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China Proposes Merger of QFII and RQFII Programs

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The China Securities Regulatory Commission (CSRC) earlier this year invited public comments on a new consolidated regime under draft regulations¹ (Draft Regulations) for Qualified Foreign Institutional Investors (QFIIs) and Renminbi Qualified Foreign Institutional Investors (RQFIIs). If adopted, the proposed regime would: consolidate the existing QFII and RQFII programs under a single regime; lower thresholds for overseas applicants; and provide a wider scope of permitted investments than currently allowed. Foreign investors would be provided with more convenient access to China and additional flexibility in terms of investment options.

Current QFII and RQFII Programs

The QFII and RQFII programs were established in 2002 and 2011, respectively, to allow access to Chinese securities using either Renminbi (RMB) or a foreign currency. Both programs are generally subject to similar investment restrictions.

The QFII program has allowed QFIIs to invest in companies that are publicly listed on the onshore stock and bond markets in mainland China and traded in RMB. For an asset manager to qualify as a QFII, it must meet the criteria set by the CSRC (e.g. at least two years' management experience, management of no less than US\$500 million over the past year). Further, an asset manager must prove that its financial stability and credit management are in order and that it has maintained a clean regulatory record for the past three years.

The RQFII program is a modified version of the QFII program, as it allows foreign investment in the mainland market via offshore RMB accounts². The RQFII program was initially targeted at Hong Kong subsidiaries of mainland Chinese financial institutions, but has since expanded to financial institutions in 19 countries and regions. As at the end of 2018, the aggregate quota of US\$101.1 billion had been granted to 309 QFIIs while the aggregate quota of RMB646.7 billion had been granted to 233 RQFIIs.

Proposed Unified Regime under the Draft Regulations

Unifying the Two Programs

Currently, applications to be a QFII or a RQFII are made separately. Under the proposed unified program, only one application would be required for the status of "Qualified Investor". As the application process would be simplified and the review process streamlined, the time required will be shortened to 20 days for each of the application to the CSRC for the Qualified Investor status and the application to the State Administration of Foreign Exchange (SAFE) for investment quota.

¹ The proposed draft regulations are:

- (a) the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors 合格境外机构投资者及人民币合格境外机构投资者境内证券期货投资管理办法 (征求意见稿); and
- (b) the Provisions on Issues Concerning the Implementation of the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors 关于实施《合格境外机构投资者及人民币合格境外机构投资者境内证券期货投资管理办法》有关问题的规定 (征求意见稿).

² In contrast, the QFII invests in its "home currency" (i.e., a major currency other than RMB).

Existing QFII and RQFII holders would become Qualified Investors once the proposed unified program is implemented. Further, in jurisdictions where there is currently an approved RQFII quota, an existing QFII may also make investments via offshore RMB accounts. However, in jurisdictions without an approved RQFII quota, existing QFIIs and newly approved Qualified Investors may invest only with funds in foreign currencies.

Relaxing Qualification Requirements

The proposed qualification requirements would remove the quantitative eligibility requirements of the QFII program (*i.e.* assets under management (AUM) of at least US\$500 million during the past year). However, the unified regime would retain the qualitative requirements (*e.g.* financial stability, sound credit status, internal management systems, clean compliance record during the past three years).

Expanding the Scope of Investment

A highlight of the Draft Regulations is the proposed expansion of the scope of investment for a Qualified Investor beyond the current QFII and RQFII scope to include the following types of investment assets:

- i. Stocks quoted on the National Equities Exchange and Quotations market (NEEQ, or the New Third Board (*i.e.*, China's OTC market));
- ii. Asset-backed securities;
- iii. Depository receipts;
- iv. Bond repurchase agreements;
- v. Financial futures;
- vi. Commodity futures; and
- vii. Options.

The specific types of permitted investment products listed in (iv) through (vii) above would be submitted by the relevant trading venues to the CSRC for approval and published thereafter.

Furthermore, Qualified Investors would be permitted to participate in: (a) margin trading and securities lending on stock exchanges, which allows participants to borrow onshore for such mainland Chinese investments, as opposed to restructuring offshore assets to meet capital requirements; and (b) private securities investment funds, provided that the investment strategy conforms to the scope of permissible assets listed in (i) through (vii) above.

Optimizing Management of Custodians

The Draft Regulations confirm the present position whereby the QFII custodian qualification has shifted from an approval-based system to a registration-based system. The limit on the number of custodians that may be appointed by a QFII also would be removed.

Enhancing Ongoing Supervision

The proposed unified regime seeks to improve QFII account management by seeking clarification of asset ownership. The client assets of a Qualified Investor belong to the client and are to be segregated from the Qualified Investor and the PRC custodian. Where a securities account is named as "Qualified Investor + Client

Fund”, the Qualified Investor must separately open sub-accounts thereunder for each separate client, rather than establish a co-mingled account, and must identify the relevant client. Information on the relevant clients would be reported via the custodians on a quarterly basis.

The ongoing monitoring and supervision mechanisms would also be enhanced to oversee foreign investment activities into China products. Additional reporting and disclosure requirements would be introduced under the Draft Regulations, including requiring: (a) custodians, securities companies and futures companies to report any abnormal and illegal trading activities by a Qualified Investor to the CSRC, the People’s Bank of China (PBOC) and SAFE; and (b) Qualified Investors to periodically disclose information as to offshore hedging positions related to onshore transactions. Additionally, clarifications are proposed for the corresponding regulatory measures and administrative penalties related to violations of the relevant laws and regulations.

Conclusion

The unified program was proposed by the CSRC with a view to promoting liberalization of China’s capital markets. Particularly, with the expanded scope of permitted investments, it is expected that if the proposals are adopted, foreign investments through Qualified Investors would be significantly increased, thereby achieving the purpose of channeling more long-term foreign capital to mainland China.

The table below sets out key differences between the current QFII and RQFII programs and the proposed unified regime.

	QFII AND RQFII PROGRAMS	PROPOSED UNIFIED REGIME
Vetting Process	<p>Separate QFII and RQFII license obtained from the CSRC</p> <ul style="list-style-type: none"> QFII: CSRC should complete review within 20 business days after receipt of all required application documents RQFII: CSRC should complete review within 60 business days after receipt of all required application documents <p>(Note: In practice, the process has taken up to six months for both types of application.)</p> <p>Separate QFII and RQFII investment quota obtained from SAFE</p> <ul style="list-style-type: none"> QFII: Decision within 20 business days after receipt of all required application documents RQFII: Decision within 60 business days after receipt of all required application documents <p>(Note: In practice, the process has taken up to three months for each application.)</p>	<p>Single application submitted to the CSRC for the status of Qualified Investor</p> <ul style="list-style-type: none"> Decision within 20 business days after formal acceptance of application <p>Application submitted to SAFE for investment quota</p> <ul style="list-style-type: none"> Decision within 20 business days after receipt of all required application documents
Quota	Yes	Yes
Trading Currency	QFII: Any currency, except RMB RQFII: RMB	<ul style="list-style-type: none"> Existing QFII from a foreign jurisdiction where RQFII is available is allowed to make investment using RMB.

		<ul style="list-style-type: none"> Existing QFII and new Qualified Investors from a foreign jurisdiction where RQFII is not available may only trade Chinese securities using major currencies, other than RMB.
Ongoing Changes	QFII and RQFII must re-apply for a new license in the event of: a change of business name; or an acquisition by, or merger with, other institution(s).	Qualified Investors do not need to re-apply for a new license but only a change of the existing license.
Experience of Manager	Required	Required
AUM of Manager	QFII: Not less than US\$500 million during the past year RQFII: N/A	N/A
Custodian	QFII: Eligible custodian RQFII: Eligible domestic custodian (Note: A proposed custodian under both programs is subject to the approval of the CSRC and SAFE, and a license will be issued to the custodian. A QFII can retain only one custodian. There are no restrictions on the number of custodians that be retained by an RQFII.)	Eligible custodian: no approval/licensing required and no restriction on the number of sub-custodians
Permissible Categories of Investments	A-Shares/bonds/warrants listed on the SSE or SZSE Fixed-income products traded on an inter-bank bond market Public securities investment funds Stock index futures RMB-FX derivatives to satisfy hedging demand	Shares traded on the National Equities Exchange and Quotations (NEEQ, China's OTC Board) Depository receipts Bond repos Asset-backed securities Approved products of the People's Bank of China traded on the inter-bank bond market Financial futures listed and traded on the China Financial Futures Exchange (for hedging purposes) Commodity futures traded on futures exchanges approved by the State Council or CSRC Options traded on futures exchanges approved by the State Council or CSRC Foreign exchange derivatives that SAFE allows Qualified Investors to trade Margin trading Securities lending on domestic stock exchanges
Investment into Private Funds	Not permitted	Permitted, but investment strategy must conform to the scope of permissible assets of the respective Qualified Investors
Ownership	The legal relationship between the beneficial owner of securities (client) and the QFII/RQFII nominee holder (client's asset manager), including arrangements to segregate the	The clients' assets held by a Qualified Investor belong to the respective clients and are segregated from the Qualified Investor and the PRC custodian. Where the securities

	<p>client’s assets from those of the asset manager, is defined by contracts between the client and the asset manager, and governed by the laws of the jurisdiction as specified in such contracts.</p> <p>The A-share account system can support the recognition of rights and interests of beneficial owners of securities held in nominee accounts opened for the QFII/RQFII separate account (managed account) product. A QFII/RQFII may choose to open accounts in the form of “QFII – Client Assets” or “QFII – Client Name” to further demonstrate that assets in such accounts belong to the relevant beneficial owner, separate from those of the asset manager.</p>	<p>account is named as “Qualified Investor + Client Name” or “Qualified Investor + Client Funds”, the Qualified Investor must open separate sub-accounts for each separate fund product, rather than establish a co-mingled account, and must identify the investors in each of those separate fund products.</p>
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