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Regulatory Environment and Practice Concerning Offshore Securities Finance of QDII Funds

By Leo wang

In a broad term, securities finance refers to the act that a borrower acquires and maintains temporarily the title to the securities from a lender by paying commitment fees and providing related collateral, and later returns the securities and economic interests which are generated from the securities during the period of time of borrowing either at the lender's request or on the expiration of contract concerned. Compared with finance and securities lending, securities finance normally requires the collateral to exceed the securities concerned in value; nevertheless, it does not have the credit expansion function. Save for the differences above, securities finance has the same regulatory features as finance and securities loan in respect of, *inter alia*, provision of security and collateral and enforcement of collateral.

Pursuant to the Circular on the Relevant Issues Concerning the Implementation of Interim Measures for Administration of Offshore Securities Investment by the Qualified Domestic Institutional Investors (**QDII**)(**Circular**), QDII funds are allowed to participate in securities finance transactions outside the PRC (which, for the purpose of this article, does not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region and Taiwan, same as below) in accordance with relevant laws and regulations and normal market practice. Given that QDII funds are not only governed by the PRC laws, but their offshore activities will also be governed by the laws of one or more jurisdictions where the target market is located and securities investment is made, the issues arise as to whether there exists, for the reference purpose, any similar securities finance system in the PRC and what approach the relevant regulatory authority should take for the participation in securities finance by QDII funds. It is the complex legal and regulatory environment that investors, administrators, custodians, offshore investment advisors, offshore custodians and relevant onshore and offshore regulatory and service institutions will

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experience. As such, we need to fully understand relevant systems and criteria set forth in the PRC laws and broaden our experience in relation to the matters governed by the foreign laws.

PRC Laws and Securities Finance

Pursuant to Article 142 of the newly amended 2005 PRC Securities Law, a securities company shall comply with the provisions of the State Council and obtain the prior approval from the securities regulatory authority of the State Council in relation to the provision of its finance and securities services to its customers. Such provision lifted the ban on finance and securities lending contained in Articles 36 and 141 of the 1998 PRC Securities Law, which provided the legal basis for finance and securities lending and securities finance to be carried out in the PRC. Nevertheless, there is lack of relevant security law system and securities registration system to match the securities transactions in terms of their irrevocability, concentration and paperless feature.

From the perspective of securities registration and holding system, the PRC is a typical country that adopts a model of direct holding of securities. The relationship between a securities company and its investors is on an agency basis and the company has no nominal title to the securities and has no right to make entries into the securities accounts of the investors, i.e. any change to the securities holding in the securities account of an investor must be registered at the central securities registration institution. Assuming that security is provided by creating pledge over the securities of the fund property in accordance with the PRC laws, the fund custodian is required to either keep the pledge certificate for the interests of the fund holders or proceed with the pledge registration in the name of “fund custodian + funds”. Currently under the PRC laws, only two methods are available to create pledge over stocks: first, the pledged stocks are transferred to the pledgee and kept in the special seat for loans with pledge over stocks set up by the central securities registration institution in accordance with the Measures for Administration of Stock Pledge Loans of Securities Companies; secondly, the parties to the pledge contract register the pledge at the central securities registration institution in accordance with the PRC Property Law. The Security Law and the current situations in securities registration holding system lead to the lack of legal and practical basis for securities to be used as collateral in securities finance.

Pursuant to the PRC Property Law, to transfer the ownership of collateral is prohibited. Where the borrower fails to repay the due liabilities, the lender cannot set off the collateral (transferable securities) against the outstanding liabilities but could only convert into value through the agreement with the pledgor, auction or sell the pledged property. Since the pledged securities are recorded in the securities account of the pledgor under the current securities registration and holding system, the pledgee will not be able to sell or auction the pledged property unilaterally. Even if the pledgee has reached an agreement with the pledgor, the non-transaction transfer is difficult to be realised and, therefore, only judicial enforcement may enable the pledgee to realise its right of pledge. As an exception, the pledgee may only dispose of and convert into value the securities, which are pledged by the securities company in accordance with the Measures for Administration of Stock Pledge Loans of Securities Companies, through loans with pledge over stocks.

Securities Finance Systems under Foreign Laws

Most of the countries which have the advanced securities finance systems have set out the highly efficient mechanism for disposing of the collateral in the event of the default of payment or permitting the pledgee to realize the value of collateral by the most efficient means based on the renovated security laws.

Pursuant to Article 22 of the Regulation on Loan Transactions of the Japanese Securities and Finance Companies, where any member fails to repay the debts due, any money or valuable securities deposited by such member in accordance with this regulation may be invoked to set off the debts without any prior notice or demand. In England, according to the Securities Finance Rule, the parties to the securities finance fully understand that, if any default occurs, the non-defaulting party will calculate the amount that the defaulting party is liable to pay on the repayment date agreed in advance and will use the collateral to set off the outstanding debts before the commencement of either relevant bankruptcy procedure or disposal of other collateral. Such renovation in the security law has gone beyond the general principle of “prohibition on the transfer of title to collateral”.

Chapter 9 of the Uniform Commercial Code of America provides the special rules on creation and realization of security in relation to the interests of securities and abolishes the form restrictions and interim closing requirements in respect of the establishment of securities security. Based on the securities transactions practice, the terms of “security interests” and “control” have been introduced in the Uniform Commercial Code. It states that, in relation to realization of security interests, “control” refers to a method to realize security interests in respect of the “investment property”, regardless of other procedures or title transfer, while in relation to creation of security interests, “control” is a condition to the establishment. In the course of interim closing, before the purchaser delivers the payment to the securities agency and after the securities agency credits financial assets to the purchaser’s securities account, the purchaser shall owe security interests to the securities agency in respect of its interests of securities. In fact, the renovated security law in relation to the securities transactions provides the legal basis for highly efficient security mechanism for the securities transactions, realizes the security requirements in securities finance, abolishes various restrictions on creation of security for the securities, acknowledges the effectiveness of special security mechanism in the field of securities, reduces the costs of transactions and assists the promotion of securities finance.

Participation in Offshore Securities Finance by QDII Funds

Pursuant to the separation of responsibilities set forth in the Securities Investment Funds Law, a fund company is entitled to conduct legal activities on behalf of the funds (for the interests of the fund shareholders), including the execution of securities finance agreement. Meanwhile, since securities finance is involved in the change to the methods of custody of the QDII fund assets (e.g. securities lending and collateral management), a fund custodian is under obligations to participate in securities finance and supervise securities finance activities (asset operation activities) of fund manager for the purpose of maintaining the fund property, which include the execution of delivery and settlement (participation) agreements in relation to securities finance and collateral custody.

Before participating in securities finance transactions on behalf of QDII funds (for the interests of fund shareholders), the manager of QDII funds should reach an agreement with the fund custodian in respect of the matters concerning the securities finance transaction to be participated in by the QDII funds (including the delivery and settlement of securities finance and collateral custody). Pursuant to the applicable policies and rules of the place where the transaction is carried out, the QDII funds may be requested to have the principal agreement of securities finance executed by both fund manager and fund custodian, specific securities finance agreement executed by the fund manager and settlement and participation agreement executed by the fund custodian.

The QDII funds' participation in offshore securities finance is an offshore investment activity, so it should comply with the PRC laws. Meanwhile, the offshore investment activity of the QDII funds will also be governed by the laws of one or more jurisdictions where the target market is located and securities investment is made. With regard to the offshore investment activity, the fund manager and custodian of the QDII funds are ultimately responsible to the QDII fund shareholders. Hence it is necessary for both fund manager and custodian to understand the regulatory environment and technical standards of the place where relevant target market is located and investment activity is conducted, including securities finance system, security law and securities registration and holding system.

In addition to the self-learning and consultation with relevant professional institutions, the fund manager and custodian may raise issues and provide advice on the regulatory environment and technical standards of the target market through offshore investment advisors or custodians (or other relevant institutions). The QDII funds may also require offshore investment advisors or custodians to provide services on and share responsibilities for the compliance of investment of the QDII funds with relevant regulations in the target market through the contract, while the fund manager and custodian will undertake reasonable supervisions and assessment over the performance and services of the offshore investment advisors and custodians.

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