

Analysis on Significant Reform of QFII Foreign Exchange Administration and Its Impact

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On 3 February 2016, China's foreign exchange regulator, the State Administration for Foreign Exchange ("SAFE"), announced and implemented the *Rules on Foreign Exchange Administration of the Domestic Securities Investments by Qualified Foreign Institutional Investors* (SAFE Announcement [2016] No.1) (the "New Rules"). The New Rules have introduced significant reform to the foreign exchange administration of the qualified foreign institutional investors ("QFII") scheme under the former *Rules on Foreign Exchange Administration of the Domestic Securities Investments by Qualified Foreign Institutional Investors* which were issued in September 2009 and amended in December 2012 (the "Old Rules"), such as (1) removing the total investment quota limit for each QFII and introducing a "base quota" mechanism; (2) simplifying the administration of quota approval; (3) removing the required time frame for QFIIs to make inbound remittance of investment principal; (4) allowing daily remittance and repatriation for QFII open-ended funds; and (5) shortening the lock-up period.

Upon the implementation of the New Rules, the Old Rules as well as the *Operating Guidelines for Quota Administration of Qualified Foreign Institutional Investors* (Hui Zong Fa [2015] No.88) ("**Operating Guidelines for Quota Administration**") issued during the transitional period had been repealed simultaneously. This article provides an analysis on the significant reform unveiled by the New Rules and the impact through a comparison between the New Rules and the Old Rules.

I. Introducing the "Base Quota" Mechanism

1. Concept of the "Base Quota"

With respect to the investment quota, the New Rules will no longer impose an investment quota limit on each QFII. Instead, a "base quota" mechanism has been introduced.

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The “base quota” of a QFII refers to the investment quota calculated as a certain percentage of its asset size or the size of its securities assets under management (“AUM”). However, foreign sovereign wealth funds, central banks and monetary authorities will not be subject to this rule of being linked to the AUM but will be awarded investment quota according to their actual needs. QFIIs shall be able to obtain investment quota within their base quota by simply making a prior filing with the SAFE. Prior approval of the SAFE is required if the QFII would seek additional investment quota in excess of the base quota.

2. Two Scenarios for the Calculation of Base Quota

- (1) If the assets or AUM of a QFII or its corporate group are mainly offshore (i.e. outside the PRC), then its base quota would be US\$100 million plus 0.2% of its average AUM in the recent three years, minus any quota that it may have obtained under the renminbi qualified foreign institutional investor (RQFII) scheme (in US dollar equivalent, hereinafter referred to as “**RQFII Quota**”);
- (2) If the assets or AUM of a QFII or its corporate group are mainly onshore (i.e. within the PRC), then its base quota would be RMB 5 billion (or its equivalent in a different currency) plus 80% of its AUM in the previous year, minus any RQFII Quota obtained (in US dollar equivalent).

Accordingly, a QFII’s base quota will be linked and subject to its AUM deducting any RQFII Quota granted to the QFII. The formula (1) above applies to the wholly foreign-owned QFIIs, while formula (2) applies to QFIIs owned by Chinese companies such as the Hong Kong subsidiaries of Chinese commercial banks, securities companies, fund management companies or other financial institutions. The rationale for the SAFE to make such a distinction is that the investment quota obtained by the applicants owned by Chinese companies are mainly granted under the RQFII scheme, and due to the relatively late launch of their overseas business, their AUM is normally far less than the wholly foreign-owned QFIIs.

3. Setting the Upper and Lower Limit of the Base Quota and Removing the Upper Limit on the Total Investment Quota Available to Each QFII

The Old Rules stipulated that the investment quota applied by a QFII each time shall be no less than US\$50 million and the cumulative investment quota shall not exceed US\$1 billion (other than a sovereign wealth fund, central bank or monetary authority, all of which are not subject to the US\$1 billion quota restriction). However, under the New Rules, it is only provided that the base quota of

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each QFII shall be within the range of US\$20 million to US\$5 billion. US\$5 billion is the upper limit for the base quota only, and according to the SAFE, a QFII may apply for additional investment quota in excess of the base quota subject to the SAFE's prior approval. In other words, the US\$1 billion upper limit on the cumulative total investment quota of each QFII imposed by the Old Rules has been removed.

II. Simplifying the Administration on Approval for Investment Quota

Upon obtaining the QFII licence from the China Securities Regulatory Commission ("CSRC"), each QFII can be awarded an investment quota within its base quota after having made a filing with the SAFE (multiple filings are permissible as needed). Applications for additional investment quota in excess of the base quota, however, are subject to prior approval of the SAFE. The specific requirements can be found in Articles 7 to 9 of the New Rules.

1. Pursuant to Article 7 of the New Rules, for the filing of application for investment quota within its base quota, a QFII shall submit the following documents to its PRC custodian: (1) a statement of the filing of the application for investment quota together with a Registration Form for Qualified Foreign Institutional Investors; (2) the audited balance sheet of the QFII for the last three years or the preceding one year (or the audited financial report on the securities assets under its management, etc.); and (3) a photocopy of the supporting documents of the QFII licence issued by the CSRC. The PRC custodian shall, after having rigorously reviewed the documents and verified the QFII's base quota as well as its entitlement to the quota sought, submit the filing applications for investment quota of each QFII to the SAFE by the 10th day of the month on a consolidated basis. If the filing is accepted and confirmed by the SAFE, it will provide the filing information to the PRC custodian.
2. Under Article 8 of the New Rules, where a QFII applies for investment quota exceeding its base quota, it shall submit the following documents to the SAFE through its PRC custodian: (1) a written application elaborating the reasons for increasing its investment quota and the use of its current available investment quota; (2) its audited balance sheet for the last three years or the preceding one year (or the audited financial report on the securities assets under its management); and (3) other documents/ information as required by the SAFE.
3. Article 9 of the New Rules provides that, for a QFII which had obtained its investment quota prior to the issuance of the New Rules and which applies for the increase of its investment quota, the procedures listed below shall be followed:

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- (1) If the investment quota obtained plus the additional investment quota sought does not exceed the base quota, then the filing procedure as set out in Paragraph 1 above shall apply ;
- (2) If the investment quota obtained plus the additional investment quota sought exceeds the base quota, then the procedure as set out in Paragraph 2 above shall apply ; and
- (3) If the investment quota obtained already exceeds the base quota, then the procedure as set out in Paragraph 2 above shall apply.

III. Adopting Quota Management by the Balance of Investment Quota and Removing the Time Frame Requirement for Inbound Remittance of Funds

1. Adopting Quota Management by the Balance of Investment Quota

A major reform to the QFII foreign exchange administration introduced by the New Rules is the adoption of quota management by the balance of QFII investment quota, which only requires that a QFII's cumulative net inbound remittance of funds shall not exceed its total investment quota filed for and approved.

According to the Old Rules, investment quota was granted separately to a QFII's proprietary assets, client assets and open-ended China funds¹, respectively, with each type of assets or funds having different lock-up periods and different permitted frequency of exchange and remittance. Subsequently, the *Operating Guidelines for Quota Administration* divided the QFII investment quota into two categories, (1) investment quota for open-ended funds² and (2) investment quota for other products or funds. It was further allowed that the investment quota for open-ended funds can be shared among different open-ended funds, while for the allocation of investment quota between open-ended funds and other products or funds, a QFII was required to submit a filing form to the SAFE.

The New Rules further simplify the quota management framework under the *Operating Guidelines for Quota Administration*, by adopting a new quota management system by the balance of investment quota. Under the new system, investment quota will be granted to each QFII without distinguishing different types of quota, and each QFII may freely allocate its investment quota among its proprietary assets, open-ended funds and its client assets/segregated accounts subject to its investment quota obtained without the need for prior approval or filing. Accordingly, as for the QFII's client assets, the rule of deducting the obtained investment quota upon actually-occurred usage of quota (i.e. the outbound remittance of principal already occurred) under the Old Rules shall no longer apply.

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2. Removing the Time Frame Requirement for the Inbound Remittance of Funds

Under the Old Rules, the investment principal of a QFII was required to be fully remitted into China within 6 months following approval of the quota by the SAFE. In the event that the investment principal of a QFII was not fully remitted into China but exceeding US\$20 million, the investment quota of the QFII shall be reduced to the amount actually remitted. The *Operating Guidelines for Quota Administration* provided that a QFII may apply for a single extension of not more than 6 months for the inbound remittance of its investment principal. The New Rules now removed the requirement to make inbound remittance of investment principal within 6 months but retain the requirement that a QFII shall not, in any form or by any means whatsoever, resell or transfer its investment quota to any other institutions or individuals, and further clarify that if a QFII's investment quota is not utilized within one year of filing or approval, the SAFE shall be entitled to reduce all or part of the unused investment quota.

IV. Shortening the Lock-up Period on Investment Principal

The lock-up period on investment principal refers to the period during which the investment principal of a QFII is prohibited from repatriation out of China. Under the Old Rules, pension funds, insurance funds, mutual funds, charity funds, endowment funds, government and monetary authorities as well as for open-ended China funds were subject to three-month lockup period. All other types of QFII assets were subject to a one-year lock-up period. The New Rules no longer distinguish the lock-up period among different types of QFII assets and the new lock-up period for all QFIIs on repatriation of investment principal is 3 months starting from the date on which the cumulative inbound remittance of investment principal by the QFII reaches a total of US\$20 million or its equivalent.

V. Account Administration

1. Removing the Restrictions on the Number of Accounts

Under the New Rules, a QFII shall open the respective foreign exchange accounts for its proprietary assets, client assets or open-ended funds, and shall open RMB special deposit accounts corresponding to the foreign exchange accounts. The Appendix 3 to the New Rules, i.e. the *Operating Guidance on Administration of the Domestic Accounts of Qualified Foreign Institutional Investors*, further sets out the requirements on the opening and use of the foreign exchange accounts, RMB basic deposit accounts and RMB special deposit accounts.

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Following the implementation of the New Rules, previous restrictions on the number of foreign exchange accounts and their corresponding RMB special deposit accounts have been removed. A QFII may, depending on its actual needs, open with its PRC custodian, for each of its open-ended funds and clients, respectively, separate foreign exchange accounts and the corresponding RMB special deposit accounts (including the special deposit accounts for investment in the domestic securities market (the **“Special Deposit Accounts for Securities Trading”**) and the special deposit accounts for investment in stock index futures (the **“Special Deposit Accounts for Futures Trading”**), on the premise that the Special Deposit Accounts for Futures Trading shall be one-to-one corresponding to the Special Deposit Account for Securities Trading) for each open-ended fund or each client. It should be noted that, the funds in the accounts for different open-ended funds or for different client assets shall still not be transferred among each other directly.

2. Removing the Minimum Requirement on the Amount Deposited in the RMB Special Deposit Account

Under the Old Rules, a QFII may open no more than 6 RMB special deposit accounts for its client assets for securities trading purpose and the initial amount to be deposited in each account shall be no less than US\$20 million or its equivalent. The New Rules not only removed the restriction on the number of accounts to be opened, but also removed the requirement on the minimum initial amount for each RMB special deposit account, to the effect that the initial amount when opening each RMB special deposit account and the balance of such account is allowed to be less than US\$20 million.

3. Account Name

The New Rules do not prescribe any mandatory requirement for the naming of QFII accounts. However, pursuant to the CSRC’s *Provisions on Issues Relating to the Implementation of the “Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors”* (CSRC Announcement [2012] No.17), where a QFII opens a securities account for its client assets, the account name can be set as “QFII + client”, and where a QFII applies for the opening of a securities account for publicly offered funds, insurance funds, pension funds, charity funds, endowment funds, government investment funds and other long-term funds/assets under its management, the account can be in the name of “QFII + fund (or insurance fund, etc.)”. Meanwhile, the detailed rules for implementation of QFII schemes and the guidance on account opening issued by the China Securities Depository and Clearing Corporation Limited require that the name of the securities account shall be consistent with that of the RMB special deposit account. Based on the above requirements, it is suggested that the cash account should be opened in the name of “QFII + Fund” or “QFII + Client”.

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It is of vital importance for the independence and effective segregation of the assets of different clients or the assets of different funds to reflect the name of the QFII's specific client or of the specific open-ended fund managed by the QFII in the name of the corresponding cash accounts and securities accounts. In the event of any legal dispute, the independent accounts opened with clear and definite labeling of a particular fund or client will facilitate the effective identification of the relevant credit and debt of such fund or client, the avoidance of the assets being commingled or the boundary of liabilities becoming blurred, and may possibly also more effectively prevent the assets being encumbered by legal actions (such as seizure and freezing of assets) against the QFII itself or other clients or open-ended funds.

VI. Facilitating the Administration of Remittance and Foreign Exchange

1. Allowing Daily Remittance and Repatriation for QFII Open-ended Funds

Under the New Rules, inbound and outbound remittances by an open-ended fund may be conducted on a daily basis, as opposed to a weekly basis under the Old Rules. This change greatly increases the flexibility for QFII open-ended funds. QFIIs may adjust the subscription/redemption arrangement accordingly and have this updated in the prospectus or other documents of the open-ended funds.

2. Removing the Requirement for Approval on Principal Repatriation

Under the New Rules, it is no longer required for QFIIs to obtain the SAFE's prior approval in order to repatriate the investment principal. Rather, QFIIs may directly make an outbound remittance of their investment principal and income with their PRC custodians. QFIIs who intend to repatriate their realized income derived from their non-open-ended funds shall still be required to provide documents such as the special audited financial report, proof of tax payment or tax filing.

The cap on monthly net repatriation (including principal and income) still stands, i.e. a QFII shall not in any month cumulatively repatriate more than 20% of its total onshore assets as at the end of the preceding year. In addition, for an open-ended fund, the cumulative net repatriation in a month shall not exceed 20% of the fund's total onshore fund assets as at the end of the preceding year.

3. Extending the Preparation Period on Conversion of Foreign Exchange Funds for Investment

Under the New Rules, a QFII may, according to its investment plans, instruct the PRC custodian to convert foreign exchange funds to RMB as required for investment and transfer into the RMB special

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deposit account 30 business days at most (previously stipulated to be 10 business days under the Old Rules) ahead of the actual investment.

VII. Reducing the Items that Require Registration of Changes

Pursuant to the New Rules, a QFII shall apply to the SAFE for registration of changes on the following items: (1) changes in material information such as those relating to the name of the QFII or its PRC custodian; (2) changes in product information; and (3) other changes prescribed by the SAFE.

The following changes are no longer required to be registered with the SAFE: (1) changes in the basic information of the responsible person, the major shareholder or the actual controller of the QFII; (2) changes in the QFII's appointed PRC investment institutions (i.e. brokers) or the relevant material information; (3) changes in the name of accounts or the information relating to the bank with which the accounts are opened; and (4) changes in the prospectus of open-ended China funds.

However, where a QFII or its major shareholder or actual controller has been subject of any major regulatory action by any other regulatory authorities (including overseas regulatory authorities), which may have a material impact on the investment operations of the QFII or may cause relevant business qualifications of the QFII to be suspended or revoked, the QFII's PRC custodian shall still promptly report the same to the SAFE.

Overall, the significant reform now made to the administration of foreign exchange under the QFII regime has greatly boosted the accessibility and flexibility of QFII operation in China, making the QFII scheme more attractive. The industry generally believes that this is a significant move forward to the prospect of China A-shares becoming included in MSCI's emerging market indices.

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1. Under the Old Rules, “open-ended China funds” refer to open-ended securities investment funds launched and set up as publicly offered funds outside China, which shall invest at least 70% of their assets in China market.
2. The *Operating Guidelines for Quota Administration* has replaced “open-ended China funds” with “open-ended funds” to the effect that the requirement of investing at least 70% of the fund’s assets in China market has been removed in essence. However, open-ended funds shall still be publicly offered funds.