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ANOTHER MILESTONE – PRC REGULATORS FURTHER STREAMLINED FOREIGN EXCHANGE ADMINISTRATION OF QFII AND RQFII

The State Administration of Foreign Exchange (SAFE) released an updated version of the *Foreign Exchange Administrative Provisions on the Domestic Securities Investment by Qualified Foreign Institutional* Investors (QFII) (the **QFII FX Rule**) on 10 June 2018. Two days later, SAFE, together with the People's Bank of China (PBoC), jointly issued an updated version of the *Circular on Administration of Domestic Securities Investment by Renminbi Qualified Foreign Institutional Investors* (RQFII) (the **RQFII Circular**).

Key Features

- Removal of funds repatriation limit of QFII and the lock-up period of both QFII and RQFII.
- Permission to trade FX derivatives to satisfy hedging demand.

The QFII FX Rule and the RQFII Circular, taking effect as of their respective issuance date, have removed the relevant restrictions on funds remittance and repatriation, and further streamlined the foreign exchange administration under the QFII and RQFII regime. Compared with the previous foreign exchange regulatory framework that was implemented in 2016, the key developments under the QFII FX Rule and the RQFII Circular include:

- <u>removing the 20% monthly repatriation limit for QFIIs.</u> Under the previous framework, the monthly repatriation of a QFII licence holder (or an open-ended fund managed by a QFII) may not exceed 20% of the QFII's (or the fund's) total assets in China as of the end of the preceding year. This restriction had long been one of the key disadvantages of the QFII regime when compared with other similar programmes such as the RQFII regime and the Stock Connect regime. By removing this restriction, QFII and RQFII regimes are further aligned in terms of regulation on cross-border funds flow;
- <u>removing the three-month lock-up period requirement for both QFIIs and RQFII products/accounts which are not open-ended funds.</u> Under the previous framework, investment principal of a QFII and an RQFII which is not an open-end fund is subject to a three-month lock-up period commencing from the date on which the cumulative investment principal remitted into China reaches US$20 million for QFII and RMB100 million for

RQFII. With this latest development, the lock-up period under the QFII/RQFII regime will effectively be removed; and

- *permitting QFIIs and RQFIIs to trade foreign exchange (FX) derivatives to hedge their foreign exchange exposure.* This development offers another option for QFIIs/RQFIIs to hedge their FX risk, so that they can optimise their hedging arrangements by comparing pricing and terms between onshore and offshore markets.

As a general principle, QFIIs and RQFIIs are only permitted to trade FX derivatives strictly based on its "real demand". The QFII FX Rule and the RQFII Circular implement this principle through a requirement that the derivatives positions held by a QFII/RQFII should correlate with its securities portfolio's FX risk profile and may not exceed its RMB assets size. When calculating the RMB assets size, RMB deposits and equivalent assets in RMB accounts should be excluded. The QFII/RFII's custodian has a duty to review and verify the relevant numbers. There is also a monthly adjustment mechanism, and the FX derivatives positions are required to be adjusted based on the month-end RMB securities asset size within 5 working days after the end of each month. Therefore, parties need to carefully design the additional termination events in their derivative master agreement to provide for partial termination in order to accommodate this adjustment mechanism. Separately, it is also important to understand the applicable regulatory restrictions on domestic banks when they trade FX derivatives with clients.

Developments brought by the QFII FX Rule and the RQFII Circular help address several concerns which market participants had long held, including liquidity, cross-border remittance restrictions and hedging demand. With A Shares added to MSCI's key emerging market indices, we expect that the market will see an increase demand of portfolio allocation to the A-share market, including significant amounts of passive investments. Going forward, QFII and RQFII will continue to be one of the major channels (along with other available regimes such as Stock Connect) to access the A Share market.

Issuance of the QFII FX Rule and the RQFII Circular is another important step taken by the Chinese government to further open up its securities market and marks another milestone of the evolution of the QFII/RQFII regime.

* Please feel free to contact us for a copy of our in-house courtesy translation of the QFII FX Rule and the RQFII Circular.

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