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QFII and RQFII – a practical insight to recent developments

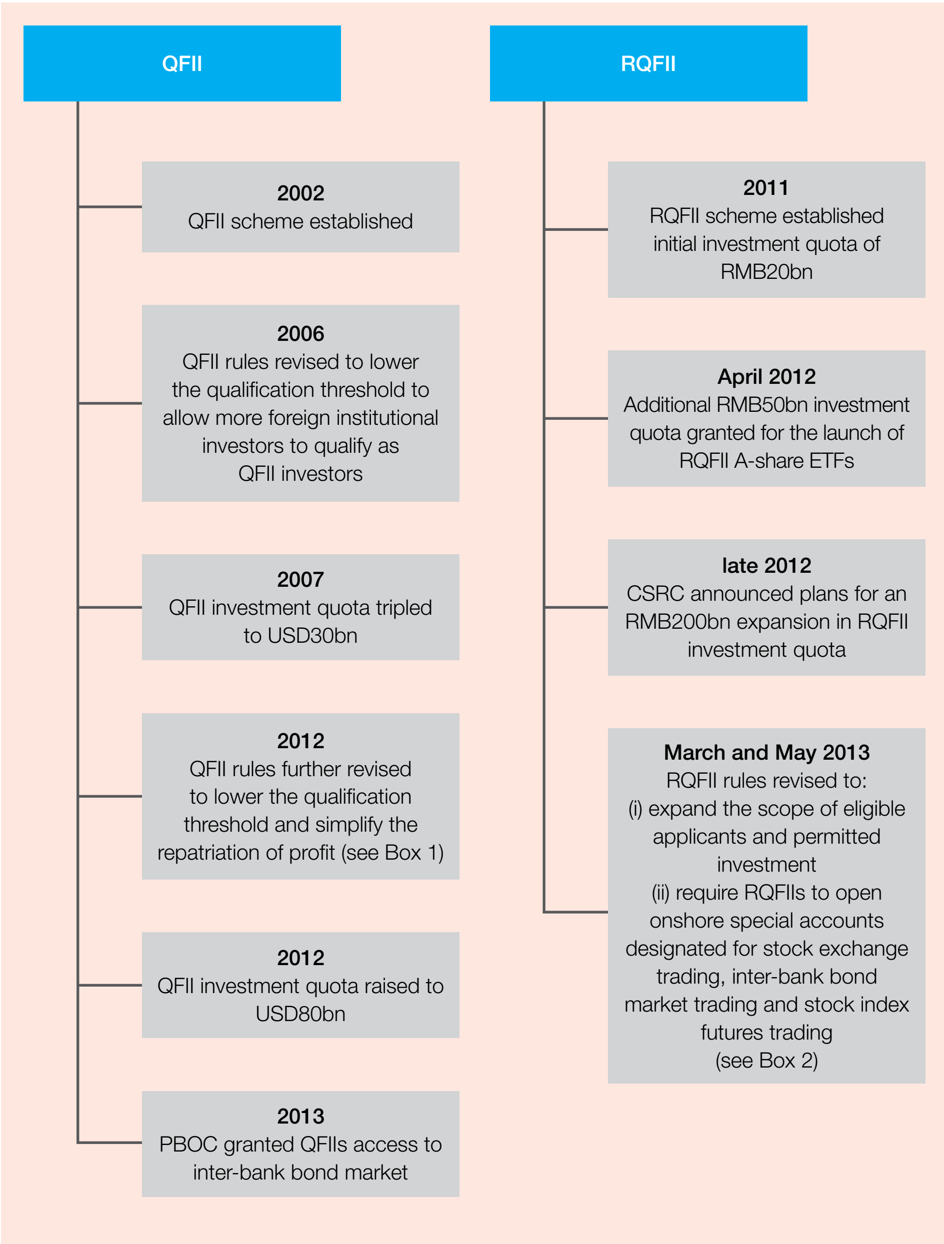
by
Richard Mazzochi, Minny Siu and Hayden Flinn

In the opening session of the Asia Financial Forum in Hong Kong held in January 2013, Guo Shuqing, the previous Chairman of the China Securities Regulatory Commission (**CSRC**), noted that China could increase the level of its QFII and RQFII investment quotas by 10 times. His comments sparked wide spread media observations that the Mainland Government intended to continue opening up the Mainland's capital markets to foreign investment.

Background – a brief introduction of the QFII and RQFII schemes

The Qualified Foreign Institutional Investor (**QFII**) scheme enables specified types of foreigners to use their offshore foreign currency for investment in the Mainland's securities market. The Renminbi Qualified Foreign Institutional Investor (**RQFII**) scheme is a modified version of the QFII scheme which facilitates the use of Renminbi held outside the Mainland for investment in the Mainland's securities market.

Key milestones of the QFII and RQFII schemes



QFII

The QFII scheme was established in 2002 to attract long-term foreign institutional investors to China's domestic A-share market.

By the end of May 2012, a total of 172 QFIIs were approved, but QFIIs accounted for only 1.1% of the total market capitalisation of China's A-shares. In order to "further introduce long-term capital from abroad, strengthen domestic market confidence and promote stable growth in China's capital markets and their opening-up to foreign investors"[1], CSRC and the State Administration of Foreign Exchange (**SAFE**) substantially revised the QFII rules (**2012 Revised QFII Rules**) in late 2012. The aggregate QFII investment quota increased from USD30 billion in 2007 to USD80 billion in 2012.

In February 2013 alone, SAFE granted an aggregate of USD850 million in investment quotas to nine foreign investors. As of the end of April 2013, SAFE had issued a total of USD41.882 billion in investment quotas to 198 QFIIs.

See Box 1 for highlights of the main changes implemented by the 2012 Revised QFII Rules.

RQFII

An initial investment quota of RMB20 billion was granted under the RQFII scheme to the Hong Kong subsidiaries of PRC fund management companies and securities companies in 2011.

The investment quota increased to RMB70 billion in April 2012, in connection with the launch of RQFII A-share Exchange Traded Funds. In late 2012, Guo Shuqing, the previous Chairman of CSRC, announced plans for an RMB200 billion expansion in investment quota of the scheme.

In view of the popularity of the RQFII products, the growing use of Renminbi in Hong Kong and in order to promote Hong Kong as the leading offshore Renminbi centre, CSRC, SAFE and the People's Bank of China (**PBOC**) relaxed the RQFII rules in March 2013 (the revised RQFII rules and the implementing rules are collectively referred to as "**Revised RQFII Rules**"). As of the end of April 2013, SAFE had issued a total of RMB76.3 billion in investment quotas to 26 RQFIIs.

See Box 2 for a summary of the key changes introduced under the Revised RQFII Rules.

The RQFII scheme is also expected to be expanded to include Taiwan.[2] Many Taiwanese institutional investors are already active investors in Hong Kong-launched Renminbi products. According to CSRC's announcement in January 2013, CSRC will accept Taiwan's request for a separate RQFII investment quota of RMB100 billion.

Box 1 – Key changes under the 2012 Revised QFII Rules

- CSRC lowered the qualification threshold for a QFII licence.
- QFIIs are permitted to invest in the fixed income products traded on the inter-bank bond market. This has been endorsed by PBOC, the regulator of the inter-bank bond market, in a notice issued in March 2013.
- QFIIs may engage more than one securities dealer to trade securities in each stock exchange.
- The Renminbi account structure has been modified so that a QFII may open a maximum of six Renminbi deposit accounts designated for securities trading for different clients.
- SAFE approval for repatriation of realised profit is no longer required provided that the total monthly repatriation (including capital and profit) does not exceed 20% of its total investment in China at the end of the previous year.

Box 2 – Key changes under the Revised RQFII Rules in 2013

- The scope of eligible applicants was expanded to include:
  - Hong Kong subsidiaries of Chinese commercial banks and insurance companies
  - financial institutions which are registered in Hong Kong and with principal places of business in Hong Kong.
- RQFIIs are no longer subject to the "20% equities/80% bonds" restriction on asset allocation.
- The scope of permitted investment was expanded to include stock index futures and fixed income products traded on the inter-bank bond market.
- SAFE has imposed stringent requirements on RQFIIs other than open-ended funds (e.g. investment deadline, recycle of investment quota, lock-up period, repatriation/ remittance restrictions) (see table under the sub-heading "Harmonisation of the two schemes" below).
- RQFIIs are required to set up separate designated accounts with onshore custodian banks for trading in domestic stock exchanges and the inter-bank bond market, and for trading of stock index futures.

1 See CSRC's explanation to the draft regulation relating to the QFII scheme published for consultation in June 2012.

2 On 6 February 2013, Bank of China launched its offshore Renminbi business in Taiwan. On the same day, Renminbi deposits reached RMB1.3 billion in total.

What do the recent developments mean for foreign investors?

Harmonisation of the two schemes

The recent changes to the QFII and RQFII rules harmonise the two schemes to a large extent.

The following table summarises the key features of the two schemes based on the current regulatory framework:

	QFII		RQFII		
Regulators	**CSRC**	**SAFE**	**CSRC**	**SAFE**	**PBOC**
	▪ approves QFII status ▪ regulates onshore securities investments by QFIIs	▪ approves and allocates QFII investment quota ▪ regulates QFIIs' onshore accounts ▪ regulates fund repatriation/ remittance	▪ approves RQFII status ▪ regulates onshore securities investments by RQFIIs	approves and allocates RQFII investment quota regulates fund repatriation/remittance	regulates onshore Renminbi accounts
Eligible applicants	▪ asset management companies ▪ insurance companies ▪ securities companies ▪ commercial banks ▪ other institutional investors, e.g. pension funds, charitable foundations, trust companies		▪ Hong Kong subsidiaries of: - Chinese fund management companies - Chinese securities companies - Chinese commercial banks - Chinese insurance companies ▪ financial institutions that are registered in Hong Kong and with principal places of business in Hong Kong		
Permitted investment	Renminbi-denominated financial products, including: ▪ stocks, bonds and warrants traded or transferred on the Shanghai or Shenzhen Stock Exchange ▪ fixed income products traded in the inter-bank bond market[3] ▪ securities investment fund ▪ stock index futures[4] ▪ other financial instruments approved by CSRC from time to time				
Investment restrictions	▪ a QFII/RQFII cannot hold more than 10% of the total outstanding shares in a single A-share listed company ▪ the aggregate shareholding of all foreign investors in a single A-share listed company cannot be more than 30% of the total outstanding shares				
Investment deadline and minimum investment capital amount	▪ 6 months after the investment quota is approved ▪ the minimum amount is USD20 million		▪ RQFIIs other than open-ended funds: 6 months after the investment quota is approved ▪ no minimum amount is specified		
Recycle of investment quota	not clear[5]		▪ yes for open-ended funds as long as the net amount of investment capital remitted into China is within the investment quota ▪ no for other RQFIIs as the investment quota is calculated based on the actual investment amount		
Lock-up period[6]	▪ 3 months for pension funds, insurance funds, mutual funds, charity funds, endowment funds, government investors, monetary authorities and open-ended China funds[7] ▪ 1 year for other QFIIs		▪ 1 year for RQFIIs other than open-ended funds		
Repatriation /remittance restrictions	▪ repatriation cannot be made before the expiry of the lock-up period ▪ open-ended China funds: - no SAFE approval required provided that the monthly net repatriation does not exceed 20% of its total investment at the end of the preceding year - may be conducted on a weekly basis ▪ other QFIIs: - repatriation of profit: no SAFE approval required provided that the total monthly repatriation (including capital and profit) does not exceed 20% of its total investment at the end of the preceding year - repatriation of capital: SAFE approval is required		▪ open-ended funds: - repatriation may be made on a daily basis ▪ other RQFIIs: - repatriation cannot be made before the expiry of the lock-up period - on a monthly basis - no SAFE approval required but capital which has been remitted out cannot be re-invested and the investment quota will be reduced accordingly		

3 A QFII needs approval, and a separate quota, from PBOC for its investment in the inter-bank bond market. An RQFII only needs to apply for an approval from PBOC to trade in the inter-bank bond market.

4 However, there are currently no operating rules for RQFIIs investing in stock index futures.

5 Although not clearly set out in the QFII rules, we understand that in practice the investment quota for QFIIs is managed similarly to that for RQFIIs.

6 For both schemes, the lock-up period starts on the earlier of the date (i) when the investment capital is fully remitted into the onshore designated account and (ii) at the end of six months after the investment quota is approved if the investment capital has not been remitted in full.

7 "Open-ended China fund" is defined as an open-ended securities investment fund set up by public offering outside China, where at least 70% of the fund assets are invested in China.

Unresolved issues

While the recent reforms to the QFII and RQFII schemes further increase the investment quotas and facilitate a more streamlined process for the repatriation of profit, market participants continue to seek clarification on a number of key issues.

Tax

The current Mainland tax position for QFIIs is as follows:

- QFIIs are exempt from business tax on income derived from the securities traded through approved securities brokers
- China-sourced dividends (from holding A-shares or B-shares) and interest (from holding PRC fixed income products) paid to QFIIs are subject to a 10% withholding tax
- if a QFII is eligible for a reduced withholding tax rate under any applicable tax treaty or other arrangement, the QFII can apply to the relevant tax bureau for the lower rate to apply.

The State Administration of Taxation (**SAT**) has not issued any specific notice in relation to tax arrangements for RQFIIs. However, given the similarity in the policies underlying the two schemes, it is reasonable to suppose that the same tax treatment applies to RQFIIs.

What is far from clear is the treatment of capital gains. Under the general tax provisions of China's income tax laws, a 10% withholding tax is imposed on capital gains derived by non-resident enterprises without a permanent establishment in the PRC. SAT has yet to publish any specific tax regulations relating to the taxation of capital gains derived by QFIIs or RQFIIs. It was reported in 2012 that China's regulators were reviewing draft regulations to introduce capital gains tax on foreign institutional investors' earnings from onshore equity transactions. We await the publication of those regulations.

In practice, we see increasing numbers of QFIIs including special tax provisions for PRC capital gains withholding tax in their investment documents, in anticipation of such a tax to be imposed in the future.

If China imposes a withholding tax on capital gains derived by QFIIs or RQFIIs, RQFIIs may be eligible to tax treaty benefits under the PRC-Hong Kong Avoidance of Double Taxation Arrangement because RQFIIs are all Hong Kong incorporated or registered entities under the current scheme.

Eligible institutions for RQFII status

Following the expansion of the range of eligible applicants under the Revised RQFII Rules, all entities holding a Type 9 regulated activity licence issued by the Securities and Futures Commission (**SFC**) in Hong Kong are eligible to apply for an RQFII licence. There are currently over 900 Type 9 licence holders in Hong Kong. The market expects that China's regulators are likely to give priority in the near term to applicants with an existing PRC connection.

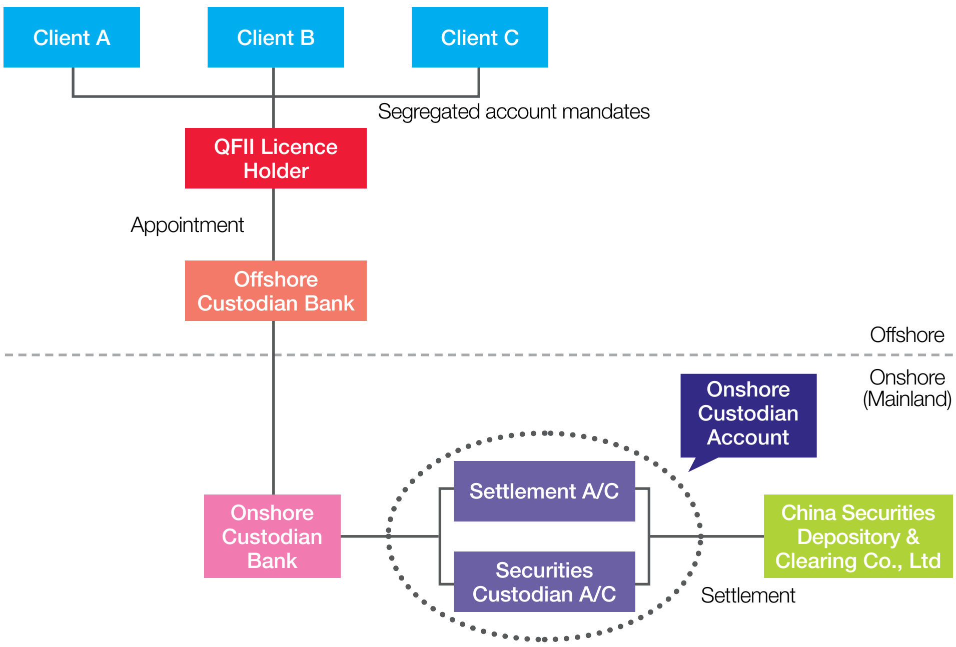
Under the Revised RQFII Rules, financial institutions registered in Hong Kong and with their principal places of business in Hong Kong are now also eligible to apply for an RQFII licence. There has been discussion among Hong Kong entities as to how to determine whether a financial institution is "registered in Hong Kong". The discussion also centres on whether the place of incorporation of the applicant entity is relevant, or whether wider analysis at the group level is required to determine that an applicant entity has its "principal place of business in Hong Kong" for the purpose of an RQFII application.

In addition, CSRC requires an applicant to not only have obtained the Type 9 licence from SFC but also to have started its asset management business prior to application. It is not clear whether an entity which has launched its asset management business overseas before obtaining the Type 9 licence will be considered as satisfying this requirement.

Offshore segregated account mandate structures

Offshore segregated account structures have been used under the QFII scheme to enable offshore investors to have access to the China's securities market without offshore investors needing to hold QFII licences. Following the relaxation of the types of permissible products under the Revised RQFII Rules, we expect to see similar segregated account mandates adopted under the RQFII scheme.

The chart shows a basic segregated account mandate structure under the QFII scheme:



While a segregated account mandate structure is cost effective for offshore investors, an offshore investor is exposed to risk on the QFII licence holder in relation to the ownership of the PRC securities held in the onshore custodian account. We commonly see one of the following onshore custodian account arrangements for QFIIs:

- *Segregated Custodian Client Account* – The onshore custodian account is categorised as a segregated client account designated for an offshore investor. Currently, a segregated client account is only available for offshore open-ended fund clients. The offshore investor's ownership in the PRC securities is recognised under PRC law.
- *Nostro Custodian Client Account* – The onshore custodian account is categorised as a nostro client account, with no segregated sub-accounts for individual offshore clients.

  A nostro custodian client account carries the risk that upon the insolvency of the onshore custodian or the QFII licence holder, the offshore investor is unable to recover its securities, although the risk is generally perceived to be low because the onshore custodian account is in the nature of a client account.
- *Proprietary Custodian Account* – The onshore custodian account is categorised as a proprietary account of the QFII licence holder under PRC law, without any reference to the offshore investor.

  PRC law does not recognise an offshore investor's ownership in the PRC securities under a "proprietary custodian account" structure. The offshore investor is therefore at risk that upon the insolvency of the onshore custodian or the QFII licence holder, the offshore investor is unable to recover its securities held in the onshore custodian account because its assets are held to be owned by the onshore custodian under PRC law.

In structuring the onshore custodian arrangement, it is important for an offshore investor to understand the type of the onshore custodian account being used and to consider whether it has a direct claim against, or right of subrogation to, the PRC securities held in the onshore custodian account.

What next?

We expect to see a steady increase in the QFII investment quota granted by China's regulators as China continues to relax its capital controls on foreign currency movements. Notwithstanding the limited pool of Renminbi outside China, the RQFII scheme is expected to be further expanded in order to meet the increasing demand for offshore Renminbi products. Taking advantage of their unique RQFII status, the trend for PRC financial institutions (including large PRC insurance companies) tapping Hong Kong's capital markets will continue at full speed.

We will continue to keep an eye on further developments on the QFII and RQFII schemes and share our observations and insights with you.

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Key contacts

Richard Mazzochi
Partner, Hong Kong
T +852 3443 1046
richard.mazzochi@hk.kwm.com

Minny Siu
Partner, Hong Kong
T +852 3443 1111
minny.siu@hk.kwm.com

Hayden Flinn
Partner, Hong Kong
T +852 3443 1113
hayden.flinn@hk.kwm.com

Vivienne Zang
Professional Support Lawyer, Hong Kong
T +852 3443 1110
vivienne.zang@hk.kwm.com

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