CLIFFORD CHANCE

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CSRC New Rules to Buck Up the QFII Program

Key issues

Introduction

Ever since the Qualified Foreign Institutional Investors (QFII(s)) initiative started in 2002, the China Securities Regulatory Commission (CSRC), the People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) have taken a step-by-step approach to promote the program by lowering barriers for QFIIs' entry and expanding the universe of permissible investments available to QFIIs. China remains keen to continue to deepen the opening of its domestic capital markets, and in that context CSRC and SAFE have looked to issue more QFII licenses and quota. At present, 172 institutions have obtained QFII licenses, of which 147 have been granted a total quota of US$28.533 billion.

In light of the still smaller market share of QFIIs, following a public consultation from 20 June 2012 to 5 July 2012, CSRC issued the Provisions on the Issues Related to Implementing the Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors (QFII Provisions) on 27 July 2012, which came into effect on the same day. The new QFII Provisions should permit the easier participation by a wider group of QFIIs. This article discusses the major changes as a result of the new QFII Provisions.

Lowered Entry Barriers and Simplified License Application Procedures

The previous regulations set high thresholds for entry for QFII applicants requiring significant levels of assets under management (AUM) and high paid-in capital. This left many foreign institutions unable to meet the eligibility criteria to apply to become QFIIs. The QFII Provisions lower the eligibility requirements for QFIIs:

- for asset management companies, insurance companies and other institutional investors (i.e., pension funds, charity funds, etc.), the track record period requirement is lowered from five years to two years, and the amount of securities AUM required is reduced from USD5 billion to USD500 million;
- for securities companies, the track record period requirement is lowered from thirty years to five years; the requirement on paid-in capital of no less than USD1 billion is replaced with the requirement on net assets of no less than USD500 million; and the minimum AUM requirement is lowered from USD10 billion to USD5 billion; and
- for commercial banks, the ranking requirement is removed and instead, the banks should have more than ten years' of being in banking business and at least USD300 million Tier 1 capital; and the minimum AUM requirement is lowered from USD10 billion to USD5 billion.

In addition, CSRC further explains that foreign private equity investment institutions may also apply for a QFII licence as asset managers.

Online application is now available for all applicants. To apply for a QFII, an applicant is required to submit the application documents through CSRC's website and also deliver hard copies to CSRC. Where any material event occurs to a QFII, the QFII shall also make the filing through CSRC's website.

Multiple Broker Model Feasible

QFIIs were previously permitted to appoint up to three securities brokers for the Shanghai Stock Exchange and Shenzhen Stock Exchange respectively. However, given the previous QFII rules required that the securities accounts must correspond with the Renminbi account approved by SAFE, a QFII would in practice only be able to open one securities account with one broker for each stock exchange. The QFII Provisions remove this practical restriction on accounts and now make it possible for one QFII capital account to correspond to multiple securities accounts opened with different securities brokers.

QFII Account Management

Previously, a QFII was required to open a nominee account for clients' assets under its management (where the client was not a fund including a mutual fund, insurance fund and "open-ended China fund" under QFII's management, for which "QFII - Fund" accounts are available). In practice, the nominee account structure had not been actively adopted, and as a modification some QFIIs opened a general "QFII - client assets" account. Under the QFII Provisions, QFIIs are now permitted to open separate accounts for different underlying clients in the name of "QFII - Client Name" While the QFII Provisions reiterate that the assets in the "QFII - Fund (Insurance Fund) Name" account belong to the relevant fund and are independent from the QFII and the custodian for other types of QFIIs (especially the nominee account type of QFII), ownership remains ambiguous.

Furthermore domestic fund management companies are now permitted to provide QFIIs with special client assets management services and open corresponding accounts. As such, it becomes more convenient for QFIIs to invest in special account products of fund management companies.

Expansion of Permissible Investment Scope

In addition to exchange traded stocks, bonds and warrants and securities investment funds, the QFII Provisions for the first time permit QFIIs to invest in fixed-income products in the inter-bank bond market. The ability to invest on the inter-bank bond market is definitely attractive to QFIIs as the interbank bond market is where the liquidity and the bulk of the onshore bond market is. The superior market access and liquidity of the interbank bond market will significantly enhance QFII's ability to capture investment opportunities. Although the universe of permissible investments have been expanded, the QFII Provisions have not relaxed the practical asset allocation restriction that a QFII should invest at least 50% of its assets in listed equities.

The QFII Provisions also restate that QFIIs can invest in stock index futures. However, without PBOC issuing appropriate RMB account rules to permit a QFII to open a special RMB account for the purpose of the stock index futures, QFIIs will remain unable to actually enter into any stock index futures transactions.

Loosened Shareholding Restriction

The cap of the aggregate amount of shareholding of all foreign investors in a single A-share listed company is increased from 20% to 30%, whereas the cap of shareholding of a single foreign investor remains unchanged at 10%.

Outstanding Issues

While the QFII Provisions provide a more favorable QFII framework, there are still some uncertainties that need further clarification with a view to enhancing a clear and comprehensive QFII regime.

- Despite an expanded scope of new universe of permissible investments available to QFIIs, QFIIs remain concerned that restrictions will be imposed on the allocation of their QFII quota to each type of investments. In practice, each QFII has been required to maintain at 50% of their asset allocation in listed equities. Now QFIIs are permitted to enter the interbank bond market, QFIIs wish to have more flexibility to invest more than 50% of the assets in fixed income products.
- CSRC indicated in a Q&A session published this May that outstanding market access products will not affect QFII's application of additional quota. However, this position is yet to be confirmed by SAFE. Other than the market access product issue, QFIIs are also seeking further relaxation on the foreign exchange restrictions. Currently, QFIIs are required to remit investment principal within 6 months upon being granted the quota and they can only convert foreign currency into RMB through its custodian bank for the investment. QFIIs expect more simplified procedures of the inward and outward remittance of Renminbi by QFIIs.
- Restrictions on the liquidity of QFIIs remain unchanged. For the open-ended fund launched by a QFII, the subscriptions and redemptions of the fund are processed on a monthly basis, and the inward or outward remittance of funds with an

amount of more than US$50 million requires SAFE approval. Given the fact that the parallel renminbi qualified foreign institutional investors (RQFII(s)) are not subject to such restriction and that the custodian of an RQFII could process the remittance or repatriation of RMB/foreign funds on a daily basis without SAFE approval, QFIIs wish to be provided with more liquidity.

- In addition, QFIIs remain very concerned about their preferential tax treatment in China. Reportedly the State Administration of Taxation (SAT) is revising the taxation rules under which QFIIs might be subject to capital gains tax. More clarity on the tax implications of QFIIs in China would be greatly applauded.

Conclusion

All the outstanding issues were submitted to CSRC during the consultation period. Realising they are not within its sole jurisdiction, CSRC has given assurances that it will consult with the relevant PRC authorities to facilitate QFIIs' investment and operation. With CSRC's assurance, QFIIs are anticipating SAFE, PBOC and SAT to issue favorable rules as well. Against the backdrop that China is seeking to deepen the opening up of capital markets, more coordinated efforts will be taken by relevant regulators to bolster the involvement of foreign capital.

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