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A new investment channel for QFIIs: China permits QFIIs to invest in stock index futures in a limited scope

On 4 May 2011, the China Securities Regulatory Commission (**CSRC**) promulgated the *Guidelines for Investment in Stock Index Futures by Qualified Foreign Institutional Investors* (**Guidelines**). The Guidelines officially announce that Qualified Foreign Institutional Investors (**QFIIs**) may trade in stock index futures in China with immediate effect, yet at the same time impose investment restrictions on such trading activities.

In fact, before the Guidelines were officially promulgated, the CSRC has published a consultation draft of the Guidelines in January (**Consultation Draft**) along with an explanatory note (**Drafting Explanation**) to elaborate on certain issues under the Consultation Draft. No material changes have subsequently been introduced to the Guidelines and their provisions remain almost identical to those of the Consultation Draft. As a result, this briefing will still refer to the Drafting Explanation in understanding the application and implications of the Guidelines.

The Guidelines

The Guidelines are aimed at regulating the participation of QFIIs that participate in stock index futures trading.

In essence, QFIIs may only invest in stock index futures for hedging purpose in accordance with the relevant rules of the China Financial Futures Exchange (**CFFEX**). In doing so, they must comply with specific thresholds, open separate accounts and apply to CFFEX for trading codes with respect to each account.

CFFEX is responsible for regulating QFIIs' hedging quotas and trading activities and to report to CSRC and the State Administration of Foreign Exchange (**SAFE**) regularly on the status of the QFIIs' hedging quotas that it has approved.

Hedging Purpose

The Guidelines explicitly restrict QFIIs to engage in stock index futures trading in accordance with CFFEX's rules for "hedging purpose" only. The Drafting Explanation adds detail to this requirement in that a QFII must adhere to the rules under the *Administrative Measures on Hedging of the China Financial Futures Exchange* (**Hedging Measures**), such that it must submit a hedging plan and other supporting materials when applying for the hedging quota from CFFEX. This is necessary for CFFEX to examine the trading activities of the QFII and monitor how the QFII uses the approved hedging quota.

Key Issues

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Unfortunately, none of the Guidelines, the Drafting Explanation or the Hedging Measures define what hedging is or what activities might constitute hedging. As a result, many QFIIs are unclear as to how they should design their hedging plans or trading models precisely. This has also led to uncertainty as to whether hedging quota applications would generally be approved and the basis upon which CFFEX would determine that the participation of a QFII in stock index futures trading is only for hedging purpose.

Another point worth noting is that, while both the Consultation Draft and the Guidelines are silent on whether a QFII may utilize stock index futures to launch offshore derivatives, the Drafting Explanation explicitly prohibits it from doing so as a result of the hedging principle. This is because QFIIs may trade stock index futures to hedge its exposure and hence, there appears no need for it to launch offshore derivatives. The prohibition is therefore deemed as an implicit requirement under the hedging purpose limitation.

Application Procedures

When applying to trade in stock index futures, a QFII must arrange for account opening and apply for a hedging quota in accordance with the rules of CFFEX. It must obtain the approval of People's Bank of China (**PBOC**) and SAFE in opening separate accounts, each with a trading code as approved by CFFEX. It must further notify CFFEX should there be any change in its approved investment quota or hedging quota. Each QFII may appoint up to three domestic futures companies to engage in stock index futures trading.

Investment Restrictions

Unless CSRC otherwise provides, a QFII that trades in stock index futures must comply with the following as stated in the Guidelines:

- at the end of a trading day, the value of the stock index futures contracts held by a QFII must not exceed its investment quota;
- within a trading day, the amount of the stock index futures traded by a QFII (excluding squared positions) must not exceed its investment quota; and
- it must comply with the provisions of other applicable laws and regulations.

If, on any trading day, the value of the stock index futures contracts held by a QFII exceeds its investment quota as a result of price fluctuation of the securities and futures markets or other reasons, the QFII must make relevant adjustment within ten (10) trading days.

According to both the Guidelines and the Drafting Explanation, a QFII investment quota refers to the principal amount of investment actually remitted by the QFII as approved by SAFE or as adjusted and confirmed by SAFE. The QFII must further apply for a hedging quota from CFFEX if it wishes to engage in stock index futures trading.

The value of the stock index futures contracts held by a QFII refers to the total value of the long contracts and the short contracts that are not netted, while the amount of traded stock index futures refers to the total trading value of contracts but excludes trading for squaring positions.

The investment quotas of QFIIs are denominated in US dollars and must therefore be converted into RMB in accordance with the median exchange rate of Renminbi against US dollars published by the PBOC on the day on which the QFII applies for the hedging quota. The rate will be effective within six months of the approval of the QFII hedging quota by CFFEX, which will apply to the QFII's application to CFFEX for the hedging quota and the implementation of the relevant provisions of the Guidelines.

Market Reaction

In recent years, an increasing number of foreign institutions have participated in China's capital market through the QFII regime. By the end of March 2011, CSRC has approved 109 QFIIs in total. Until 29 April 2011, the total approved investment quota of 103 QFIIs amounted to US$20.69 billion. QFIIs will no doubt welcome the extended ability to invest in stock index futures, and in fact, many QFIIs have already begun to contact domestic futures companies for potential cooperation in such trading activities.