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SAFE Punished Some Chinese Financial Institutions in relation to Nei Bao Wai Dai and QDIIs

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On 1 December 2017, the State Administration of Foreign Exchange (**SAFE**) issued the *Announcement of the SAFE on Cases of Violating Foreign Exchange Regulations* (the **SAFE Circular**),¹ which includes 20 typical cases concerning (i) evasion of foreign exchange by enterprises and individuals, (ii) non-compliant processing by commercial banks of onshore guarantees for offshore loans (**Nei Bao Wai Dai**, “内保外贷” in Chinese), and (iii) illegal transfers by non-banking financial institutions of Qualified Domestic Institutional Investor (QDII) quotas. This note will focus on the cases of the latter two categories and analyze their legal implications.

Cases of violations involving onshore guarantees for offshore loans

The SAFE Circular cited the following four commercial banks for the non-compliant processing of onshore guarantees for offshore loans:

- a. The Quanzhou Branch of a PRC domestic joint-stock commercial bank

During the periods from September 2014 to June 2015, and September 2015 to July 2016, the Quanzhou Branch of the domestic commercial bank “**engaged in the purchase and payment of foreign exchange in violation of the regulations by failing to conduct due diligence on debtors’ qualifications, sources and use of secured funds, sources of funds for repayment and the backgrounds of the underlying transactions.**” SAFE found the bank to have violated the foreign exchange regulations and to have seriously harmed the order of

¹ 《国家外汇管理局关于外汇违规案例的通报》 [Announcement of the State Administration of Foreign Exchange on Cases of Violating Foreign Exchange Regulations] (St. Admin. of For. Exch., issued on Dec 1, 2017), available at the following [link](#) (Chinese).

the foreign exchange market. As a result, the branch was ordered by SAFE to rectify the violations within a prescribed time period and was subject to the confiscation of illegal proceeds amounting to RMB 3,041,000 and a fine of RMB 8,000,000.

b. The Zhuhai Branch of a Sino-foreign joint-stock commercial bank

From August 2014 to August 2015, the Zhuhai Branch of the Sino-foreign bank “**engaged in the purchase and payment of foreign exchange in violation of the regulations by failing to carry out due diligence on the repayment capacity of the overseas debtors and the source of funds for repayment, and failing to consistently supervise or track the use of funds loaned under the onshore guarantee for offshore loan arrangements.**” SAFE found the bank to have seriously disturbed the order of the foreign exchange market and ordered the confiscation of illegal proceeds amounting to RMB 816,000 and imposed a fine of RMB 1,000,000. The Zhuhai branch was suspended from engaging in foreign exchange business for corporate clients for three months.

c. The Beijing Branch of a wholly foreign-owned commercial bank registered in Shanghai

In the periods from September 2015 to October 2015 and September 2016, the Beijing Branch of the wholly foreign-owned commercial bank “**engaged in the purchase and payment of foreign exchange in violation of the regulations by failing to conduct due diligence on loan contracts, sources of the expected repayment funds and the backgrounds of the underlying transactions.**” SAFE found the branch to have severely violated the foreign exchange regulations, and to have disturbed the order of the foreign exchange market. The branch was ordered to rectify the violations within a prescribed period of time, and was subject to the confiscation of illegal proceeds amounting to RMB 3,879,000 and a fine of RMB 4,000,000. The branch’s foreign exchange business was suspended for three months.

d. The Shenzhen Branch of a wholly-owned commercial bank registered in Tianjin

During the periods from September 2014 to November 2014, and from October 2016 to November 2016, the Shenzhen Branch of the wholly-owned commercial bank “**engaged in the purchase and payment of foreign exchange in violation of the regulations by failing to conduct due diligence of the source of funds for repayment, the possibility of enforcing the security and background of the underlying transaction where there existed obvious inconsistencies between the beneficiary of the bill of lading and the transaction parties.**” The branch was ordered to rectify the violations within a specified period of time, and subject to the confiscation of the illegal proceeds amounting to RMB 229,000 and a fine of RMB 2,000,000.

Legal implications

While the banks were ordered to “rectify the breach within a prescribed period” (with no specific

deadlines stated in the SAFE Circular), SAFE did not challenge the validity and enforceability of these onshore guarantee for offshore loan arrangements. The SAFE Circular does not name any offshore counterparties in those cases or indicate whether the foreign counterparties were subject to liability.

This is not the first time for SAFE to release cases on foreign exchange violations for public notice. Nonetheless, the sanctions imposed by SAFE in the foregoing cases are generally believed to be more severe than those in previous comparable cases in terms of the type of penalties and the amounts of fines. The market has interpreted this as SAFE's determination to implement the calls of the National Financial Work Conference held in July 2017 and the 19th National Congress of the Communist Party of China to strengthen foreign exchange supervision, increase penalties and rectify foreign exchange market disorder.

Illegal transfer of QDII quotas

The SAFE Circular disclosed two cases where two asset managers unlawfully transferred QDII quotas to unqualified entities.

a. Illegal transfer of QDII quota by a Shanghai-based asset management company

From January 2015 to June 2016, the Shanghai-based asset management “***transferred its QDII investment quotas to non-QDIIs, which led to a net remittance of USD16,280,000 outside of China; this asset management company also submitted to SAFE false supporting documents.***”

In accordance with the *Provisions on the Foreign Exchange Administration of Overseas Securities Investment of Qualified Domestic Institutional Investors* (the “***QDII Regulation***”), QDIIs are prohibited from transferring or reselling their investment quotas. Thus, SAFE found this Shanghai-based asset management company to have seriously disturbed the order of the foreign exchange market and imposed a warning and a fine of RMB 7,750,000 on the company.

b. Illegal arbitrage by a Shenzhen-based fund management company

In October 2015, the Shenzhen-based fund management converted and remitted USD 2,987,000 offshore to make purported QDII investments; however, the company “***settled the foreign exchange outside of China and remitted the funds back on the same day so as to seek improper benefits from the different onshore and offshore exchange rates.***” SAFE held that this Shenzhen-based management company violated QDII Regulation Article 2 (concerning the permitted investment scope of QDIIs) and Article 16 (concerning the prohibition of transferring or reselling of QDII investment quotas, or otherwise illegally using foreign exchange), and was ordered to pay a fine of RMB 950,000.

Legal implications

The PRC regulator began issuing QDII quotas to qualified investors in 2006 as an interim arrangement to bypass the country's capital account foreign exchange controls. The QDII quota arrangement meets domestic financial institutions' demand for overseas assets while protecting the balance of international payments from the adverse impact that would be caused by a concentrated outflow of foreign currency from China.

However, many institutions with offshore investment opportunities are not eligible to receive investment quotas, and SAFE has ceased granting most QDII quotas since late 2015. As of 29 November 2017, the 132 approved QDIIs in aggregate hold only USD 899.93 million in quotas.² This has created a large gap between strong investment demand and limited QDII quotas. As a result, "lending" or "reselling" QDII quotas has increasingly been conducted as a way of "channeling business."

The two QDII quota cases published in the SAFE Circular send a powerful signal to the market that misconduct involving QDIIs has drawn the attention of the regulator. A SAFE official in a relevant press interview commented that "any market player cannot float outside of the supervisory regulations, and any violation of foreign exchange regulations will be subject to severe punishment."³ By publishing these cases, it appears that SAFE has begun a new round of inspections of QDII business activities and more violations occurring in the market may be handled in the near future. According to the same SAFE official, the purpose of SAFE regulations is "to deter the illegal and criminal activities in the foreign exchange markets, and to further warn entities engaging in cross-border trade and investments to observe the principles of authenticity and compliance."⁴

Although each of the QDIIs cited by SAFE were imposed with a warning or fine as punishment, the underlying offshore QDII investments (or the foreign exchange settlements outside of China in the case of the Shenzhen-based fund management company) disclosed in the SAFE Circular were not ordered to be cancelled or invalidated. It appears that SAFE's inspections are more focused on compliance of the onshore QDIIs who are accountable for the valid use of QDII quotas, while the related QDII investments involving other offshore stakeholders continue to be respected. However, it is not clear whether, and if so, to what extent, the underlying transactions are or will be adversely impacted. Therefore, foreign market players participating in QDII investments are well advised to follow these SAFE regulatory developments closely and to prepare for potential and increasing regulatory risks.

2 《合格境内机构投资者(QDII)投资额度审批情况表(截至2017年11月29日)》 [Qualified Domestic Institutional Investors (QDII) Investment Quota Approval Table] (St. Admin. of For. Exch., issued on Nov. 30, 2017), available at [link](#) (Chinese).

3 See Dandan Li, SAFE Takes a Sword to Market Disorder by Investigating 20 Regulatory Violation Cases, Shanghai Securities News, Dec. 7, 2017 (the official information disclosure platform designated by the China Securities Regulatory Commission), available at [link](#) (Chinese).

4 *Id.*

● **Important Announcement**

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