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Maximising opportunities in China – an update for European funds and investors

Thanks to the controlled nature of its currency, inbound and outbound investment in China has long been fraught with challenges. The past decade has seen the advent of first the QFII and then the RQFII regimes, which allow licensed foreign investors to buy and sell shares on China's mainland exchanges under a quota system, and the new Chinese presidency could open the markets still further. Here Clifford Chance experts discuss the landscape, changes on the horizon, and the opportunities on offer.

It may be a slow burn, but in the past year in particular we have witnessed clear signs of the Chinese economy gradually opening its doors to foreign investors. A process that began in 2002 with the introduction of the Qualified Foreign Institutional Investor (QFII) regime, which allows licensed foreign investors to buy and sell yuan-denominated "A" shares on China's mainland stock exchanges, gathered pace in 2011 with the launch of the offshore Renminbi QFII regime (RQFII) in Hong Kong, allowing foreign holders of RMB to invest directly in the mainland stock and bond markets.

In 2013 the liberalisation has continued. The start of the year saw the rules relaxed to allow financial institutions and fund management companies set up in Hong Kong to apply for an RQFII quota, moving away from the previous restriction that had limited the regime to subsidiaries of Chinese fund management and securities companies (though quotas still look most likely to go to Hong Kong asset managers with connections to mainland China). And then in October George Osborne, the UK chancellor, announced that China had granted the UK an allocation of RMB80bn (£8.2bn) quota under RQFII, making London the first location outside Hong Kong to have such an allocation, with Singapore likely to follow close behind.

Ying White, partner and head of Clifford Chance's Funds and Investment Management Group in China, says: "the mentality of the Chinese regulators has changed, from one focused on what you can't do, to what are your wishes and how can we support you. Regulators are showing support for the new presidency's initiative to help foreign investors, and there is a definite change of tone."

Investing in the Chinese market

Because China is a currency-controlled country, approval is required from the authorities before money can be moved either in or out of the economy. As such there is a complex regulatory regime, beset by acronyms, overseeing investments into the market and the way in which foreign asset managers can access Chinese investor capital.

Foreign investors looking to put their own capital to work in China are governed by the QFII regime, which has been in place for more than a decade

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and allows for investments into the Chinese stock market. A separate infrastructure oversees investment into Chinese private equity funds, and that system is the Qualified Foreign Limited Partners (QFLP) scheme.

Those investors with offshore RMB to put to work on the mainland have benefitted from RQFII since December 2011, and recently the Shanghai authorities have opened up the QFLP programme by allowing overseas RMB holders to make direct onshore investments using their RMB funds through the RQFLP scheme. That pilot is aimed at absorbing the large amount of RMB funds that have resulted from the rapid development of RMB internationalisation.

Both the QFII and RQFII regimes have seen liberalisation in the past 12 months. Under QFII, hedge funds are still looked at with caution, but trading of stock index futures is now permitted, for hedging purposes only, and trading in the inter-bank bond market is also now allowed.

New March 2013 rules relaxed the RQFII scheme by lowering the entry criteria, expanding permissible investments, and lessening the control on remittance and repatriation of funds. Regulators also introduced yuan-denominated exchange-traded funds (ETFs) that track major mainland indexes to fire up investor interest. As such the expansion to London with the quota of RMB80bn continues a process that is consistent with the Chinese policy goal of facilitating a two-way renminbi flow, both out of China and back in.

When choosing between QFII and RQFII, foreign investors must consider differences between the regimes with regard to entry criteria, sources of funds, permissible investments and lock-up periods and, crucially, repatriation among others. For example, the QFII scheme is open to non-PRC institutional investors and asset managers that satisfy requirements on track record period, capital adequacy and securities assets under management, none of which apply under RQFII.

Accessing Chinese investor capital

For those interested in accessing Chinese investor capital, there is a quota system for Qualified Domestic Institutional Investors (QDII), which allows Chinese financial institutions to pool Chinese money to access foreign markets. There is also a pilot scheme in Shanghai for Qualified Domestic Limited Partners (QDLP) that is the only means currently available for international hedge fund managers to move onshore and tap into Chinese investment capital.

Under QDII there are restrictions on what money can be invested in, and only Chinese financial institutions that are banks, trust companies, fund managers, securities companies or insurers can participate. Those five classes are all regulated separately in China and as such have their own distinct limits on permissible investments.

The QDII scheme has recently seen a proposed expansion of permissible investments to include private funds registered in jurisdictions with a memorandum of understanding with the CSRC, China's securities regulator. Insurance QDIIs were expanded last October to permit money market products, fixed income products, equities and private equity, and while hedge funds remain excluded, the insurance regime is the most liberal and may yet open up further.

The opportunity for London

The expansion of the RQFII regime into London marks a significant development in the liberalisation of China's foreign investment rules, and the quota system will closely resemble that employed in Hong Kong since 2011. While London's quota of RMB80bn is dwarfed by Hong Kong's RMB270bn, there will be major differences between the London RQFII and the Hong Kong RQFII.

Ying says, "the Hong Kong RQFII is mostly retail-investor driven, with Hong Kong subsidiaries of Chinese securities companies and fund managers making up the bulk of the HK RQFII quota holders. The rules may have recently been relaxed, but still about 90% of HK RQFII quota holders are Hong Kong subsidiaries of mainland firms.

"The London RQFII is quite different. The Chinese regulators expect that they will be dealing with London managers who are not subsidiaries of Chinese financial firms."

For managers unable to get a RQFII license, there remains the option of

"London has only got a small amount of quota to begin with, but that's because China wants to make sure it's successful, and so will be picking the right managers with the right products. If it is a success, it will get bigger and bigger."

Mark Shipman, Partner, Clifford Chance, Hong Kong structuring a fund that is co-managed with an existing RQFII quota holder, and essentially accessing their quota.

London will have an advantage over Hong Kong in its ability to access European investors, and particularly because London managers will be more familiar with relevant regulatory regimes like the Alternative Investment Fund Managers Directive (AIFMD).

Simon Crown, a partner in Clifford Chance's Financial Regulation Group, says: "the European fund management regime is now set up in such a way that London managers, once authorised in such a way that they have a passport to market funds across the EU, are much better able to target the European investor base than a non-EU manager. London also has significant expertise, with a very large asset management business."

The level of RMB retail deposits is also not necessarily an issue for London, as a manager can theoretically launch a new RMB-denominated fund, and can accept sterling deposits from investors before converting them into RMB.

Mark Shipman, head of Clifford Chance's Investment Management sector, says: "London has a great opportunity. It has only got a small amount of quota to begin with, but that's because China wants to make sure it's successful, and so will be picking the right managers with the right products. If it is a success, it will get bigger and bigger. It is up to London to make the most of the opportunity that's there."

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Simon Crown, Partner, Clifford Chance, London

New Chinese investment funds law

For those asset managers that are interested in going onshore and setting up shop in China to access Chinese capital for Chinese investments, there is a new investment funds law that became effective 1 June 2013. This recognises hedge funds for the first time, and privately offered funds are no longer forced to rely solely on "sunshine" channels for distribution. Domestic managers will be able to look to raise offshore funds, and multi-platform asset managers are likely to emerge.

With the legislation comes a new oversight regime, with a new regulator called the Asset Management Association of China (AMAC), which is part of the CSRC. AMAC registration will be required and AMAC will issue filing requirements for private equity, venture capital and hedge funds and managers.

Ying says, "at the moment they are still finalising the implementing rules, but this could open up the private funds market in a bigger way than the mutual funds market, and represents a really big step forward."

The future

There are many uncertainties that remain for European investors looking to access opportunities in China, not least the restrictions on marketing to Chinese investors and the strict currency controls. Plus as far as market entry restrictions are concerned, China's regulations are still not clear.

The Shanghai pilot Free Trade Zone has created opportunities in the insurance sector through the launch of an overseas investment pilot programme, as well as opportunities in the banking sector, and in capital markets to make two-way investments in domestic and overseas markets.

Big questions remain about RMB internationalisation, particularly around interest liberalisation, RMB capital account convertibility and the need for a tailor-made foreign exchange administration system. But RQFII represents RMB already offshore going back into China, and as such is a priority for the new presidency. Its expansion into London and Singapore, and potentially soon Taiwan and elsewhere, can only present growing opportunities for international investors looking to capitalise on Chinese potential.

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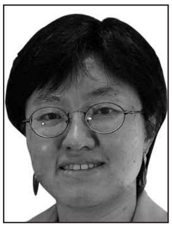

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