Legal Commentary

May 11, 2020

Will Quota Removal Put R/QFII Back in the Game?

Authors: TieCheng YANG | Yin GE | Ting ZHENG | Eryin YING | Flora WEI

Background

In an effort to reinvigorate interest in the Qualified Foreign Institutional Investor (QFII)/RMB Qualified Foreign Institutional Investor (RQFII) program, the People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) announced their decision to abolish the investment quota restrictions for QFII and RQFII on 10 September 2019. The market has expected relevant implementing rules since then. On 7 May 2020, PBOC and SAFE issued the *Provisions on Administration of Securities and Futures Investment Funds of Foreign Institutional Investors* (《境外机构投资者境内证券期货投资资金管理规定》) (the "**New Rules**")[1] to implement the above decision and to further facilitate R/QFIIs' onshore capital management. Interestingly the New Rules came out after the issuance of guidance by the U.S. Securities and Exchange Commission (SEC) and the U.S. Public Company Accounting Oversight Board (PCAOB) on emerging market investments, e.g. the *Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited* issued on 21 April 2020[2], which, in particular, advised U.S. funds and registered investment advisors to consider more risk factors for exposure to securities traded on Chinese stock exchanges (e.g. A-shares).

As expected, the New Rules will unify the existing capital management rules applicable to QFIIs and RQFIIs, namely the *Measures on the Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* (《合格境外机构投资者境内证券投资外汇管理规定》) and the *Circular on the Management of Domestic Securities Investment by RMB Qualified Foreign Institutional Investors* (《关于人民币合格境外机构投资者境内证券投资管理有关问题的通知》) (collectively, the "**Existing Rules**"). The New Rules will take effect and supersede the Existing Rules from 6 June 2020.

We have summarized below notable key aspects of the New Rules.

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[1] Our in-house English translation of the New Rules is available upon request.
[2] https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting.

Key Aspects

I Quota restrictions abolished

After the effectiveness of the New Rules, R/QFIIs will no longer be required to apply for investment quotas from SAFE. Instead, after obtaining R/QFII licensure from the China Securities Regulatory Commission (CSRC), R/QFIIs will only need to register with SAFE (via their respective main custodian) before being permitted to open custody accounts. PBOC, in a Q&A for the New Rules[3], further clarified that current R/QFIIs will be allowed to directly open custody accounts using their existing registration information and need not again register with SAFE.

II Free selection of remittance timing and currency

An R/QFII may freely choose the timing and currency in which investment capital will be remitted into China, which can be RMB and/or foreign currency. However, in principle, the currency of an inward remittance shall be consistent with future repatriation to avoid currency arbitrage between RMB and the foreign currency.

III Simplified process for routine repatriations

The Existing Rules require a special audit report by a PRC certified accountant and a tax clearance or filing form before an R/QFII may repatriate investment proceeds out of China. The New Rules substantially simplify the documentation requirements for routine repatriations – an R/QFII is only required to provide a repatriation application/instruction and a tax payment undertaking letter. A special audit report and a tax clearance or filing form will still be required when an R/QFII or its product is liquidated.

IV Removal of restrictions on number of custodians an R/QFII may appoint

The New Rules remove the restrictions on the number of custodians that an R/QFII may appoint and allow for the appointment of multiple custodians based on actual need. Where an R/QFII appoints more than two custodians, one of them is required to be designated as the main custodian for filing and registration purposes.

V General requirements on derivatives transactions remain substantially unchanged

1. The New Rules substantially retain the general requirements for derivatives transactions for R/QFIIs under the Existing Rules. Specifically, Article 16 provides that derivatives transactions conducted by an R/QFII within China are limited to foreign exchange derivatives for hedging purposes and other financial derivatives that comply with applicable rules. Exposure to derivatives should be reasonably related to the risk exposure under the underlying domestic securities investment. Based on our understanding, such other financial derivatives include stock index futures and other financial derivatives which may be available in the future (under CSRC's proposed R/QFII rules). However, it remains unclear whether transactions involving other financial derivatives must also be conducted

[3] The Q&A is available at http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4019498/index.html?from=timeline&isappinstalled=0.

only for hedging purposes or whether other applicable rules will apply (e.g. CSRC's new R/QFII rules).

2. Article 17 provides that foreign exchange derivatives positions held by a R/QFII must not exceed the scale of the underlying RMB-denominated assets relative to its domestic securities and futures investments, to ensure compliance with the principle of trading on an actual-need basis.

Outlook

While the New Rules mark another step forward in reforming the QFII and RQFII programs, issuance of the New Rules may not be sufficient to attract more foreign investors to participate in the R/QFII program. This is because limited investment scope is primarily responsible for the R/QFII program to be less attractive, rather than quota limits or the difficulty of repatriation. Another issue which may complicate matters is the issuance by SEC and PCAOB of guidance on emerging market investments as discussed above. While the full implication of the SEC and PCAOB guidance is not yet known, it may discourage certain foreign investors from investing in A-shares, either via R/QFII or otherwise.

As a result, the CSRC's new R/QFII rules[4] may be more helpful to put the R/QFII program back in the game, because they propose to substantially enlarge the investment scope of R/QFIIs to cover asset classes other than A-shares and bonds.

We will continue to monitor the developments and provide further insight on a timely basis.

[4] On 31 January 2019, CSRC issued the consultation drafts for amended QFII and RQFII rules (accessible at http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201901/t20190131_350613.html) which propose several changes to the current R/QFII program, e.g. merging QFII and RQFII regimes, expansion of the investment scope of R/QFIIs, requiring reporting of offshore derivatives positions relevant to domestic securities investment, etc. CSRC has not yet promulgated these R/QFII rules.

Important Announcement

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If you have any questions regarding this publication, please contact:

TieCheng YANG

Tel: +86 10 8516 4286
Email: tiecheng.yang@hankunlaw.com

Yin GE

Tel: +86 21 6080 0966
Email: yin.ge@hankunlaw.com