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The Qualified Foreign Institutional Investor Program in China – Recent Developments, New Opportunities and Ongoing Challenges

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Since its launch in 2002, the Qualified Foreign Institutional Investor (QFII) program has been the principal means for foreign investors to invest directly in the securities markets of the People's Republic of China (PRC or China).[1] In the intervening decade, foreign investment in China's securities markets has grown steadily, notwithstanding operational challenges, a limited array of permitted investments and an opaque regulatory framework governing investment. To facilitate increased foreign participation in China's securities markets, PRC regulators recently have made the QFII program more flexible and more accessible to a larger audience of foreign investors.

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This article provides a brief overview of the QFII program in China, a more in-depth look at the recent regulatory changes and the anticipated impact of the same, as well as a summary of issues relevant to US and other financial institutions seeking to invest in the PRC securities markets in accordance with the QFII program.

Overview of the QFII Program

Under the QFII program, foreign institutional investors may apply to the China Securities Regulatory Commission (CSRC), the primary securities regulatory agency in China, for a QFII license to invest in China's securities markets.[2] QFII applicants are classified as belonging to one of five different categories: asset management companies, insurance companies, securities companies, commercial banks, and other institutional investors.[3] Applicants in each category must meet specific qualification requirements and be approved by the CSRC in order to become QFIIs.

In the decade since the launch of the QFII program, the CSRC and the People's Bank of China (PBOC), the PRC's central bank, have continued to refine the securities and foreign exchange rules applicable to QFIIs. Over time, the CSRC gradually has relaxed QFII qualification requirements, expanded the scope of the permissible investments for foreign investors, and increased the amount of investment quota available to QFIIs. As of late December 2012, the CSRC had approved 202 QFII applications, and QFIIs had been allocated approximately $33.57 billion of investment quota by the State Administration of Foreign Exchange (SAFE), China's primary regulator of foreign exchange and foreign exchange reserves.

Generally Applicable Rules

Becoming licensed as a QFII and commencing investment activities entails four basic steps, and requires close cooperation with whatever PRC bank the QFII will use to custody its assets held in China in connection with its QFII investment activities. First, the applicant must submit an application and related documentation seeking the approval of the CSRC. Second, the applicant must, within one year from the date of receipt of the QFII license, apply through its PRC custodian bank to the SAFE for an investment quota. In practice, the applications to CSRC and SAFE typically are submitted at the same time, with the CSRC and SAFE consulting with each other during the review process. Upon obtaining the approvals from the CSRC and the SAFE, the QFII should submit an account opening form from the PBOC for the purpose of opening an RMB cash account. Finally, the applicant needs to apply to the China Securities Depository and Clearing Corporation, China's central securities depository, in Shanghai and/or Shenzhen for an investor code with respect to the relevant exchange(s).

QFII accounts are subject to significant restrictions regarding currency remittance into, and currency repatriation from, the PRC. QFIIs generally must, within six months of having each investment quota approved, remit the investment principal into China, and may not commence investment operations until remittance of the entire quota or expiry of the period for remittance. A failure to remit the entirety of the investment quota within this timeframe will result in forfeiture of the unremitted portion of the quota unless an additional quota approval has been granted. The QFII regulatory regime also imposes significant restraints upon repatriation of assets from the PRC. After remittance of the QFII investment quota, a QFII's assets are locked-up in China for a definite period of time and may not be repatriated from China.[4] Once the initial lock-up period is over, QFIIs generally may repatriate assets no more frequently than once a month in an amount no greater than 20% of its PRC assets as of the end of the past year, and repatriation generally results in forfeiture of an equivalent amount of the QFII investment quota.

Additionally, a QFII's investment quota may become invalid under specific circumstances, and may be reduced or even cancelled by SAFE.[5] A QFII may not apply for a quota increase until at least one year has passed since its last application for an investment quota was approved.

Custody issues also may arise, although recent developments are intended to address some of these custodial concerns. PRC law generally has recognized only QFII proprietary accounts or omnibus nominee accounts on behalf of the QFII's clients, and has not expressly recognized that assets held in a QFII's nominee account on behalf of its clients are separate from the assets of the QFII or the custodial bank. Accordingly, a nominee account structure may raise concerns regarding adviser custody, proper segregation among client accounts, and protection of assets in the account from claims of creditors of the QFII or the custodial bank. However, SAFE recently implemented guidelines on a trial basis that are designed to permit a QFII to open up to six special deposit accounts at its PRC custodial bank on behalf of the QFII's clients, with a minimum account size of at least $20 million.[6] These guidelines offer the prospect of helping QFIIs to address the adviser custody, account segregation and asset protection concerns traditionally associated with nominee accounts, if a QFII is able to utilize the structure.

Open-End China Funds

More favorable terms are afforded to a certain type of QFII (or QFII client) – the "open-end China fund." An open-end China fund is defined as an open-end fund established overseas through a public offering that invests no less than 70 percent of its assets in China.

A QFII may establish more than one open-end China fund. Unlike other types of QFIIs, open-end China funds may commence investment operations upon remittance of $20 million, rather than upon remittance of their entire investment quota. Open-end China funds have an investment principal lock-up period of three months, instead of the 12-month lock-up period generally applicable to QFIIs. This lock-up period starts from the date when the principal has been fully remitted, or six months after the investment quota is approved if the principal has not been remitted in full within the remittance period specified by SAFE in the quota permit. After the lock-up period, open-end China funds may repatriate assets equal to net redemptions on a weekly basis in an amount no greater than 20 percent of its PRC assets as of the end of the past year.[7] Furthermore, unlike most other QFIIs, repatriation of open-end China fund assets will not reduce the investment quota available to the open-end China fund, and open-end China funds may remit assets equal to net subscriptions on a weekly basis, subject to its QFII investment quota.[8]

QFIIs establishing open-end China funds also follow special rules with regard to account administration. A QFII is forbidden to transfer funds among its proprietary asset accounts, clients' capital accounts, and the capital accounts of open-end China funds. Funds also must not be transferred among capital accounts of two or more open-end China funds managed by the same QFII. Finally, PRC law has for several years permitted the establishment of separate securities accounts for open-end China funds and has recognized that the assets in such an account belong to the fund, and not the QFII or the custodian bank. This has helped to address, at least in part, traditional concerns regarding segregation of QFII client assets and protection of client assets from the claims of the creditors of the QFII or the custodian bank, as PRC law in this area is not well developed. Successful implementation of the 2012 SAFE Regulations may provide further assurances in this regard.

Issues of Concern

Notwithstanding the growth in the QFII program, a number of operational and other difficulties have become apparent over time. The most widely shared concerns by foreign investors include: (i) the CSRC and SAFE have been very strict on eligibility requirements for QFIIs and their investment quotas, leading to a relatively small aggregate size of QFIIs in China's securities markets; (ii) as a practical matter, QFIIs were only authorized to engage a single broker-dealer; (iii) inflexible custody and depository account structures, which typically required commingling of QFII proprietary assets with the assets of QFII clients; and (iv) an overly time-consuming application process, typically requiring 12-18 months from the date of application until receipt of a QFII license, which could be subject to bureaucratic interference by Chinese regulators.

Recent Changes to the QFII Program

On July 27, 2012, the CSRC modified the rules governing the QFII program by issuing the "Provisions on Issues Concerning the Implementation of the Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors" (QFII Implementation Rules). These newly enacted rules represent a continued opening of China's securities markets to foreign investors, and specifically: (i) open the QFII program to a wider array of financial services companies by lowering the qualification requirements applicable to QFIIs; and (ii) facilitate the investment activities of QFIIs by giving them greater investment latitude and improving convenience of account management. It also appears likely that the very recently enacted 2012 SAFE Regulations will facilitate this effort.

Relaxed Qualification Requirements

The QFII Implementation Rules significantly lower the assets under management (AUM) and capitalization requirements, as well as the minimum number of years of experience needed, for various kinds of institutions to qualify as QFIIs, as follows:

1. Asset management institutions, insurance companies and other institutional investors must have a minimum of two years of operating history, with AUM of no less than $500 million for the latest fiscal year. Under the previous requirements, five years of experience and AUM of no less than $5 billion were required.
2. Securities companies must have five or more years of operating history, net assets of no less than $500 million, and AUM of no less than $5 billion for the latest fiscal year. Previously, securities companies were required to have 30 or more years of operating history, paid-in capital of no less than $1 billion, and AUM of no less than $10 billion.
3. Commercial banks must have at least 10 years of operating history, with tier 1 capital of no less than $300 million, and AUM of no less than $5 billion. Previously, commercial banks had to rank among the top 100 global banks, with AUM of no less than $10 billion.

More Investment Opportunities for QFIIs

While additional guidance from Chinese regulators is required, the QFII Implementation Rules will provide QFIIs with significantly enhanced investment flexibility.

1. Enlarged Scope of Investments

The new QFII Implementation Rules expand the permitted scope of QFII investments. In addition to the China A-shares and listed bonds and warrants previously available for QFII investment, the QFII Implementation Rules explicitly permit QFII investment in the inter-bank bond market (which currently accounts for approximately 95 percent of fixed income trading in China), private placement bonds of small- and medium-sized enterprises, and stock index futures (see further details below).[9] However, many aspects of QFII investment in the inter-bank bond markets remain unclear. For example, it is not yet known whether QFIIs will enjoy the preferential tax treatment applicable to certain bond products traded on the inter-bank bond market. Further clarification is expected to be provided in the near future.

2. Higher QFII Shareholding Ceiling

Under the QFII Implementation Rules, QFIIs may now hold up to an aggregate of 30 percent of the outstanding China A-shares of a listed Chinese company. The former limit was 20 percent. However, a single QFII shareholder may hold no more than 10 percent of the outstanding China A-shares issued by a listed Chinese company.

3. Separately-Managed Accounts

The QFII Implementation Rules allow domestic fund management companies to provide separately managed account services to QFIIs and open corresponding accounts for them. This measure is expected to help domestic fund managers gain greater international exposure.

Enhanced Account Management

The QFII Implementation Rules also include important reforms that will facilitate the registration and investment operations of QFIIs.

1. Securities Accounts with Multiple Brokers

QFIIs previously were permitted to open only one securities account with respect to each of the Shanghai and Shenzhen Exchanges, which would correspond to the approved RMB account of the QFII, and could choose only one broker for each of these securities accounts. The QFII Implementation Rules remove these limitations. Under the new rules, QFIIs may maintain multiple securities accounts corresponding to the QFII's RMB account, and choose different brokers for these securities accounts.

2. Segregated Securities Accounts for Different Clients of a QFII

The QFII Implementing Rules also address the prior requirement that QFIIs generally were required to maintain a single securities account with respect to the assets of all clients on whose behalf the QFII invests in China. The use of a single securities account potentially raised significant custody, asset segregation and bankruptcy risks that needed to be addressed by QFIIs. Under the new rules, QFIIs now are required to maintain a securities account for the assets of each client on whose behalf they invest in China. This development will improve segregation and protection of different clients' assets and help mitigate custody risks, although it will be critically important for QFIIs to attempt to negotiate a custody structure that takes advantage of this change, either in reliance on the flexibility provided by the 2012 SAFE Regulations to open additional special deposit accounts on behalf of multiple QFII clients or via contractual provisions that seek to address these concerns.

3. Simplification of Filing QFII Applications and Compliance Reports

The CSRC has long contemplated a simplification and acceleration of its review and approval process. The QFII Implementation Rules reflect this vision. Foreign investors eventually will apply for QFII licenses and file compliance reports electronically. The CSRC also has informally indicated that it will no longer necessarily require an in-person meeting in connection with the consideration of a QFII license application. In addition, the new rules reduce the time period covered by the audited financial statements that must be included in a QFII license application to one year (formerly three years of audited financial statements were required), and no longer will require the submission of the QFII applicant's articles of association (or other constitutive documents).

It is intended that these changes will streamline the QFII license application process and reduce the CSRC's processing time, with the eventual goal of reducing the application process to approximately six months.

Other Recent Developments

The QFII Implementation Rules build upon several other significant recent developments affecting the QFII program that are intended to make investment in China more attractive to foreign investors, and which follow extensive consultations with QFII custodian banks and other industry participants.

1. QFII Investment Quotas

On April 3, 2012, the CSRC, the PBOC and the SAFE announced an increase of the total QFII investment quota from $30 billion to $80 billion. Moreover, the CSRC increasingly is approving larger QFII investment quotas, with five QFII applicants recently obtaining $1 billion quotas for investment. Most recently, the 2012 SAFE Regulations make clear that the general $1 billion limit on QFII quotas will not apply with respect to sovereign wealth funds, central banks or monetary authorities. To date, QFII applicants have applied for, but not yet obtained, $5 billion quotas.

2. Fixed Income Investments

The CSRC no longer requires QFIIs to invest at least 50 percent of their assets in equities, thus permitting more significant investment in fixed income instruments. However, the CSRC continues to prohibit a QFII from holding more than 20 percent of its QFII quota in cash or cash equivalents.

3. Multiple QFIIs Within One Corporate Family

The CSRC has relaxed a former internal operating policy that significantly restricted the ability of affiliated companies with a common corporate parent to each obtain a QFII license. Given the size and scope of various global financial services firms and the common use of holding company structures, the former policy severely impinged on the ability of global financial services firms to obtain a meaningful QFII investment quota.

4. Opening of Chinese Stock Index Futures Market to QFIIs

Investments in the Chinese stock index futures market by QFIIs has been clarified. Previously, it was theoretically possible for QFIIs to invest in the Chinese stock index futures market, but due to discrepancies between various regulations, such investments were *de facto* impossible. The PBOC and the SAFE recently clarified the situation and removed part of the practical obstacles preventing QFIIs from investing in the Chinese stock index futures market. However QFIIs may only engage in program trading when participating in stock index futures trading, and are forbidden from issuing derivatives outside of China.

5. New Tax Regime

Currently, investments in China's securities markets through the QFII program are subject to a 10 percent income tax imposed on dividends, bonuses and interest generated from securities investments. Domestic investors are not subject to this tax, although domestic financial institutions are subject to a five percent business tax that is not levied on QFIIs.

Although no specific regulations or policies yet have been issued, recent media and government reports indicate that the basis of the 10 percent income tax to which QFIIs are subject soon will expand to include gains from securities transactions. It is anticipated that this increase in the basis of income tax will be imposed on QFIIs only - domestic investors will continue not to be subject to this tax. Specifically, this new income tax will apply to the proprietary funds of QFIIs and QFII client assets, although open-end China funds are reported to be exempt from this income tax.

Details of the new tax policy, such as calculation methods and timelines, scope of imposition, ability to offset losses, potential retroactivity, and grandfathering periods, are expected to be released at a later date.

This disparate, and less favorable, treatment of foreign investors in China may at the margins discourage foreign investors from investing in China's securities markets. However, given the relatively small percentage of the China A-share market represented by QFII investments, the change of tax basis is unlikely to significantly impact the broader China A-share market.

This change also may create uncertainty for financial services companies who are considering or are in the process of applying for QFII licenses, at least until more details regarding the change are available. Given the lack of definitive information currently available, it is difficult to assess the impact of this new tax on the disclosures required as part of the license application process or the regulatory processing of applications.

Once implemented, this new tax is likely to clarify the situation of QFIIs in China. Until now, QFIIs have encountered practical difficulties in calculating performance and profitability of China A-share investments and repatriating their profits outside of China due to the lack of clear taxation rules on gains from securities trades. Additionally, this new taxation regime will increase the predictability for QFIIs and their clients at the time of investment regarding the appropriate accrual and accounting for applicable taxes at exit. Due to the uncertainty to date, QFIIs have taken inconsistent positions regarding the need to set aside funds for purposes of tax payment. Finally, greater clarity and transparency should decrease potential legal risks associated with QFII investment in China.

Selected US Regulatory Issues

Liquidity Concerns

As noted above, QFII accounts that qualify as "open-end China funds" benefit from more relaxed regulatory requirements. Even so, the restrictions on repatriation of assets may render QFII investments, in whole or in part, illiquid for US regulatory purposes.[10] This is an issue for US-registered open-end funds, which may invest no more than 15 percent of their net assets in illiquid positions.[11] Open-end China funds must also invest no less than 70 percent of their assets in China, effectively disqualifying any fund that does not geographically focus its investments in or around China. In light of this, some US managers have sought to use a master-feeder structure to centralize assets from various funds (as well as non-fund clients) in a master fund that then seeks to be regulated as an open-end China fund. The master-feeder structure aims to simultaneously comply with the requirements applicable under PRC law to open-end China funds while facilitating QFII quota access to open-end US funds and other investors with significant liquidity needs that do not focus their investments on China. These arrangements will require SEC exemptive relief, and will be subject to the imposition of various terms and conditions.[12]

If a fund cannot qualify as an open-end China fund, it generally may not regularly repatriate proceeds. Many market participants are wary of any repatriation, as QFII investment quotas might be reduced or even eliminated following repatriation. One possible solution, particularly for larger asset managers, may be to cross-trade A-share investments between client accounts in accordance with Rule 206(3)-2 under the US Investment Advisers Act of 1940 and Rule 17a-7 under the US Investment Company Act of 1940. However, the ability to engage in such transactions under existing PRC law and market practice is unclear, and may not be supported by the PRC custodian.

Custody Concerns

Chinese regulation of asset segregation also presents challenges. While the recently enacted 2012 SAFE Regulations provide greater flexibility than formerly existed in terms of structuring custody accounts, QFIIs may be required to maintain a single commingled custody account for multiple client assets. While the new rules help to address concerns associated with this structure by requiring separate securities accounts for each client of the QFII, these accounts are still in the QFII's name. Moreover, a similar arrangement may not be possible with respect to custody arrangements, and PRC law concerning the enforceability of contractual segregation provisions and the protection of custody assets from creditor claims or the bankruptcy of either the QFII or the PRC custodian bank is not well-developed. Accordingly, QFIIs should (i) take advantage of the flexibility provided by the 2012 SAFE Regulations to establish client-specific custody accounts if they are able to do so; (ii) negotiate for clear contractual segregation of client assets (and other contractual terms), and (iii) consider seeking legal guidance regarding the enforceability of contractual terms.

Conclusion

The QFII program diversifies the sources of investments in the Chinese securities markets, and therefore is an important component of China's ongoing economic reforms and opening-up of its capital markets. While significant aspects of the recent changes to the QFII program await further clarification from Chinese regulators, the developments summarized above make clear that the door to the Chinese securities markets is opening slowly but steadily to foreign financial services firms.

Looking at numbers, the QFII Implementation Rules and the other recent developments discussed in this article are already considered to have succeeded in stimulating the QFII program. Record numbers of foreign investors have entered the Chinese securities markets in recent months. It took the first nine years of the QFII program to fully use up the original $30 billion QFII quota. In contrast, the first 11 months of 2012 have seen 64 new QFIIs enter the market and utilize $11.93 billion of newly available investment quota.

Continued and accelerating growth of foreign institutional investor participation in the PRC's securities markets is likely. The Chinese securities markets stand apart from most other securities markets—about 95 percent of A-share investors are individuals, and 80 percent of market volume is attributable to individual investor transactions. This almost certainly will evolve over time toward the patterns seen in more mature securities markets, where institutional investor trading accounts for a significant amount of market volume.

While challenges remain for foreign institutional investors, investor interest in the QFII program remains high, and interested investors should consider how best to access the Chinese markets, including consideration of setting up a presence in China. Most QFIIs participate in the Chinese securities market through the filter of local dealers in China. It may be an opportune time for QFIIs to begin to build a presence in China, such as by a representative office, to help coordinate the investment process by bringing the QFII closer to Chinese regulators and dealers and facilitating local administrative procedures, such as obtaining a QFII license from the CSRC or discussing investment quotas granted by SAFE. Further, a legal presence in China may help a QFII keep an eye on the local market and strengthen connections with regulators, thus helping to ensure that QFIIs remain aware of what direction the market is taking and helping them make timely decisions to adjust their strategies accordingly.

Notes

1. *Interim Administrative Measures for Securities Investments in China by Qualified Foreign Institutional Investors* (Dec. 1, 2002).

2. QFIIs traditionally have concentrated their attention on A-shares traded on the principal Chinese exchanges in Shanghai and Shenzhen. A-shares are equity shares subscribed and traded in Renminbi (RMB). A limited number of B-share investments, which are reserved for foreign investors and traded in foreign currencies, also are available. While QFIIs may trade both types of shares, the B-share market is considered to be much less desirable, and is characterized by limited trading and a lack of market depth.

3. These other institutional investors include pension funds, charity foundations, endowments, trust companies and sovereign wealth funds.

4. Lock-up periods typically range from three months (for many types of open-end funds, including retail mutual funds) to one year (for other types of accounts, including closed-end funds), counted from the day the principal is remitted in full (or the period for remittance has expired).

5. A QFII's investment quota may become invalid under the following circumstances: (1) the CSRC has withdrawn the QFII's securities investment operating license; (2) the investment amount remitted by the QFII within six months of investment quota approved is less than the equivalent of $20 million; (3) the QFII withdraws its investment and remits it overseas, thereby causing the total value of its remaining domestic principal to fall below the equivalent of $20 million; (4) the original investment quota of the QFII is cancelled by SAFE; or (5) any other circumstances specified by SAFE. SAFE is authorized to cancel an investment quota under limited circumstances.

6. *See Regulations on Foreign Exchange Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors (QFII) Decree [2012] No. 2 of SAFE* (Dec. 17, 2012) and its annex, The Guideline on the Accounts Management for Qualified Foreign Institutional Investors (For Trial Implementation) (Dec. 17, 2012) (collectively, 2012 SAFE Regulations).

7. *Id.* Open-end China funds formerly could repatriate up to $50 million on a monthly basis upon making a notice filing with a local foreign exchange authority.

8. *Id.*

9. The QFII Implementation Rules needed additional action on the part of the PBOC to facilitate the trading of stock index futures, which was provided in the new 2012 SAFE Regulations that expressly permit the maintenance of multiple RMB denominated accounts by QFIIs and address various custody issues relating to futures trading.

10. The recently enacted 2012 SAFE Regulations, if successfully implemented, may provide more breathing space in this regard, in light of the weekly liquidity, subject to limits, that open-end China funds apparently will have.

11. Although this section focuses on US regulatory concerns, retail UCITS investment funds will generally face similar liquidity concerns.

12. As of the date of this article, the SEC has not issued an order of exemption in response to such a request. However, we anticipate that such an order will be forthcoming in the near future.