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FOREIGN INVESTOR APPROVAL REACHED RECORD HIGHS IN 2012 AS CHINA REVISED QFII REGULATIONS ON FOREIGN EXCHANGE

On 14 January 2013, Guo Shuqing, China Securities Regulatory Committee (CSRC) chair, told an audience at the Asia Financial Forum held in Hong Kong that China would grant foreign investors greater access to its mainland capital markets, continuing to raise quotas for its foreign investor schemes (i.e., the qualified foreign institutional investor (QFII) scheme and the renminbi qualified foreign institutional investor (RQFII) scheme.[1] Current investments by QFIIs and RQFIIs are estimated to account for somewhere between 1.5 and 1.6 per cent of the total investments in China's A-share markets, and Guo expects a ten-fold increase in that proportion.

The QFII scheme, which was introduced in 2002, allows foreign institutional investors to invest in China's capital markets, subject to first obtaining a QFII license from CSRC and then an investment quota allocated by the State Administration of Foreign Exchange (SAFE).

Guo's above comments followed an acceleration of China's QFII approval process in 2012, with CSRC issuing 72 QFII licenses in total, compared to 29 and 13 in 2011 and 2010, respectively. Annual investment quotas granted by SAFE rose dramatically in 2012, reaching USD 15.8 billion, whereas, in the previous nine years, the figures had never exceeded USD 3.5 billion. By the end of 2012, 207 foreign investors had received a QFII license since the scheme's introduction, and the aggregate quotas granted had reached around USD 37.5 billion.[2]

The year 2012 also saw CSRC and SAFE implement a number of regulatory changes aimed at attracting more foreign investors, including:

- increasing the total quota available to QFIIs from USD 30 billion to USD 80 billion[3]
- reducing entry barriers (i.e., lower track record and asset requirements) and simplifying application procedures with less application documents being required
- raising the ceiling on the combined shareholding of all foreign investors in any A-share company from 20 per cent to 30 per cent
- expanding investment options to include fixed-income products traded on the inter-bank bond market.[4]

In addition, in December 2012, SAFE revised its QFII-related regulations i.e. the *Provisions on Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* issued in September 2009 ("2009 SAFE Rules"). The revised regulations ("New SAFE Rules") were released on 7 December 2012, along with the *Trial Operation Guidelines for the Administration of the Domestic Accounts of Qualified Foreign Institutional Investors* ("SAFE Account Guidelines"), both becoming effective immediately.

As a result of this latest regulatory development:

1. **Investment Quota per Investor Partly Removed**

Under the 2009 SAFE Rules, all QFIIs were subject to an accumulative investment quota per investor capped at USD 1 billion.

According to statistics published by SAFE, by the end of November 2012, five QFIIs had already reached the USD 1 billion ceiling, namely Government of Singapore Investment Corporation, Temasek Fullerton Alpha Pte Ltd, Norges Bank (Norway's Central Bank), Hong Kong Monetary Authority and Qatar Holding LLC (wholly owned by Qatar Investment Authority).

The New SAFE Rules remove the USD 1 billion ceiling for three types of investors, namely sovereign wealth funds, central banks and monetary authorities, although it is still applicable to other investors.

2. **Foreign Exchange Controls Relaxed**

The New SAFE Rules continue distinguishing between open-end China funds and other QFIIs in connection with foreign exchange controls while introducing the following changes:

(1) Open-end China funds

Open-end China funds are now allowed to remit into or repatriate out of China the net difference between subscription and redemption amounts more frequently, on a weekly basis, compared with a monthly basis under the 2009 SAFE Rules.

In addition, fund remittance and repatriation by open-end China funds[5] are no longer subject to SAFE's approval, regardless of the amount involved, whereas, under the 2009 SAFE Rules, SAFE's approval was required where the amount remitted or repatriated exceeded USD 50 million.

(2) QFIIs other than open-end China funds

Previously, the repatriation of both investment and profits by QFIIs other than open-end China funds required SAFE's approval. The New SAFE Rules, however, remove the approval requirement for profit repatriation. As a result, custodian banks now may proceed with profit repatriation for QFIIs upon their presenting the required documents, including tax clearance certificates.

It is worth noting, however, that there have been longstanding unanswered questions as to how QFIIs should be taxed on their capital gains, due to a lack of QFII-specific rules regarding this issue. In practice, Chinese tax authorities, without clear guidance to follow, have not yet started collecting tax on QFIIs' capital gains (except in the Lehman Brothers case[6]) and are reluctant to issue tax clearance certificates, not knowing how much capital gains tax (if any) should be paid.

SAFE stated in 2011 that, prior to the introduction of the applicable capital gains rules, QFIIs intending to repatriate profits would need to give a covenant that they would pay the tax retrospectively when the rules are passed.[7]

CSRC has reportedly been very close to finalising the capital gains rules with the State Administration of Taxation. However, at the time of writing this update, no such rules have been published.

(3) A new monthly cap

While introducing the above-mentioned relaxations, the New SAFE Rules also impose a cap on a QFII's total monthly repatriation (or monthly net repatriation in the case of open-end China funds), which is set at 20 percent of its total onshore assets as at the end of the previous year.

3. **QFII Bank Account Structure Improved**

The 2009 SAFE Rules introduced a multiple bank account structure i.e., a QFII may open a foreign exchange account and a corresponding RMB special account for proprietary funds and client funds respectively, and is required to open a foreign exchange account and a corresponding RMB special account for each open-end China fund launched.

The SAFE Account Guidelines further develop the structure by allowing a QFII to open up to six RMB special deposit accounts for client funds (corresponding to the foreign exchange account) so that assets of different underlying clients can be held separately. Each such account requires a USD 20 million minimum to open.

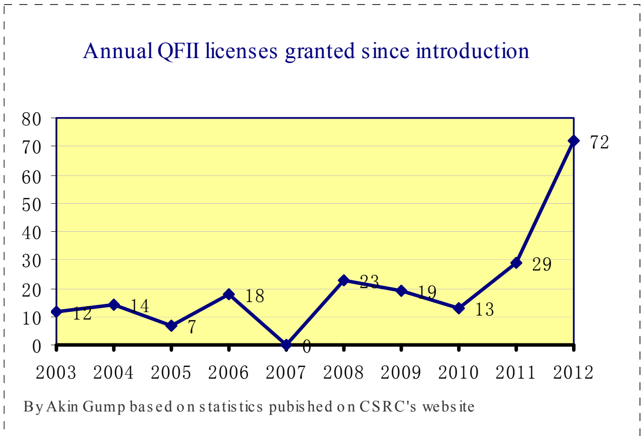
In addition, the SAFE Account Guidelines introduce guidance on the opening and use of RMB special deposit accounts for trading stock index futures. This is a step forward in facilitating QFIIs' trading of stock index futures on the China Financial Futures Exchange, which is reportedly expected as early as the end of January 2013.

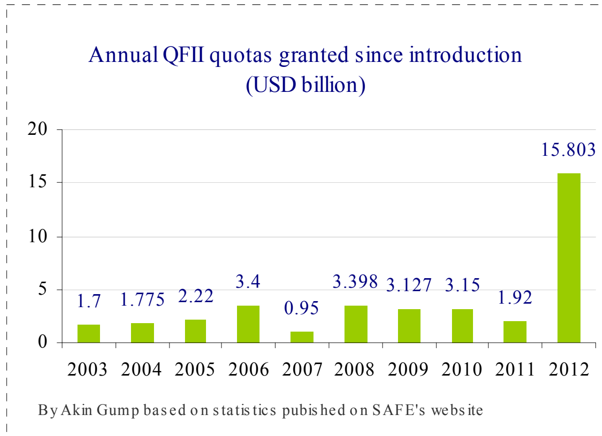
Like the 2009 SAFE Rules, the New SAFE Rules and SAFE Account Guidelines expressly prohibit any mingling of funds among the bank accounts opened by a QFII.

For existing QFIIs intending to split client funds into separate RMB special deposit accounts, there is a deadline for application set at six months following the introduction of the SAFE Account Guidelines on 7 December 2012.

CONCLUSION

Substantial regulatory reforms of the QFII scheme were implemented in 2012 that grant foreign investors greater market access, streamline the application process with lowered entry barriers, relax foreign exchange controls and provide for an improved bank account structure. Although a 20 percent monthly repatriation cap is also introduced, these regulatory reforms, together with the acceleration of the QFII approval process, are undoubtedly an encouraging development signaling China's intention to attract more foreign investment.





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[1] The RQFII scheme was introduced in December 2011. It allows Hong Kong subsidiaries of Chinese fund management companies and securities firms to invest in China's capital markets using RMB funds raised in Hong Kong. The initial RQFII quota was set at RMB 20 billion and was increased to RMB 70 billion in April 2012. By the end of 2012, a total of RMB 67 billion had already been allocated to 24 investors. Reportedly, the quota has now been increased to RMB 270 billion. SAFE's statistics on RQFII quotas are available at www.safe.gov.cn.

[2] A list of QFIIs as of the end of 2012 is available at CSRC's website www.csrc.gov.cn and SAFE's statistics on QFII quotas as of the end of 2012 are available at www.safe.gov.cn.

[3] CSRC's announcement is available at www.csrc.gov.cn/pub/newsite/bgt/xwdd/201204/t20120403_208155.htm

[4] For details, see *Provisions on Issues in relation to the Implementation of the "Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors" (CSRC [2012] No 17)* issued by CSRC on 27 July 2012.

[5] Open-end China funds refer to open-end securities investment funds publically raised offshore, which allocate at least 70 per cent of their assets to investment in mainland China's capital markets. See article 9 of the New SAFE Rules.

[6] Lehman Brothers International (Europe), which had held a QFII license since July 2004, paid RMB 399 million in tax on its RMB 3.99 billion capital gains, before remitting all of its funds out of China during the course of its liquidation in 2010.

[7] See SAFE's reply to certain QFII-related questions available at http://www.safe.gov.cn/wps/portal/!ut/p/c4/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PQyNPI_2CbEdFAKLWUno!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/wsfw/node_wsfw_zcwd/node_wsfw_ywzn_store/c30db88048184e829864d884909d05cd

