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THE RQFII PROGRAM—OPPORTUNITIES AND CHALLENGES FOR INTERNATIONAL INVESTORS INTERESTED IN DIRECT ACCESS TO PRC SECURITIES WITH OFFSHORE RMB

By Choo Lye Tan

The Renminbi Qualified Foreign Institutional Investor ("**RQFII**") pilot program allows non-PRC institutional investors from certain jurisdictions that have officially implemented the RQFII (the "**Relevant Jurisdictions**") to deal in People's Republic of China ("**PRC**") domestic securities using offshore Renminbi ("**RMB**"). Additionally, because of special RQFII rule provisions, the RQFII program affords broader investment possibilities in some contexts and much greater flexibility not found in its predecessor pilot program, the Qualified Foreign Institutional Investor ("**QFII**"). Currently, only Hong Kong, London and Singapore (the "**Relevant Jurisdictions**") have been announced as eligible jurisdictions under, and have officially implemented, the RQFII program locally—although Taiwan and Paris have also been announced as recipients, they have not yet locally approved the program[1].

The RQFII program is potentially attractive to non-PRC investors keen to deal directly in the PRC onshore securities market as it provides direct access to:

- PRC A-shares and fixed-income bonds of PRC entities not currently available offshore, even with the existence of H-shares or dual listings
- numerous fast-growing Chinese sectors such as healthcare, technology, multimedia and consumer sectors not currently listed outside of the PRC with valuations Bloomberg estimates are trading at price-to-earnings multiples of eight times for 2014 and seven times for 2015, which are approaching historical 10-year lows; and
- onshore fixed-income bonds whose yields are higher even than those of PRC offshore bonds, which were already the best-performing bond market in Asia in 2013 with average returns of 6%.

RQFII versus QFII

Before the introduction of the RQFII program, a non-PRC entity that wanted to deal in securities issued in the PRC domestic market would have required approval as a QFII under the QFII program. The RQFII has not eliminated the QFII program, which is still a useful avenue into the PRC domestic securities market for certain types of institutional investors, but the programs differ in significant ways that are material to certain investors, among them (i) currency of settlement; (ii) investor eligibility parameters; and (iii) suitability considerations, including flexibility of investments and repatriation of proceeds.

[1] Hong Kong currently has the largest RQFII quota of RMB 270 billion, followed by the UK and France with RMB 80 billion each and Singapore with RMB 50 billion. Taiwan is expecting RMB 100 billion.

Table I shows a summary comparison of the key requirements of the RQFII and QFII programs.

RQFII Application Process

Table 2 sets out the timeline for a typical RQFII application process through to listing. As the RQFII program and uses of it in the form of open-ended funds and listed vehicles is still fairly new, it is an optimistic timeline and draws substantially from its practice and use in Hong Kong, which is the only one of the Relevant Jurisdictions to have both authorized and listed such funds.

Potential Uses of RQFII in an International Investor's Portfolio

- Developing new products based on onshore PRC securities
  - RQFII Undertaking for Collective Investment in Transferable Securities ("**UCITS**") funds invested solely in PRC-listed securities such as fixed-income bonds and/or PRC A-Shares
  - EU alternative investment fund invested in PRC listed securities
- Tapping a previously non-existent or non-available market
  - Middle-Eastern, African and South American investors with a large appetite for Chinese products
  - Entities that may not by themselves be able to satisfy RQFII eligibility requirements or the costs of compliance and maintenance of RQFII license holders
- Developing products based on a combination of different factors depending on needs and purposes
  - Listing for purposes of liquidity
  - Dual listings
  - RQFII funds domiciled in Luxembourg and Ireland
  - RQFII exchange-traded funds ("**ETFs**") listed on the New York Stock Exchange
  - Passive as well as actively managed funds

Considerations in the Choice of a Relevant Jurisdiction for a RQFII License Applicant

Where should you apply for your RQFII license—Hong Kong, London or Singapore?

- Less of a strategic than a practical decision with the blurring of borders and barriers. Purely from the perspective of convenience, if an entity is already licensed or located in one of the Relevant Jurisdictions, it makes commercial sense to apply for its RQFII license from that jurisdiction. However, strategic considerations may include the product that the firm wants to launch, the familiarity of the process in each jurisdiction and the overall RMB quota available in that jurisdiction.
- Consider your distribution strategy and investor base

- UCITS products clearly best-launched from a European jurisdiction if target investors are European
- Additionally, for the UCITS fund to attract investors outside of Europe, they may consider a primary or secondary listing on an Asian stock exchange

- The familiarity of regulators and service providers with the product being offered is also a relevant consideration, as it can minimize delays and costs.
  - Hong Kong has been the traditional home for ETFs
  - Since the RQFII program has been in place and operating in Hong Kong before any of the other Relevant Jurisdictions, a robust and skilled infrastructure in Hong Kong has arisen to support RQFII funds as Hong Kong custodian banks, lawyers, auditors, administrators, compliance and record-keeping specialists and other on-going maintenance service providers have been dealing with RQFII procedural and administrative issues since 2011.
- Ultimately, the investment quotas granted to each jurisdiction may be the most important issue to consider, as a prospective RQFII applicant will naturally not want to establish in a Relevant Jurisdiction that has exhausted or will likely soon exhaust available quotas. With a plethora of Relevant Jurisdictions competing for RQFII funds business, potential RQFII applicants first entering the RQFII market should carefully consider their particular situation in both the long and short term in order to determine the most suitable Relevant Jurisdiction from which to make an RQFII application. Important considerations would likely include the following :
  - How long is the structure required or anticipated to be required?
  - What is the applicant's investment focus and how flexible is it? For example, if listing an ETF is the focus, which stock exchange would give you the best liquidity? Which market would give you greatest access to offshore RMB? If you needed to apply for greater quota as a fund, what sort of (further) authorizations and/or disclosures would be required, and how easy would it be to do this?
  - What are the additional burdens or benefits of listing in a third jurisdiction? What is the purpose of that listing? Would the additional costs outweigh the benefits?
  - Does a license in a Relevant Jurisdiction add any benefit to the focus of the applicant's group of companies as a whole?
  - Which jurisdiction would have the most skilled service providers to deal with RQFII follow-up issues down the road?

Issues

Need for innovative investment thesis

Simply having access to the PRC domestic securities market will not ensure the success of an RQFII applicant. Fund managers need to identify and/or develop specialized investment products tailored to clients' needs.

Potential Impact of PRC-Hong Kong mutual fund recognition and mutual stock market access

Some observers believe these developments may actually enhance PRC fund managers' interest in the RQFII program because in order for the RQFII program to work successfully, offshore RQFII managers would require the specialized investment skills and techniques of onshore PRC investment professionals with expertise in PRC assets. In any event, these issues are currently moot as the Hong Kong-PRC mutual fund recognition program has been announced as imminent for the better part of a year but has yet to be implemented, while the Hong Kong-PRC mutual stock exchange access is slated to go live by the end of year at the earliest.

Lack of clarity in interpretation and application of the RQFII program rules

With PRC laws in general, much needs to be derived from observation, repeated practice without adverse reaction and general public consensus. Some specific areas of uncertainty have been discussed above, and there are many other areas in which knowledgeable practitioners' advice is a necessity.

Among other things, there are questions as to the definition of "principal place of business" in a Relevant Jurisdiction (a key requirement for RQFII eligibility). On another note, what exactly is an RQFII open-ended fund since no specific definition has been provided, and why the distinction between QFII open-ended China funds and RQFII open-ended funds? The practical way to deal with such uncertainties has been to watch other RQFII applicants in action or to take the leap with fingers crossed. So far, there has been no indication otherwise from the PRC regulatory authorities and as the RQFII program gains traction, more clarity and certainty will surely arise.

Withholding tax

Another stumbling block had been the taxation of profits, especially that on capital gains, which has now been clarified by the PRC regulators to some extent. Earlier this year, China Asset Management Company announced that it had obtained a Hong Kong Resident Tax Certificate from the Inland Revenue Authority of Hong Kong which exempts its China AMC CSI 300 Index ETF from a 10% withholding tax on unrealized and realized capital gains derived from all its disposals of China A-shares other than those A-Shares in "land-rich companies" in China. As a result, the fund reversed all provisions it had made for withholding tax since the date of inception of the fund in respect of its trading in non-land-rich A-shares although, as a small proportion of its holdings were in land-rich companies, it would continue to make the necessary 10% withholding tax provision for those holdings only and, going forward, would cease to make any provisions for its trading in non-land-rich A-shares and would apply this position retroactively from the date of the inception of the fund. It is anticipated that the China Securities Regulatory Commission ("**CSRC**") and SAT will likely address this issue formally in the coming months.

One must also bear in mind that amendments to the rules and "practice" of the RQFII program may not necessarily be reflected in the actual rules or legislation themselves as they would be elsewhere, but may end up being "accepted" by virtue of repeated usage or announcements and press releases.

Time lag

The technical details for London's RQFII have still to be clearly ascertained—and the only truly tried-and-tested model is the Hong Kong model, which requires funds to be domiciled in Hong Kong. This puts foreign managers at a distinct disadvantage to Chinese asset managers which are able to obtain approval and launch their products immediately, irrespective of demand. However, the target market for RQFII products is different from that for direct Chinese fund products, which foreign investors could not access by themselves so this is, perhaps, an unfair comparison and is, in any event, better than no access at all. That RQFII ETFs have been listed in New York, Ireland and Luxembourg indicates that this is merely a temporary blip that can be overcome and as the program develops, the timing issue will resolve itself.

Time limits for investments

While the RQFII license is granted by the CSRC to the fund manager itself, the quota is obtained from the State Administration of Foreign Exchange ("**SAFE**") on the basis of the relevant product that the fund manager wants to launch. At the same time, the SAFE requirement is that a quota be obtained within one year of the RQFII license being obtained. This creates an issue of developing an RQFII product, obtaining regulatory approval for that RQFII product (if an RQFII open-ended fund) and obtaining a quota before the year expires, failing which the SAFE has the right to revoke or reduce the quota. However, the SAFE has reportedly approved an amendment to its RQFII quota policies as a result of which an RQFII now has the flexibility to allocate its RQFII quota across different fund products under its management. It is understood that, following the amendment, the SAFE will not grant a specific quota to a specific fund product – although this is very recent, it is likely to ease the time limit concerns of RQFII managers.

Requirement for RMB

There is a presumption that a steady supply of offshore RMB is necessary for RQFIIs to purchase PRC assets. However, since the introduction in March 2012 of RQFII ETFs, virtually all RQFII ETFs are traded in two or more currencies; a Hong Kong-managed New York-listed ETF would trade in U.S. dollars on the New York Stock Exchange, which are then converted into RMB in Hong Kong before the ETF purchases the PRC securities in the PRC. The continued need for currency conversion and hedging in the meantime will require that RQFII funds consider the application of financial markets regulations such as the European Markets Infrastructure Directive and the U.S. Commodity Exchange Act.

On the basis of these uncertainties, it becomes doubly important that interested parties contact advisers, such as legal advisers familiar with the process on their intentions, and work closely with such advisers to ensure that they do not misinterpret current practice and provisions or inadvertently run afoul of practice (especially when this is changing on a regular and very rapid basis) and to ensure that the RQFII process flows smoothly and possible issues can be anticipated and dealt with efficiently and seamlessly.

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Conclusion

As China pursues efforts to internationalize the RMB, there are expanding opportunities for international investors to obtain exposure to onshore PRC assets and funds and hedge their exposures in offshore RMB markets. The RQFII program marks a potentially important step in that internationalization and would appear to be the way to go, as opposed to the QFII, as recent announcements as to the incentives to be offered for the RQFII program would indicate. The CSRC, the SAFE and the People's Bank of China are aware of the need for investors' confidence and have indicated that they are addressing the issues affecting the RQFII program, among them, taxation, repatriation and access to the fixed-income markets as a top priority, and are likely to resolve them shortly. The RQFII application process has been very much streamlined and clarified with the CSRC announcing an unprecedented 60-day performance pledge in the processing of RQFII applications. The speed in quota issuance for the RQFII and QFII programs and the liberalization of access to these programs has left observers in no doubt as to the PRC regulators' intentions. Market participants need to start planning their involvement in the market and mastering the technical complexities attached to the RQFII program now so that they are not left scrambling for a position when demand hits.

Authors:

Choo Lye Tan
Choolye.tan@klgates.com
+852-2230-3528

TABLE 1

The following table summarises the key features of the two schemes based on the current regulatory framework as at April 2014:

	QFII	RQFII
1. **Relevant Laws/ Regulations**	• Administrative Measures on Domestic Securities Investments by Qualified Foreign Institutional Investors 合格境外机构投资者境内证券投资管理办法 • Provisions on Issues in relation to the Implementation of the "Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors" 关于实施《合格境外机构投资者境内证券投资管理办法》有关问题的规定 • Foreign Exchange Administration of Domestic Securities Investments 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	• Measures for the Pilot Program of Securities Investment in China by RMB Qualified Foreign Institutional Investors 《人民币合格境外机构投资者境内证券投资试点办法》 • Provisions on the Implementation of the Measures for the Pilot Program of Securities Investment in China by RMB Qualified Foreign Institutional Investors 关于实施《人民币合格境外机构投资者境内证券投资试点办法》的规定 • Notice on Relevant Issues on the Pilot Domestic Securities Investments 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试点有关问题通知 • Notice on Relevant Matters on Implementing the Pilot Domestic Securities Investments by RMB Qualified Foreign Institutional Investors 关于实施《人民币合格境外机构投资者境内证券投资试点办法》有关事项的通知
2. **Regulators**	**CSRC** • approves QFII status • regulates onshore securities investments by QFIIs **SAFE** • approves and allocates QFII investment quota • regulates QFIIs' onshore accounts • monitors and regulates repatriation/remittance of funds	**CSRC** • approves RQFII status • regulates onshore securities investments by RQFIIs **SAFE** • monitors and regulates repatriation/remittance of RMB funds • approves and allocates RQFII quota **PBOC** • regulates onshore RMB accounts • regulates investment by RQFIIs **Regulators in Relevant Jurisdiction** **Hong Kong**: The Securities and Futures Commission **London**: The Financial Conduct Authority **Singapore**: The Monetary Authority of Singapore
3. **Eligible applicants**	Eligible applicants in the jurisdictions which have signed an MOU with the CSRC. There are currently 58 regulators in 54 countries and cities which have signed an MOU with the CSRC. **Applicant** / **Operating History** / **Asset Held or Managed (during the preceding account year)** / **Others** Asset management institution: ≥2 years; ≥US$500m; N/A Insurance company: ≥2 years; ≥US$500m; N/A Securities company: ≥5 years; ≥US$5b; ≥US$500m net assets	Eligible applicants in Hong Kong, London & Singapore (the "**Relevant Jurisdictions**")[1] • Subsidiaries in Relevant Jurisdictions of - PRC fund management companies - PRC securities companies - PRC commercial banks - PRC insurance companies

[1] Currently, only Hong Kong, London and Singapore have been announced as recipients of, and have officially implemented the RQFII program locally - although Taiwan and Paris have also been announced as recipients, they have yet to approve the program locally

	Commercial bank	≥10 years	≥US$500m	≥US$300m tier one capital	• Financial institutions with a principal place of business in that Relevant Jurisdiction that have: - obtained an asset management licence issued by a regulator in the Relevant Jurisdiction[2]; and - already conducted relevant asset management business[3].
	Other institutional investors (e.g. pension funds, charitable foundations, donation funds, trust companies, government investment management companies, etc.)	≥2 years	≥US$500m	N/A	
4. Application process	• CSRC will make decision within 20 working days of receiving all required documents • SAFE will approve investment quota within 20 working days of receiving all required documents				• CSRC will make decision within 60 working days of receiving all required documents[4] • SAFE will approve investment quota within 60 working days of receiving all required documents
5. Permitted investments	To invest in the following RMB-denominated financial instruments within the approved investment quota : • stocks, bonds and warrants traded or transferred on stock exchanges; • fixed income products traded on the interbank bond market;[5] • securities investment funds; • stock-index futures; and • other financial instruments allowed by the CSRC. (including the subscription of additional share issues, rights issues, IPO of shares; and IPO of convertible bonds)				
6. Shareholding restrictions	• A single foreign investor shall not hold through a QFII/ RQFII more than 10% of the total shares of an individual listed company. • The total A-shares of an individual listed company held by all foreign investors shall not exceed 30% of its total shares.				
7. Investment quota restrictions	USD 1 billion per applicant (except for QFIIs which are sovereign wealth funds, central banks and monetary authorities)				N/A
8. Deadline for investment proceeds to be remitted	• 6 months after the investment quota is approved				• Open-ended funds[6] : not specified • 6 months after the investment quota is approved (other than open-ended funds)

[2] Type 9 in Hong Kong, Singapore-incorporated financial institutions which are approved by the Monetary Authority of Singapore to conduct fund management activities, i.e. registered and licensed fund management companies and banks and insurance companies exempted from the requirement to hold a Capital Markets Services Licence in Singapore and firms authorised by the UK Financial Conduct Authority who have a licence to carry on discretionary management, to manage an alternative investment fund and/or to manage a UCITS in London

[3] There is no strict definition of the track record required to classify as having already conducted relevant asset management business so long as it is justifiable although a reasonable period would be expected

[4] In practice, however, the CSRC takes 3-4 months to review and approve RQFII licence.

[5] Prior approval and a separate quota are required from the PBOC for QFII investments in fixed income products traded on the interbank bond market, whereas in the case of RQFIIs, only the prior approval of the PBOCis required.

[6] There is no specific definition in RQFII rules for open-ended fund which should, in any event, be distinguished from the definition of "open-ended China fund" in QFII rules as "China" is specifically excluded from all references to this type of fund. In practice, so long as the fund is publicly-offered and listed on a reasonable (no definition for this but generally accepted to be major, well-known stock exchanges including HKEX, the Irish Stock Exchange and NYSE) stock exchange, it will be accepted as an open-ended China fund

9. Minimum investment requirement	• The minimum investment capital amount is USD20 million	N/A
10. Lock-up period	• Pension funds, insurance funds, mutual funds, charity funds, endowment funds, government investors, monetary authorities and open-ended China funds[8]: 3 months • Other QFIIs: 1 year	• Open-ended funds: no lock-up period • Other RQFIIs: 1 year
11. Recycling of investment quotas	• Not specifically permitted (open-ended China funds may be permitted to do so)	• Open-ended funds: Yes, as long as the net amount of investment capital remitted into China is within the investment quota • Other RQFIIs: No
12. Further quotas	• Not permitted until the expiry of 1 year from the grant of the previous quota	• Permitted to apply for further quota once 80% of the current quota has been utilised
13. Repatriation	• Repatriation can only be made after the expiry of the lock-up period • Open-ended China funds: - may repatriate or remit in the net amount of its subscription or redemption proceeds on a weekly basis - SAFE pre-approval is not required - the monthly accumulative net outward remittance cannot exceed 20% of the total domestic assets of the open-ended China fund • 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 • investment quota will be reduced accordingly	• Open-ended funds: - may repatriate or remit foreign exchange on a daily basis - may reinvest within investment quota permitted • Other RQFIIs: - may repatriate or remit on a monthly basis after the expiry of the lock-up period - SAFE pre-approval is not required - may not re-invest or recycle the remitted capital and the investment quota will be reduced accordingly
14. Monthly repatriation restrictions	• The monthly accumulative net repatriation (principal and profits) cannot exceed 20% of the total domestic assets of its total investment at the end of the preceding year	N/A

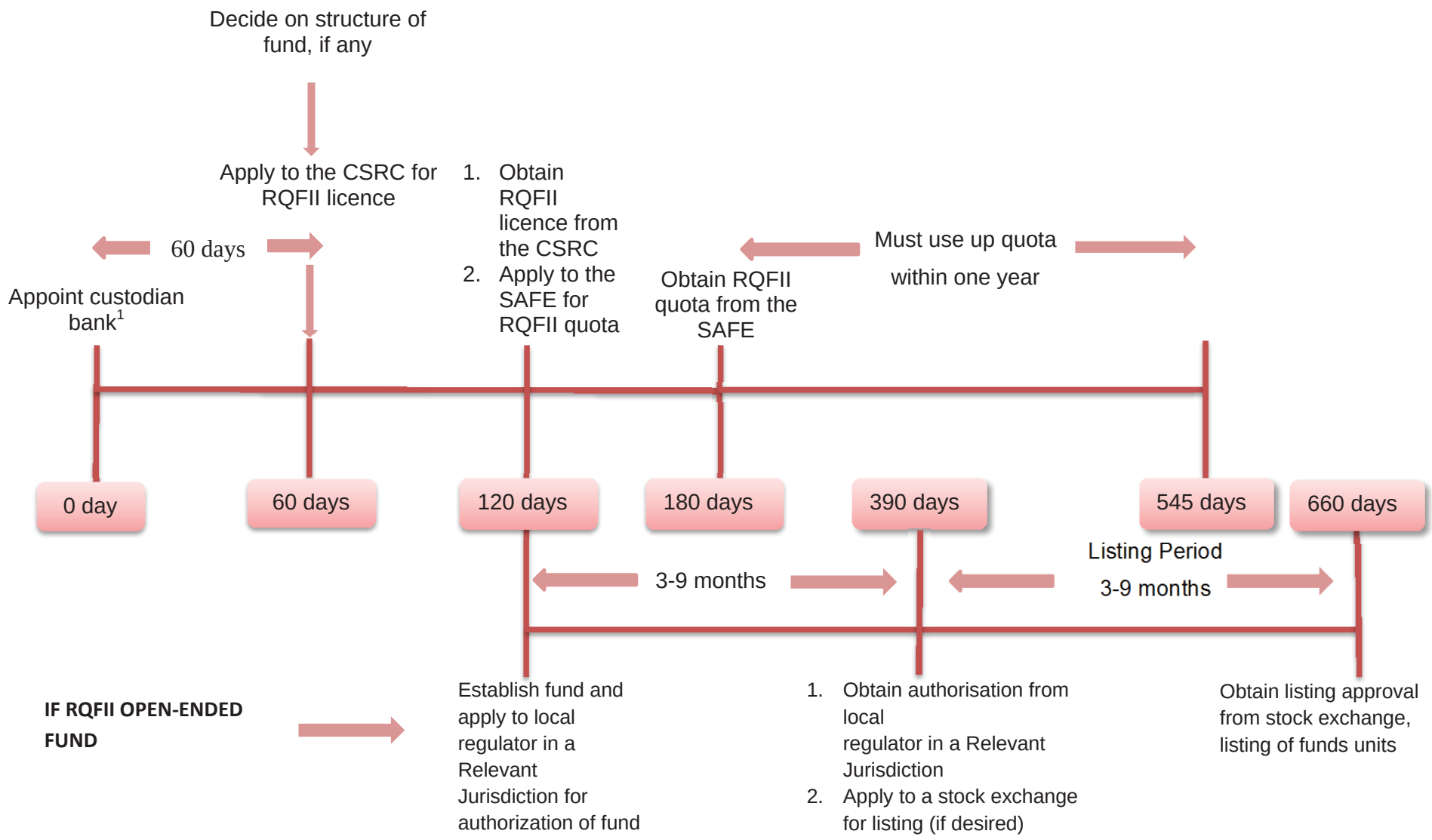
[7] For both QFIIs and RQFIIs, the lock-up period is deemed to commence from the earlier of the date (i) when the investment capital is fully remitted into the onshore designated account and (ii) the end of six months after the investment quota is approved if the investment capital has not been fully remitted within the prescribed deadline.

[8] "Open-ended China fund" is defined in the QFII rules 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.

15. Capital gains tax	• Not clarified	• RQFIIs in Hong Kong are treated as exempt from a 10% withholding tax on unrealised and realised capital gains derived from all its disposals of China A-shares other than those A-Shares in "land-rich companies" in China[9]

[9] Under the "Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income", capital gains generated by a Hong Kong tax resident from the transfer of shares in a PRC company will only be subject to tax if the relevant PRC company is a land-rich company or if the Hong Kong tax resident holds at least 25% of shares in the PRC in the 12 months before the alienation.[Both London and Singapore have a similar treaty with the PRC.]

TABLE 2



[1]Assumes the applicant is already licensed to conduct asset management business in a Relevant Jurisdiction