insurance business to be conducted by "institutions possessing the relevant licenses and practitioners possessing the relevant certificates", to strengthen regulation of compliance and risk management of insurance intermediaries engaging in internet insurance business, to re-define the roles of each type of cooperating institutions and to provide full protection for consumers' rights and interests. Considering the fact that decisions involving fines of over RMB1 million were issued at the beginning of 2020, we expect that the regulatory authorities will take more law enforcement actions against internet insurance business. In addition, it remains to be seen how the legacy platform business will be resolved and the extent to which the authorities will allow part-time agency business after the issue of the new regulation.

05

The regulatory regime governing insurance assets management business will be established, and the regulatory authorities will encourage the development of such business

In comparison to the securities and funds, banking and trust sectors, the size of assets management business run by insurance institutions is significantly smaller. We believe that the regulatory authorities will encourage setting up insurance assets management institutions, and introducing other institutions to participate in the development of the insurance assets management business (e.g. involving private fund managers to act as investment advisors, and cooperating with wealth management subsidiaries of commercial banks).

The *Interim Measures for the Administration of Insurance Assets Management Products (consultation draft)* issued at the end of November 2019 is expected to be officially released in 2020, which will lay the foundation for the regulation of insurance assets management business. Pursuant to the new rules on asset management business, the legal relationship between an asset manager and an investor in insurance assets management products should be defined as a trust relationship, and such products will include a broad scope of permissible investments, such as (in addition to standardized products) asset-backed securities and equity securities. Separately, under the above-mentioned consultation draft, insurance assets management products are categorized as private products. It remains to be seen whether these products will be permitted to be sold to the public.

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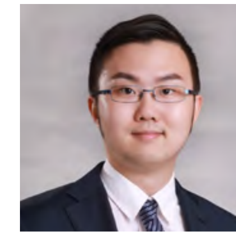

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