China's QFII Regime – A Complete Review of the Regulatory Scheme and Compliance Risks

Since its inception in late 2002 and UBS AG being granted the first Qualified Foreign Institutional Investor (**QFII**) licence in mid-2003, China's QFII regime has evolved rapidly attracting a wide range of international institutions from sizable securities houses and banks to fund managers, insurance companies, sovereign wealth funds, central banks, pension plans and universities. As of April 2012, China's securities regulator, the China Securities Regulatory Commission (**CSRC**), had approved 158 QFIIs from 23 countries of which 129 QFIIs[1] had been granted investment quotas by the State Administration of Foreign Exchange (**SAFE**, China's foreign exchange regulator) in the amount of US$24.55 billion. As of 23 March 2012, the total market value of securities investments of all QFIIs had reached around RMB265.6 billion (US$42.2 billion), representing approximately 1.09% of the total market value of tradable A shares. CSRC statistics show that the top five QFII origin countries/regions are the United States, United Kingdom, Japan, Korea and Hong Kong.

Although QFII investments still constitute a tiny percentage of the total market capitalization of China's A share market, their investment strategies and trading activities are under the spotlight of financial press covering this market. According to CSRC, the QFII program has enhanced its experience of monitoring and regulating cross-border investment and capital flows and has, therefore, been a positive experiment to further opening the market and achieving the free convertibility of RMB under the capital account. On 3 April 2012, CSRC announced that, according to a joint decision made by CSRC, SAFE and the People's Bank of China (**PBOC**), the total QFII quota would be raised by US$50 billion to US$80 billion. The quota increase is representative of the regulators' decision to promote the development of QFII program and the market reaction has been very positive.

[1] Those statistics exclude quota granted to RQFIIs.

By analogy to the QFII program, in December 2011 China launched a pilot program called the RMB qualified foreign institutional investor (**RQFII**) scheme. Similar to the traditional QFII regime, any RQFII applicant needs to apply for a license from CSRC and an investment quota from SAFE before making an investment in the PRC domestic securities market. Nevertheless, the RQFII scheme only applies to the Hong Kong subsidiaries of PRC fund management companies and securities companies in relation to their raising of RMB funds in Hong Kong for domestic securities investment. An increase of the RQFII quota was also announced on 3 April 2012 by RMB50 billion (roughly US$7.94 billion) to RMB70 billion (roughly US$11.11 billion).

1. Introduction

China's QFII regime has been a key component of China's staged opening up of its financial markets, in particular its securities market, permitting foreign investors to gain access to the previously restricted RMB denominated A share market under relatively strict regulatory oversight. This article aims to discuss the regulatory issues we have identified based on our experience advising various types of QFII clients and considerations as to future regulatory changes that Chinese regulators may implement.

1.1 The Regulators

The primary PRC regulators in this field are CSRC and SAFE, with the People's Bank of China (**PBOC**, China's central bank) having responsibility over policy making. A typical investment process by a QFII would be that (i) it first applies to CSRC for a QFII licence; (ii) it then applies to SAFE for an investment quota ranging from US$50 million to US$1 billion on an aggregated basis under the current practice and (iii) after SAFE grants the investment quota to the QFII, it will remit investment capital into China and convert this into RMB for trading in RMB denominated financial instruments including A shares, bonds, fund units and warrants. For fund manager type QFIIs, a disclosure as to the overall structure of the underlying investment fund that will utilize the QFII quota will be required.

1.2 The Regulations

In August 2006, CSRC, PBOC and SAFE promulgated the revised *Administrative Measures on Domestic Securities Investment by Qualified Foreign Institutional Investors* (**CSRC QFII Measures**) and CSRC issued a circular providing detailed rules on the securities investment aspects of QFII operations (**CSRC QFII Circular**).

Three years after the promulgation of the CSRC QFII Measures and the CSRC QFII Circular, SAFE finally issued QFII-specific rules titled the *Provisions on the Foreign Exchange Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors* (**SAFE QFII Rules**) on 29 September 2009. The SAFE QFII Rules set out detailed provisions on quota applications, remittance and repatriation of funds, QFII accounts, etc.

Certain ancillary measures have also been issued by various PRC authorities to deal with issues like opening securities accounts, registration and settlement of securities trading and tax treatment.

2. Qualification Process

2.1 Eligibility Requirements

To qualify as QFIIs, the applicants shall satisfy certain eligibility requirements. We set out below the key eligibility criteria for different types of QFII applicants:

Type of Institution	Minimum Years of Operation	Minimum Paid-in Capital	Assets under management (in previous fiscal year)
Fund managers	5	—	US$5 billion
Insurance companies	5	US$1 billion	US$5 billion
Securities companies	30	US$1 billion	US$10 billion
Commercial banks	—	—	US$10 billion, and ranked in top 100 world-wide
Other institutional investors	5	—	US$5 billion

In addition, another requirement applicable to all types of QFII applicants is that there has not been any material disciplinary action imposed on the applicants by the regulators in the past 3 years.

2.2 Qualification Preference

Together with a CSRC press release, the CSRC QFII Measures and the CSRC QFII Circular officially confirmed the regulators' preference for long-term buy-side foreign institutional investors which, in the mind of the Chinese regulators, are mainly pension funds, insurance funds, mutual funds and charity funds.

Although there is no definitive evidence indicating that funds are necessarily long-term investors who will not conduct trading opportunistically driven by China's fluctuating securities market, it seems that since 2006 CSRC has shown that its nearly exclusive interest is in attracting fund-type investors. As a result, out of the 158 QFII licences granted so far, there are 82 asset managers, 11 insurance companies and 29 funds (including endowment funds and sovereign wealth funds, etc.). Currently long-term buy-side investors represent around 77% of all the QFIIs. Moreover, CSRC does not commonly view hedge fund managers as falling into the category of "long-term investors" based on their use, as an industry generally, of short positions. Although there are a number of foreign fund managers operating both traditional and hedge fund businesses who have obtained a QFII licence and quota it is unclear as to how much of their QFII quota has been allocated to the hedge fund component of their business (if any). We have also seen other reputable hedge fund managers whose applications are still "pending" despite meeting the eligibility requirements set by CSRC.

The above pronounced regulatory approval preference should, of course, be taken into consideration by foreign investors interested in tapping into the growth and diversification opportunities of the Chinese securities market.

3. Open-ended China fund and Remittance/Repatriation of Investment capital

3.1 Open-ended China fund

The concept of the "open-ended China fund" was introduced by the SAFE QFII Rules, which is defined as an open-ended securities investment fund (i) that is sponsored and established by a QFII outside China in the form of public issuance and (ii) at least 70% of whose funds are to be invested in the securities market in China (i.e. including A shares, bonds, PRC funds but excluding B shares, which are foreign currency denominated shares listed on PRC stock exchanges). Open-ended China funds enjoy certain preferential treatment in terms of liquidity and account structure as discussed below.

3.2 Remittance of Capital

A QFII must remit its funds into China within six months after being granted the investment quota by SAFE. If a QFII fails to remit the principal in full within the stipulated six month period and the amount actually remitted is more than the equivalent amount of US$20 million, the amount actually remitted will be its investment quota. The unutilised balance of the investment quota will be revoked by SAFE; if a QFII fails to remit at least US$20 million within six months after the approval of its first investment quota, its quota will be totally cancelled by SAFE. Re-application with SAFE for a new investment quota must be undertaken if the QFII intends to remit more funds into China with the risk of rejection by SAFE.

3.3 Repatriation of Capital

3.3.1 Lock-up Period

Under the SAFE QFII Rules, all QFIIs are subject to a lock-up period during which QFIIs are prohibited from remitting their investment principal out of China. The lock-up period for a QFII is calculated from the date when the investment principal is remitted in full or the six-month remittance period falls due, whichever is earlier. A three-month lock-up period applies to open-ended China funds and certain types of QFIIs such as pension funds, insurance funds, mutual funds, charity funds, endowment funds, government and monetary authorities. The lock-up period for all the other types of QFIIs is one year.

Where there is a quota increase, the strict position is that the lock-up period should apply to both the existing quota and the additional quota as a whole. In practice, to the extent the additional quota can be segregated from the existing quota (e.g., new quota will be solely used by a new fund product) and subject to SAFE approval, the lock-up period may be applied only to the additional quota.

3.3.2 Repatriation of Capital

According to the SAFE QFII Rules, following the end of the three-month lock-up period, an open-ended China fund may remit or repatriate funds into or out of China without SAFE's approval on a monthly basis according to the net subscriptions or redemptions of the fund provided that (i) the net repatriation from China does not exceed US$50 million per month and (ii) the aggregate net remittance into China does not exceed the investment quota granted by SAFE to the QFII in question.

For QFIIs other than open-ended China funds, if they intend to purchase foreign exchange to repatriate its principal or profits after the one-year lock-up period, it shall apply to SAFE for prior approval on a case-by-case basis. It is worth noting that repatriation of the principal will lead to a reduction of the QFII quota by an amount equivalent to the repatriated principal amount. While the repatriation of profits will not cause a reduction in quota, it has been difficult in practice.

This effectively means that, compared to other QFII funds failing to meet the open-ended China fund criteria, an open-ended China fund may enjoy more flexibility in dealing with its clients' subscription and redemption needs and thus provide a more attractive investment proposition to investors. Other QFIIs in contrast may only repatriate their principal investment out of China through seeking SAFE's case-by-case approval.

4. Transfer or Sale of Investment Quota

Given the relatively high thresholds to qualify as a QFII and the regulatory requirements which QFIIs are subject to, there has been substantial demand among the non-QFII overseas investors in utilizing other QFIIs' quota to trade A

shares. Since the launch of the QFII scheme in 2002, sell side QFIIs (i.e. the investment banks) had been making their QFII quotas available to third parties in one of the three ways below:

a) a direct trading facility or account granting the clients a degree of freedom to trade A shares using the QFII as the broker and "contractual" custodian (QFII remained the owner of the A shares for PRC law purposes);

b) indirect market access products such as participatory notes and other structured products which essentially replicate the economic exposure of the underlying A shares; and

c) use of total return swaps (**TRS**) to create an equivalent economic exposure to that currently available by making use of a direct trading facility.

After years of remaining silent on the above, the SAFE QFII Rules have included a provision that prohibits QFIIs from transferring or selling their quota. It is generally believed that the fundamental rationale behind such a provision is to prohibit non-qualified foreign investors from trading A shares in China through synthetic products, in which case all the qualification requirements under the QFII scheme would be rendered meaningless. SAFE is also concerned that the QFII system, which was originally intended to encourage long-term investments in A shares, is being abused for short-term speculative trading, particularly by hedge fund managers.

As a result, option (a) which uses a direct trading facility is totally shut down. For options (b) and (c), although they are not explicitly prohibited under the QFII regulations, they are not in line with the intentions of the QFII regime according to CSRC and SAFE. Since the promulgation of SAFE QFII Rules, the regulators' general position had been that no QFII quota would be granted for issuance of structured products (including market access products and TRS) and no additional quota application will be approved if the applicant has any outstanding structured products. Until very recently CSRC announced that, for existing QFIIs with outstanding structured products, additional quota may be granted to the extent it will not be used for issuance of structured products.

5. Account Structure

5.1 Available Structures

Under a typical QFII fund investment structure, a PRC custodian bank (**PRC Custodian**) needs to be appointed to handle, through designated cash accounts, the RMB and foreign exchange transactions for remittance and repatriation into and out of the PRC, securities settlement as well as to take custody of the A shares held by the QFII fund. Each QFII may only appoint one PRC Custodian. The QFII applies through the PRC Custodian to open its securities account(s) with the China Securities Depository and Clearing Corporation Limited (**CSDCC**) for securities registration and settlement. In addition, a QFII appoints PRC securities companies to conduct its securities trading activities in the PRC. The structure of custody accounts for both cash and securities assets is important for QFII funds, particularly in terms of ownership of the assets under custody.

Most importantly, the CSRC QFII Circular explicitly provides that the assets in the "QFII - Fund" account belong to the "Fund" as independent assets from the QFII and the PRC Custodian. This type of account suggests that a fund manager QFII may be able to open a designated sub-account for a specific fund under its management, in the name of that fund, each such fund benefiting from the express provision as to that fund's ownership of the A shares held in such sub-account and independent of the QFII and the PRC Custodian.

However, under the SAFE QFII Rules, this joint name account treatment is apparently only available to open ended China funds as defined in Section 3.1. Therefore, for cash accounts, it seems that such joint name accounts may not be available to funds other than open-ended China funds.

As to the securities accounts, pending the implementing rules from CSDCC, it is not clear whether funds, other than open-ended China funds, may enjoy the joint name account privilege provided under the CSRC QFII

Circular to funds in general. Under the CSRC QFII Circular, securities accounts are required to correspond with the RMB cash accounts approved by SAFE, which may imply that unless joint name cash accounts are approved by SAFE, no joint securities accounts may be opened by funds managed by QFIIs.

The account structures available to QFIIs are set out below:

a) *Single Direct Proprietary Account*: A QFII remains able to use its QFII investment quota for its own proprietary investments through a single cash account with the PRC Custodian and a single securities account with CSDCC. In this case, the QFII fund manager is clearly the owner of all the A shares credited to the securities account and all cash credited to the cash account.

b) *QFII - Fund Account*: This type of account will allow fund manager QFIIs to open a designated sub-account for specific funds under its management in the name of that fund and with each fund benefiting from the express provision outlined in the CSRC QFII Circular as to that fund's ownership of the assets held in such a sub-account independent of the QFII and the PRC Custodian. The advantages brought about by a joint name account structure are numerous if the custody arrangements are properly structured:

- the fund is treated as the owner of the A shares held in the securities account, not the QFII fund manager;
- the assets belonging to the fund are segregated from the fund manager's own, and its other clients' (under the nominee account structure, as discussed below) assets;
- the QFII fund manager is not holding client assets.

c) *QFII - Client Assets Account*: A QFII may also open a securities account and corresponding cash account as a nominee account. QFII fund managers may use this type of account for its clients under individually managed accounts or for funds under its management that do not fall within the categories referred to in section (b) above. However, it is important to note that in contrast to joint name "QFII - Fund" accounts, there is no specific language in the CSRC QFII Measures or the CSRC QFII Circular stating that assets in such nominee accounts belong to the underlying clients, investors or funds. On the basis that securities of a client held with this account may be comingled with securities held for other clients (with managed accounts) and funds, as well as reflecting market access products or swaps written by the QFII, there is potentially a risk that "client" assets and own account assets of the QFII are mixed.

5.2 A Real Case

In October 2008, following the Lehman Brothers' insolvency, the assets in the QFII account of Lehman Brothers International (Europe) (**LBIE**) were frozen by a PRC court in response to a petition made by HuaAn Fund Management Company (**HuaAn FMC**), a client of Lehman Brothers. The damages claimed were unrelated to LBIE's QFII business and related instead to a fund product of HuaAn FMC which invested in a Lehman Brothers structured note. While some QFIIs were alerted of the asset ownership issues arising from the case, this case is considered to be unique as there was no clear distinction between proprietary accounts and nominee accounts at the time when LBIE was approved as a QFII. The case was settled without a court's ruling. It therefore remains to be tested as to how the PRC courts will enforce any claim against QFII assets held in a nominee structure in common litigation proceedings.

6. Investment Process

In this section, a number of significant issues that relate to a foreign investor's investments into A shares are discussed, particularly in terms of the gaps in PRC legislation to deal with complex trading scenarios arising from the opening up of China's domestic market to foreign investors.

6.1 Investment Restrictions

Several restrictions set out in the CSRC QFII Measures and the CSRC QFII Circular and some other implicit restrictions in China's foreign investment laws and regulations are worth noting.

6.1.1 Restrictions under QFII Regulations

Two restrictions are imposed on QFII investments:

a) an individual foreign investor investing through QFIIs may not hold more than 10% of the shares of a listed company; and

b) the A shares held by all foreign investors investing under the QFII regime may not exceed 20% of the shares of a listed company.

6.1.2 Restrictions under General Foreign Investment Laws

The PRC has a *Guidance Catalogue for Industries with Foreign Investment* (**Foreign Investment Catalogue**), last amended in 2011, which classifies the industries that are encouraged, restricted or prohibited for foreign investment. Industries not listed in the Foreign Investment Catalogue are permitted for foreign investment.

Practically speaking, the chance that a QFII may breach the relevant foreign investment restrictions (other than for prohibited industries) may be low because the relevant ratio caps are relatively high and, as detailed above, the foreign investment by all QFIIs are subject to the stock exchanges' close monitoring from the point when aggregate investment in A shares of a listed company by all QFIIs exceeds 16% of the total issued shares of the company.

6.2 Disclosure of Interest

Under the PRC Securities Law and certain ancillary regulations, if an investor, together with the person(s) acting in concert with him, holds 5% of the issued shares of a listed company, they are required to make a filing of its shareholding status and make corresponding disclosure of interest reports for each subsequent increase or decrease of 5% in its (their) holding. This reporting requirement appears to be less demanding compared with the requirements in more developed jurisdictions such as Hong Kong. However, when applied to investments made by foreign investors under the QFII regime, several challenging issues arise.

6.2.1 Shares Held in Nominee Accounts

First, "shares held by an investor" are defined as (i) the shares registered or recorded under its name and (ii) the shares not registered under its name but the voting rights of which may be controlled *de facto* by that investor. The disclosure of interest requirements are applicable extraterritorially in the case of companies listed both on domestic and overseas securities markets, i.e. dual-listed companies. According to the first limb of this two-limb test, many overseas nominee holders (such as securities houses) holding overseas issued shares of a dual-listed company and having such shares registered under their names could be required to take into account these shares as shares held by them, if the test is applied literally.

6.2.2 Concert Parties

Second, as to the concept of acting in concert, concert parties are defined as persons jointly holding shares through agreement or other arrangements. A presumed acting in concert relationship will be determined in certain cases unless the presumed parties present CSRC with evidence to the contrary. Some noteworthy scenarios include:

a) there are controlling shareholding relationships between the investors;

b) they are controlled by a common entity;

c) the directors, supervisors or main members of the senior management of one investor are also the directors, supervisors or members of the senior management of another investor; or

d) one investor holds an equity interest in another investor and has a significant influence on the decision making of such investor.

Obviously, these may cause compliance difficulties for large financial groups. For example, a financial conglomerate may have two QFII licences: one for its proprietary trading and the other for its asset management business. Another example is that different funds and fund managers within the same group may easily be considered as concert parties by applying the standards above. However, the relevant regulation also provides that any such presumed concert parties may present contrary evidence to CSRC to obtain a waiver if they do not wish to be treated as concert parties.

6.2.3 Indirect Access Through Structured Products

Various derivatives products have been developed and marketed by QFIIs to foreign investors that do not hold a QFII licence but want to gain access to Chinese securities markets. One such product is the participatory note, which a non-QFII investor purchases from a QFII in order to enjoy the economic benefits arising from the underlying shares held by the QFII and assume the investment risks associated therewith. After the announcement of the SAFE QFII Rules, even though market access products are not prohibited under the relevant laws and regulations, their use is not encouraged by the regulators with a belief that these products are not in line with the intention of the QFII regime. In practice, any proposed issuance of structured products needs to be reported to CSRC in advance even though it is very difficult (if not impossible) to get CSRC's approval. For existing QFIIs with outstanding market access products, it would generally be very difficult for them to get additional quota before they undo all such products.

6.3 Short Swing Profit Rule

6.3.1 Martin Currie Case

The first dispute involving a QFII under the PRC securities regulatory regime is in relation to the short swing profit rule under the PRC Securities Law. The suit was brought by a PRC listed company in 2008 against Martin Currie Ltd (**MCL**), a UK-based investment manager, and its two wholly owned subsidiaries, Martin Currie Investment Management Ltd (**MCIM**) and Martin Currie Inc (**MCI**). According to the disclosure of interests reports made by MCL on behalf of MCIM, MCI and itself, MCIM and MCI jointly managed approximately 5.9% of the shares of the PRC listed company through its two portfolio managers for four different clients under the QFII regime but utilizing different QFII holders. The reports seem to suggest implicitly that the investment for these clients is under the joint and concert management of these two portfolio managers and, accordingly Martin Currie, aggregated the shareholdings and made disclosure reports. Within 6 months of purchasing the shares and triggering the 5% reporting threshold, MCIM and MCI sold shares in the company and made profits from the sales. Based on the above facts, the listed company's board brought suit under the short term trading rule and the case was settled in 2010 by MCL and its two wholly-owned subsidiaries agreeing to pay the PRC

listed company a lump sum amount equivalent to RMB40 million. While there is still some legal uncertainty around the issues arising from the dispute given there was no ruling by the PRC court, the general regulatory trend seems to be stringent in this regard.

6.3.2 The Rule

Under the PRC short swing profit rule, where a shareholder who holds more than 5% of the issued shares of a listed company sells the shares in that listed company within 6 months of the purchase of the shares, or buys shares in a listed company within 6 months of the sale of the shares in that listed company, the profits coming out of that transaction shall belong to the listed company. Furthermore, the board of directors of the listed company shall be entitled, and are also required, to recover the profits from the buying/selling shareholder.

The rule is generally understood to play the role of acting as a "prevention wall" against insider trading because a shareholder holding more than 5% of the shares of a listed company can be deemed a principal shareholder having access to insider information of the listed company. Therefore, seen from a policy perspective, for investment managers, if they merely make short term financial investments in listed companies and are unlikely to obtain insider information from the listed company, we would expect that they should be excluded from the operation of the short swing profit rule. Unfortunately, this is not set out explicitly in the PRC regulations.

6.4 Short Selling, Over Purchase and Erroneous Trades

Since October 2011 CSRC has officially recognized margin trading and securities lending as a regular business of securities companies, subject to a series of qualification requirements. However, currently such services cannot be provided by approved securities companies to their QFII customers due to certain infrastructure issues relating to QFIIs' account structure and custody arrangement. In addition, over purchase (i.e. purchase of securities without sufficient corresponding settlement funds) is not permitted. CSRC has issued a special notice on how to handle such erroneous trades (i.e. over purchases) such as how to allocate the responsibilities among the broker, custodian and the QFII if over purchases occur.

6.5 Stock Index Futures Trading

On 4 May 2011, CSRC promulgated the *Guidelines for Investment in Stock Index Futures by Qualified Foreign Institutional Investors* (**QFII SIF Guidelines**) under which QFIIs are permitted to trade the CSI 300 index futures. While QFIIs no doubt welcome the extended ability to invest in stock index futures, due to some technical reasons (mainly in relation to the mismatch of most QFIIs' custodian banks and the designated margin account banks for stock index futures trading), no QFII has commenced trading of stock index futures trading. It is expected that such technical issues will be resolved shortly enabling QFIIs to commence trading in the stock index futures soon.

It is worth noting that, pursuant to the QFII SIF Guidelines, QFIIs approved to invest in stock index futures may only engage in trading for hedging purpose. In addition, the value of the stock index futures contracts (long and short contracts in aggregate without netting) held by a QFII shall not exceed its investment quota at the end of any trading day and that the amount of stock index futures traded by a QFII (purchased and sold contracts in aggregate, excluding squared positions) shall not exceed its investment quota on any trading day.

6.6 Insider Dealing and Manipulation of the Market

PRC Securities Law also prohibits insider dealing and manipulation of the market, which applies to QFIIs and foreign investors investing in PRC listed companies through the QFII quota. Under PRC law, an investor may not utilize inside information to trade the shares of the company concerned. Inside information is loosely defined as non-public information in respect of a company's operation or financials or having material impact

on the market price of the company's securities in securities trading activities.

An investor is also prohibited from manipulating the securities market in the following ways:

a) anyone, independently or in collusion with others, manipulating the trading price of securities or the trading quantity of securities by centralising their advantages in funds, their shareholding advantages or taking their information advantage to trade jointly or continuously;

b) anyone collaborating with any other person to trade securities pursuant to the time, price and method as agreed upon in advance, thereby affecting the price or quantity of the securities traded;

c) anyone trading securities between different accounts under his/her own control, thereby affecting the price or quantity of the securities traded; or

d) anyone manipulating the securities market by any other means.

7. Withholding tax

On 23 January 2009, the Chinese tax authorities issued the *Notice on Issues relating to Withholding Tax of Dividends and Interests Paid by a Resident Enterprise to a Qualified Foreign Institutional Investor* (**QFII Withholding Tax Notice**) under which it is expressly provided that a QFII will be subject to withholding tax of 10% on dividends and interest it derived from China (subject to reduction by applicable tax treaties). The PRC resident enterprise that distributes dividends or pays interest to the QFII will be the withholding agent and will be required to withhold and deduct the 10% withholding tax.

While at the moment no regulation has yet been issued on the taxation of capital gains realised by QFIIs on the sale of A shares, many believe that there is a risk that PRC tax authorities may seek to collect tax on capital gains at some point and on a retrospective basis. There have been different arrangements with respect to the contingent PRC withholding tax on the QFII fund's capital gain. Some QFIIs will, in anticipation of the contingent PRC tax liabilities, withhold a certain percentage of tax for a period of time and then repatriate to the fund if such liabilities have not been actualized at the end of the period. Other QFIIs do not withhold any amount on the disposal but will claim against the investors if PRC authorities request them to pay tax on the capital gains in the future.

8. Recent Developments

According to a recent announcement CSRC, CSRC and SAFE will accelerate the QFII licence and quota approval process and CSRC will further ease some of the restrictions on QFIIs' investment in China. Among other things, an unofficial rule that QFIIs are required to invest at least 50 percent of their assets in equities (as opposed to fixed-income products and cash) will be lifted by CSRC going forward. In addition, CSRC will allow more than two institutions of the same group to apply for separate QFII licences.

9. Conclusion

It has been a decade since the debut of the PRC QFII program. While the regulatory landscape has become clearer and common practices becoming more established, the overall QFII regime and the related securities laws and regulations are still evolving towards further transparency and opening-up. Notwithstanding the issues presented by China's opening-up of its securities market to foreign investors which remain unresolved, it is anticipated that more opportunities will be created in the PRC market. In the meantime, compliance must remain a priority. Based on our experience, proactive communication with relevant regulators is always encouraged and is of vital importance in addition to close monitoring of market developments which is also of tremendous value.

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