CLIFFORD CHANCE

Briefing note

4 January 2013

SAFE Revises Foreign Exchange Rules for QFIIs

In order to attract more global institutional investors to participate in China's securities market, the China Securities Regulatory Commission (**CSRC**) has recently revised its regulations on the qualified foreign institutional investors (**QFIIs**) regime[1]. In December 2012, the State Administration of Foreign Exchange (**SAFE**) promulgated amendments[2] to the *Measures on Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors*, which became effective as of 7 December 2012 (**Amended SAFE Measures**). The *Trial Operation Guidelines for the Administration of the Domestic Accounts of Qualified Foreign Institutional Investors* (**SAFE Account Guidelines**) were also included in the Amended SAFE Measures as an appendix.

This briefing seeks to highlight the main changes introduced by the Amended SAFE Measures and their implications.

An increased investment quota

The Amended SAFE Measures have increased the investment quota originally allowed of sovereign funds, central banks and monetary authorities from USD1 billion to beyond USD1 billion. Based on SAFE's published information at the time of writing, the respective quota of the five sovereign funds, central banks and monetary authorities has in fact already reached USD1 billion.

Key issues

- An increased investment quota
- A new account structure
- Repatriation
- Implications for existing QFIIs
- Conclusion

1 *Implementing Rules on Issues Relevant to the Regulation on the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* referred to as the **Revised CSRC QFII Rules**

2 SAFE Bulletin [2012] No. 2

A new account structure

Asset manager QFIIs often question the type of account structure permitted. Before the Amended SAFE Measures came into effect, QFIIs were only allowed to open a separate account for each open-ended China fund they manage. Other client assets may only be held in an omnibus client-asset account. With the promulgation of the Amended SAFE Measures, the following account structure is envisaged:

- for foreign exchange accounts, the rules remain unchanged such that a QFII can open one special foreign exchange account for proprietary funds (**Proprietary FX Account**), one special foreign exchange account for client funds (**Client FX Account**), and/or one special foreign exchange account for each open-ended China Fund (**Fund FX Account**) with its PRC custodian. Each of these accounts will be referred to as an **FX Account** below;
- before opening an RMB account for securities investment, a QFII should open a basic RMB deposit account if it does not already have one. This basic RMB deposit account may not be used for securities investment but neither the Amended SAFE Measures nor the SAFE Account Guidelines clarify what its permissible usage is. The QFII may open this account with any commercial bank in China (but not necessarily the PRC custodian) upon obtaining a *Permit Certificate on Account Opening* issued by the local branch of PBOC;
- as a result, QFIIs are now subject to the same rules as PRC-incorporated companies in that they must open a basic RMB deposit account for settlement of funds upon obtaining the *Permit Certificate on Account Opening*. Generally speaking, the basic RMB deposit account functions more as an identity certificate of a QFII in China's RMB settlement network;
- as for the Proprietary FX Account and the Fund FX Account, a special RMB deposit account for securities transaction (**Securities Funds Account**) may be opened with the PRC custodian that corresponds to each FX Account and be used for securities investment. As for the Client FX Account, up to six Securities Funds Accounts may be opened with the PRC custodian to correspond to different clients or client groups provided that the initial balance in each Securities Funds Account is no less than USD20 million. According to the Revised CSRC QFII Rules, a QFII can open one securities account with the China Securities Depositary and Clearing Corporation Limited (**CSDCC**) under each Securities Funds Account;
- for stock index futures investment, a QFII can also open a special RMB deposit account for futures transaction (**Futures Funds Account**) with a qualified futures margin custodian[3] that corresponds to each Securities Funds Account. Funds in the Futures Funds Accounts can only be remitted from or back to the Securities Funds Accounts. However, if the PRC custodian of a QFII is qualified to engage in the custody of futures margin, this QFII can use its Securities Funds Account (or the special RMB account opened according to the rules prior to the effectiveness of the Amended SAFE Measures) to trade stock index futures without opening new accounts.

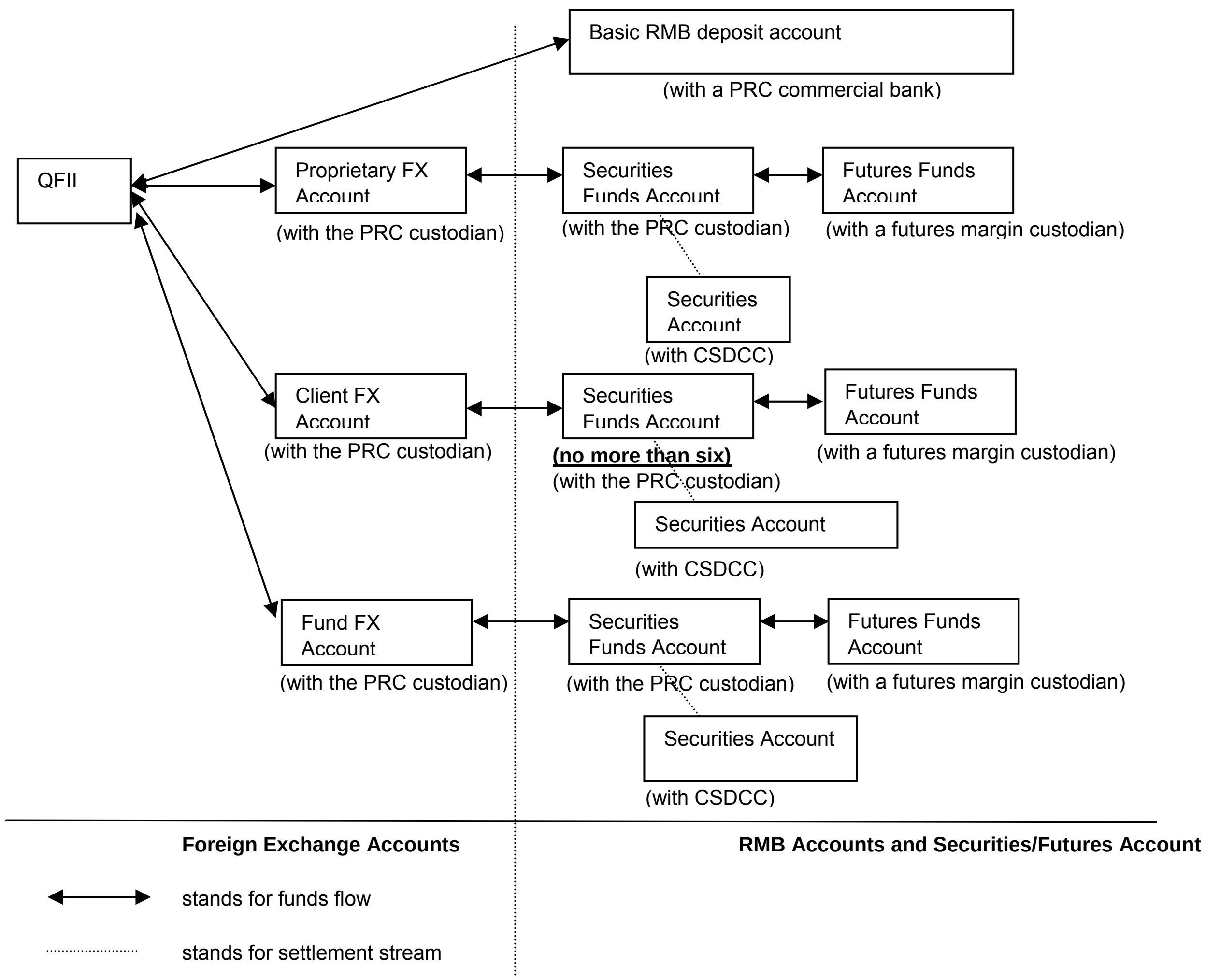
The above new account structure will facilitate the identification of asset ownership in China and help to address the requirements of specific clients of QFII asset managers. The introduction of the Futures Funds Account helps satisfy the need for a cash account structure before QFIIs may trade stock index futures on the China Financial Futures Exchange (**CFFEX**). However, the operation guidelines for QFIIs to open futures accounts with CFFEX remain unclear. In addition, as provided under the *Guidelines for Qualified Foreign Institutional Investors Participating in Stock Index Futures Transactions* issued by CSRC in 2011, QFIIs intending to trade stock index futures must apply for a hedging quota within which they may trade stock index futures for hedging purposes. Market participants are currently anticipating CFFEX to clarify the operation guidelines for the hedging quota application and how QFIIs may use such a quota. Meanwhile, CFFEX has begun to

[3] Currently, only five state-owned PRC commercial banks have obtained this qualification.

receive, through futures brokers, applications of account opening and hedging quota by QFIIs. Reportedly, QFIIs may be able to finally trade stock index futures on CFFEX in early 2013.

Although the Revised CSRC QFII Rules allow QFIIs to trade fixed-income products in the inter-bank market, it is still unclear what account structure the PBOC would prescribe for inter-bank market trading.

Please find below a chart on the account structure contemplated under the Amended SAFE Measures:



Before the Amended SAFE Measures came into effect, QFIIs that did not manage open-ended China funds may only open two sets of foreign exchange accounts and special RMB accounts: one for proprietary trading and the other for clients. Under the SAFE Account Guidelines, QFIIs can now (i) open new Securities Fund Accounts, Futures Fund Accounts and the basic RMB deposit account after cancelling and transferring funds from their original special RMB account into a corresponding Securities Fund Account; or (ii) apply to convert the special RMB account for client assets into the above account structure separating assets of different clients (i.e. up to six accounts for different clients) within the six-month deadline falling on 6 May 2013 following the promulgation of the SAFE Account Guidelines.

Repatriation

Another issue of substantial interest for QFIIs is the repatriation of principal and profits from China after the initial QFII lock-up period.

SAFE has now clarified that a QFII can remit its investment principal and/or profits out of China in installments, subject to the new restriction that the remitted amount per month must not exceed 20% of the total onshore assets of the QFII (i.e. total onshore assets of the fund in respect of an open-ended China fund) as at the end of the last calendar year.

The Amended SAFE Measures have therefore provided more flexibility to an open-ended China fund for repatriation of funds as follows:

- an open-ended China fund may remit funds into, or repatriate funds out of China on a weekly basis based on its net subscription or redemption amount. Originally, this was only permitted once a month. This change definitely helps improve the liquidity of open-ended China funds launched by QFIIs and hence attract more investors; and
- the remittance and repatriation of an open-ended China fund can now be processed directly with the PRC custodian without the need for SAFE approval (which was required in the past if a single repatriation exceeds USD50 million).

The implications of the above amendments are two-fold for an open-ended China fund. On the one hand, open-ended China funds can repatriate funds out of China without SAFE approval regardless of the amount. On the other hand, this is subject to a monthly ceiling of 20% of the fund's assets as at the last calendar year.

The repatriation of accrued profits by QFIIs other than for open-ended China funds can now be processed with the PRC custodian directly with the submission of a tax certificate. According to our experience, since the tax treatment on the capital gains of a QFII through investment in China is not entirely clear, tax authorities are generally unwilling to issue tax certificates to QFIIs. Until the State Administration of Taxation issues rules to address this, such operational difficulties still remain. Currently, if a QFII wishes to repatriate profits, it may apply to SAFE on a case-by-case basis by presenting an undertaking that it has reserved sufficient funds in China to repay any PRC tax as and when the PRC tax authorities formally issue the relevant tax rules.

Implications for existing QFIIs

With the promulgation of the Amended SAFE Measures and SAFE Account Guidelines, an existing QFII may wish to consider taking the following steps:

- amending its prospectus, private placement memorandum and/or asset management agreements in respect of the changes to the account structure, repatriation frequency and monthly repatriation maximum;
- amending its business plan filed with SAFE and CSRC to allow the trading of stock index futures to hedge market risk onshore (while considering PBOC's further flexibility in allowing QFIIs to trade fixed-income products in the inter-bank market);
- negotiating new infrastructure documentation for new accounts to be opened and engaging futures broker;
- checking the custody and infrastructure documentation to determine whether amendment is necessary to cater for the change in the account structure; and
- how to take advantage of the ability to open up to six Securities Funds Accounts that correspond to the Client FX Accounts to realise the separation of client assets to the extent possible, and how to allocate the six accounts among existing and potential clients.

Conclusion

The Amended SAFE Measures reflect several areas of deregulation that had been anticipated by the market. This is a clear indication of the Chinese government's intention to encourage offshore investors to invest in the onshore securities market. However, several key issues remain unclear. PRC regulators are urged to provide further clarification in respect of the implementation of inter-bank trading of fixed income products, as well as, crucially the tax treatment of capital gains by QFIIs.

Contacts

Yang TieCheng
Partner
E: tiecheng.yang@cliffordchance.com

Ying White
Partner
E: ying.white@cliffordchance.com

Ge Yin
Senior Associate
E: yin.ge@cliffordchance.com

Mark Shipman
Partner
E: mark.shipman@cliffordchance.com

Teresa Leung
Consultant
E: teresa.leung@cliffordchance.com