The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 21, NO. 8 • AUGUST 2014

The Renminbi Qualified Foreign Institutional Investor Program—Opportunities and Challenges for International Investors Interested in Direct Access to PRC Securities with Offshore Renminbi

By Choo Lye Tan

The Renminbi Qualified Foreign Institutional Investor (RQFII) pilot program marks a significant departure from its predecessor, the Qualified Foreign Institutional Investor (QFII) pilot program. Not only does it permit settlement in offshore Renminbi (RMB) (unlike the QFII program, which requires that foreign currency be converted into RMB for settlement), the RQFII program affords broader investment possibilities in some contexts and much greater flexibility. With the grant of the first RQFII license to a non-HK London-based entity in January 2014 and the announcement of Paris as an additional jurisdiction under the RQFII program in March 2014, it is timely to revisit the RQFII program and to consider its usefulness, particularly in contrast with the QFII program and as utilized in the different jurisdictions where it has been officially implemented.

The RQFII program was first established in late 2011 by the China Securities Regulatory Commission (the CSRC), the People's Bank of China (the PBOC) and the State Administration of Foreign Exchange (the SAFE). It was significantly expanded and revised in March 2013 when the CRSC, the PBOC, and the SAFE jointly issued the "Pilot Measures on Securities Investment in Mainland China by Renminbi Qualified Foreign Institutional Investors." It allows non-PRC institutional investors from certain jurisdictions that have been announced as RQFII eligible jurisdictions and have officially implemented the RQFII locally to deal in PRC domestic securities using offshore RMB. The jurisdictions that have been announced as RQFII eligible jurisdictions are currently Hong Kong, London, Singapore, Taiwan, Paris and most recently, Korea and Germany. However, of these RQFII eligible jurisdictions, only Hong Kong, London and Singapore (the Relevant Jurisdictions) have officially implemented the RQFII program locally. Taiwan has not received an official RQFII quota as yet and there has been no official announcement as to whether or not Paris, Korea, or Germany have introduced the necessary local framework for the RQFII program (although an RQFII application from a Paris-licensed entity has reportedly been submitted for consideration to the CSRC).[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 six percent.

Fund managers would have the ability to create a new offshore product from onshore PRC securities. Those who can structure their investments in the form of an open-ended fund would enjoy additional benefits under RQFII that are not available to other foreign investors, and with the growth of an offshore RMB market, the ability to settle in offshore RMB creates opportunities for leveraging the underlying investments through collateralized loan obligations or securitizations.

RQFII vs. 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 been required to obtain 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.

Table 1, which appears at the end of this article, shows a summary comparison of the key requirements of the RQFII and QFII programs.

Currency of Settlement

Unlike the QFII program, where foreign currency must be converted into RMB for settlement, investments under the RQFII program are settled using offshore RMB, thus eliminating the need to hedge currency exposure with non-deliverable currency forward transactions. This is a very important step in the PRC government's stated intention to internationalize the RMB, and the increased availability of a wide range of offshore products denominated in RMB will facilitate the eventual convergence of the onshore RMB market and the offshore RMB market. It will represent an important route for RMB held outside of China in the form of reserves and other holdings to flow back into the onshore asset market.

Investor Eligibility

At first glance, the RQFII program appears to be open to a more limited range of participants than the QFII program, where the basic qualification for investor eligibility is simply to be from a jurisdiction that has signed a memorandum of understanding with the CSRC. However, the RQFII program may, in fact, be available to a much wider spectrum of participants than the QFII program because it is open to two categories of investors:

(1) Applicants in the Relevant Jurisdictions that are subsidiaries of Chinese fund management companies, Chinese securities companies, Chinese commercial banks, and Chinese insurance companies; and, more importantly,

(2) *Financial institutions that are registered in a Relevant Jurisdiction and with a principal place of business in a Relevant Jurisdiction*.

It is the second category of eligible applicants that opens up the domestic PRC securities market to any party that can obtain an asset management license or similar regulator-approved recognition in any of the Relevant Jurisdictions. By shifting the focus from the rules, guidelines, practices and interpretations of the CSRC to the satisfaction of the requirements of the relevant regulatory bodies in the Relevant Jurisdiction, it divides the legal framework regulating these entities between the PRC, which grants the RQFII license and quota, and the Relevant Jurisdiction, which grants the required license or registration to the entity. Furthermore, it may facilitate applicants from a wider spectrum of jurisdictions than those that have signed memoranda of understanding with the CSRC since, so long as they are licensed or registered and have a principal place of business in one of the Relevant Jurisdictions, but do not necessarily have to be locally-constituted, they would qualify.

As set out in paragraph 3 of Table 1, potential applicants for QFII must also demonstrate a minimum level of assets under management and a long-term operating business with a track record in its home jurisdiction.

These requirements for QFII eligibility mean that potential QFII applicants must have an asset-rich, long-term operating business with a track record in their home jurisdiction before they can qualify under the QFII program. In contrast, the RQFII program has no specific requirements for track record, capital adequacy, or assets under management and there is no investment quota limit per applicant, thus enabling new participants to set up businesses in the Relevant Jurisdictions and, once registered or licensed, to make the RQFII application immediately after satisfying the regulatory requirements of a Relevant Jurisdiction.[2] Further, the absence of an investment quota limit per RQFII applicant underlines the openness of the program to relatively new or untested players. However, although no track record is required, it will be important to see how the CRSC's interpretation of that requirement will evolve, as the CSRC tends to require a reasonable period of business operation and experience in PRC asset fund management.

Suitability Considerations

The relative advantages of QFII and RQFII to an investor may depend in part on its individual circumstances and objectives.

To the extent that an investor is motivated by the ability to trade securities quickly, the RQFII program may be more suitable if the RQFII holder can structure its RQFII fund as an open-ended fund. This is because QFII applicants are subject to a three-month lock-up period under QFII rules, while non-open-ended fund RQFII applicants are subject to a one-year lock-up period under RQFII rules.[3] In this respect, the QFII program is more suited to sovereign wealth funds, family offices, and large institutions that are investing for their own long-term benefit as opposed to conducting such investments as a business for fees.[4]

Within the category of RQFII and QFII applicants, there are certain benefits for publicly offered and/or authorized funds, of which the most flexible is an RQFII open-ended fund. RQFII open-ended funds (not defined in the existing RQFII rules, but generally accepted in practice to be any publicly offered and/or authorized fund) enjoy special considerations not applicable to regular RQFII and QFII applicants, including QFII open-ended China funds. Among other things, the lock-up period for holdings in PRC securities by QFIIs and RQFIIs will not apply,[5] repatriation of profits may be carried out on a daily basis,[6] and its investment quota may be recycled so long as the net amount of investment capital remitted into the PRC is within the investment quota; in the case of non-open-ended fund RQFIIs and QFIIs, any capital repatriated will reduce the investment quota accordingly, which cannot be recycled.[7] For QFIIs in particular, prior regulatory approval is required and no more than 20 percent of investments can be withdrawn per month.[8] In contrast, while the QFII equivalent of the RQFII open-ended fund, namely, a QFII open-ended China fund (defined in the QFII rules as an open-ended securities investment fund set up by public offering outside China, where at least 70 percent of the fund assets are invested in China) may enjoy more flexibility than regular QFII applicants in terms of recycling of investment quotas and repatriation of profits,[9] they are still not as flexible as RQFII open-ended funds.

RQFII Application Process

Table 2, which appears at the end of this article, 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 are 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.

The RQFII application process is a two-stage process involving the CSRC to grant the RQFII status followed by the SAFE to approve the RQFII investment quota itself. In theory, from start to finish, a non-PRC entity without a previous license or registration in the Relevant Jurisdiction could, assuming it satisfied the requirements of the securities/financial regulator in the Relevant Jurisdiction and the CSRC, hold an RQFII license and quota and be ready to commence business within a year of commencing the application process. Further, the ability for an RQFII to apply for a further quota once 80 percent of the initial quota has been utilized means an RQFII applicant is able to react more quickly to an active market than a QFII.[10]

Potential Uses of RQFII in an International Investor's Investment Portfolio

As a result of its flexibility, the RQFII program has opened up the potential for interesting and innovative investment products. At the same time, by launching the RQFII program in the Relevant Jurisdictions, the CSRC has, intentionally or inadvertently, opened up the PRC market to the strengths, abilities and characteristics that are unique in each of those markets.

A fund manager should consider using the RQFII program to help it develop products focused on PRC assets that would be appealing to investors in its home jurisdiction. The advantage of the RQFII program, with its more flexible provisions for RQFII open-ended funds, over the QFII program has been demonstrated by a ruling of the Luxembourg Commission de Surveillance du Secteur Financier (CSSF). This ruling imposed a restriction that not more than 35 percent of the assets of a undertaking for collective investment in transferable securities (UCITS) fund with a QFII quota could consist of PRC A-shares on the basis that the QFII restrictions on repatriations affected the liquidity of such UCITS funds.[11] However, the CSSF did not impose any such restriction in respect of a UCITS fund utilizing its RQFII quota for PRC investments because an open-ended RQFII fund may repatriate its proceeds on a daily basis, thus fulfilling the liquidity requirement of a UCITS fund. That a UCITS fund with an RQFII quota could invest solely in PRC securities was confirmed by the CSSF's approval in November 2013 of the first Luxembourg RQFII UCITS fund investing solely in PRC A-shares, with insiders indicating approval from the CSSF for RQFII UCITS funds to wholly invest in PRC fixed-income bonds is imminent. In addition, there seems to be no reason in principle why a RQFII fund cannot be structured in the form of an EU alternative investment fund under the EU Alternative Investment Fund Managers Directive, provided such fund meets RQFII requirements in relation to its open-ended characteristics.

Alternatively or additionally, one could tap a previously non-existent market. For example, industry players believe that, while there is limited demand among traditional Singaporean investors for RQFII products, there has always been a large appetite for Chinese products among Middle Eastern and African investors that, for various reasons, may not be able to satisfy RQFII or QFII eligibility requirements themselves or may not have the necessary structure to do so directly. For these investors, investment in RQFII products would be ideal, as that would enable them to gain direct exposure to PRC assets without having to directly satisfy the RQFII eligibility requirements or to worry about ongoing compliance, management, and maintenance as an RQFII license holder. At the same time, the lack of specialized investment knowledge on China (but an increasing awareness of the potential for steady returns, particularly in the onshore fixed-income market where returns are higher than in the offshore RMB bond market) among US, African, and European institutional investors hampers their greater investment in the mainland, providing an immediate ready market of clients for RQFII license holders.

This dynamic may exist across jurisdictions that do not necessarily have to be Relevant Jurisdictions. One can play around with a combination of different investors, different markets and even different currencies. In addition to RQFII UCITS funds domiciled in Ireland[12] and Luxembourg,[13] there are now, at the time of this writing, at least three RQFII ETFs listed on the New York Stock Exchange trading in US dollars.[14] There are not just passive RQFII ETFs, but RQFII funds focusing purely on PRC equities and, if the proposed amendments to the Luxembourg UCITS rules are adopted by the Luxembourg regulators, a soon-to-be purely fixed-income bond-focused RQFII UCITS fund. There has also been talk of offerings to Latin American and Middle Eastern investors, and of creating derivatives out of RQFII products. In short, RQFII applicants are limited only by their imagination.

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

With the merging of borders and barriers and the internationalization of business, a prospective RQFII applicant's choice of which Relevant Jurisdiction to apply for its RQFII license becomes less of a strategic than a practical decision. 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—any track record can only enhance an application, notwithstanding the lack of a formal requirement in that respect. 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.

The ultimate distribution strategy and investor base for a RQFII product would be a crucial consideration in the choice of Relevant Jurisdiction from which to launch a RQFII product. UCITS products would clearly be best-launched from a European jurisdiction if the target investors are European, as they would be familiar with a UCITS product from that jurisdiction, even if they are not familiar with the underlying PRC asset in which the UCITS product is investing. However, as there is also an emerging market for UCITS products from Asia itself, it may be desirable for a RQFII applicant to consider a primary or secondary listing on an Asian stock exchange.[15]

The familiarity of regulators and service providers with the product being offered is also a relevant consideration, as it can minimize delays and costs. This is a fluid consideration, which is evolving rapidly. London and Luxembourg have demonstrated their competence by granting unprecedentedly swift approvals to RQFII products launched in their markets. However, since the RQFII program has been in place and operating in Hong Kong before any of the other Relevant Jurisdictions, Hong Kong's regulators have been at the forefront in approving licenses and authorizing products involving RQFII applicants. This has resulted in the creation of a robust and skilled infrastructure in Hong Kong to support RQFII funds, as Hong Kong custodian banks, lawyers, auditors, administrators, compliance and record-keeping specialists, and other on-going maintenance service providers having 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. As a practical matter, there may prove to be tranching of Relevant Jurisdictions based on the allocation of investment quotas to each. However, for the near future at least, as the RQFII program is still trying to gain traction, it appears unlikely that any Relevant Jurisdiction outside of Hong Kong will run out of quota availability.

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. With increasingly sophisticated investors, fund managers need to identify and/or develop specialized investment products tailored to his or her client's needs. While this may, at first, seem daunting, it can also be viewed as an opportunity to access a previously non-existent market.

Potential Impact of PRC-Hong Kong Mutual Fund Recognition and Mutual Stock Market Access

There is some concern that the benefits of the RQFII and QFII programs will be negated by the impending Hong Kong-PRC mutual fund recognition program and, more recently, the Hong Kong-PRC mutual stock market access program.

The mutual fund recognition and stock market access programs, in effect, bypass the need to partner with a PRC entity by enabling Hong Kong service professionals to directly access PRC investors, thereby removing PRC investment professionals from the process and essentially making competitors of Hong Kong and PRC fund managers. However, 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. The RQFII program's short history has proven that the more successful RQFII participants have been those who have product and research experience gained on the ground in the PRC through a joint venture fund management partnership with local PRC entities. Such a venture can only work if an investor partners with cooperative PRC fund managers who view them as a partner rather than a competitor (which might otherwise be the case with the mutual fund and stock market access programs). In the long term, relationships developed as a result of this cooperation and partnership could lead to new markets in the PRC becoming available to foreign fund managers (ironically, perhaps even through the Hong Kong-PRC mutual fund program itself), which might not have developed had parties started off as competitors.

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 the year at the earliest and, in any event, is only limited to the stock exchanges in Hong Kong and Shanghai and only in respect of certain of those stocks.

Lack of Clarity in Interpretation and Application of the RQFII Program Rules

"The RQFII policy and rules are new and novel in nature and there may be uncertainty to its implementation and such policy and rules are subject to change and interpretation by the PRC authorities, which may also have potential retrospective effect." This standard risk factor in RQFII fund offering documents is an eloquent reflection of the uncertainty surrounding the RQFII rules, which raises many vexing interpretive questions. Some specific areas of uncertainty have been discussed above, and there are many other areas in which knowledgeable practitioners' advice is a necessity. With PRC laws in general, much needs to be derived from observation, repeated practice without adverse reaction, and general public consensus.

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).[16] Is that the place of incorporation of the applicant entity or is a wider analysis of the group structure required? 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—hence, listings on the New York Stock Exchange and the Irish Stock Exchange when, all along, there had been an assumption that a listing had to be on an exchange in a Relevant Jurisdiction. 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. The PRC currently has no specific rules governing taxes on capital gains generated by QFIIs or RQFIIs from their trading of mainland Chinese securities; as such, any income derived from the disposal of China A-share investments is governed by the general tax provisions of the Corporate Income Tax Law, which imposes a 10 percent withholding tax on any such capital gains. However, 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 percent of shares in the PRC in the 12 months before the alienation. 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 percent 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 percent 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. For RQFII open-ended funds where investments and disposals take place on an ongoing basis and holdings tend to be more short-term, confirmation that capital gains tax would not apply to them could result in a substantial increase in the net asset value of units in such funds—in the case of the China AMC CSI 300 Index ETF, an immediate increase of 1.75 percent.[17]

Both London and Singapore have a similar tax treaty with the PRC in respect to the withholding tax issues discussed above, so it would be reasonable to conclude that the resolution described above, if upheld and/or not objected to by the PRC tax authorities, would apply equally to RQFII funds established in those Relevant Jurisdictions.

Although the announcement by the China AMC CSI 300 Index ETF makes it clear that there has been nothing clearly stated in black and white by the Chinese tax authorities in respect to this issue, its move was with the full knowledge and consent of its auditors, and many familiar with the PRC market and how it operates acknowledge that this would only have been done if there had been some sort of tacit indication from China's State Administration of Taxation (SAT). Although it may not have been publicly announced, the fact that, so far, no rebuke or correction from the SAT has been prompted appears to support this position. In any event, it is anticipated that the CSRC and SAT will likely address this issue formally in the coming months.

The situation is less clear with the QFII program in light of a comment by a CSRC official during a QFII roadshow in October 2012 to the effect that regulators had decided to issue rules imposing a 10 percent capital gains tax on QFII investors specifically. Though it was not clear when the tax would be unveiled, and to date no proposals to this effect have been unveiled, concerns remain about the fact that 1) no rebuttal to this statement has ever been made, and 2) there is a much lower likelihood of each of the home jurisdictions of the QFII jurisdictions having similar double tax treaties with the PRC as do the Relevant Jurisdictions. The fact that the CSRC appeared to have intended to cover only QFII applicants with respect to this capital gains tax was reinforced when Xiao Gang, the chairman of the CSRC, stated in March 2014 that the CSRC will clarify its tax policies for participants in the QFII scheme this year in a move to open up the mainland's capital markets, without making any mention of the RQFII scheme. It is notable that no mention was made of RQFII investors although the RQFII program was already then in existence.

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

With so many regulatory parties and jurisdictions involved, timing is bound to be an issue and foreign managers trying to register RQFII products have complained about the considerable lag time between application and launch of a product. The technical details for London's RQFII have still to be clearly ascertained—notwithstanding that a license has been granted to a London fund manager, no fund or product has actually been launched—and the only truly tried-and-tested model is the Hong Kong model, which requires funds to be domiciled in Hong Kong—when the issue of exactly what constitutes "domicile" has still to be determined (as stated above). 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

Some fund managers have also expressed concern about the timing requirements in relation to the RQFII program itself. While the RQFII license is granted by the CSRC to the fund manager itself, the quota is obtained from the 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, this position is not set in stone, and the SAFE has, in practice, been willing to work with RQFII applicants facing such issues, particularly if the hold-up is for reasons outside their control, such as approvals from their domestic regulators. The SAFE's concern has been demonstrated many times to be with low or no utilization of RQFII quotas as a matter of choice as opposed to inability to utilize RQFII quotas in time due to situations beyond the RQFII holder's control. The SAFE has reportedly approved an amendment to its RQFII quota policies as a result of which a 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 grant quotas on a company-by-company basis rather than on a product-by-product basis – although this is very recent, it is likely to ease the time limit concerns of RQFII managers. In any event, this point demonstrates more than ever how important it is to work with experienced service providers to ensure that the RQFII process flows smoothly and possible issues can be anticipated and dealt with efficiently and seamlessly.

Requirement for RMB

The growing percentage of global trade conducted in RMB will continue to support strong RMB deposit growth in key financial centers around the world, further promoting the globalization of the Chinese currency. The accelerated use of RMB in recent years for trade settlement and financing (which overtook the euro and Japanese yen in 2013 to become the second most widely used currency), among others, has led to a gradual convergence of onshore-offshore RMB spot rates. These developments have led to a presumption that a steady supply of offshore RMB is necessary for RQFIIs to purchase PRC assets. Over time, that supply will doubtless emerge. However, since the introduction in March 2012 of RQFII ETFs, virtually all RQFII ETFs are traded in two or more currencies: for example, there are now Hong Kong-managed New York-listed ETFs that trade in US 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 US 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 about 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.

Recent Developments

Index provider MSCI recently announced that it was consulting on the possibility of including China A-shares in the MSCI Emerging Markets Index as part of its 2014 MSCI Market Classification Review, with results to be announced in June. If approved, MSCI will include five percent of the China A-shares' market capitalization in the MSCI China Index in May 2015 as a first step, which would be simultaneously reflected in its corresponding composite indices, including the flagship MSCI Emerging Markets Index. This is likely to cause a shift in non-PRC investors' exposure from China H-Shares (shares of PRC companies listed in Hong Kong to China A-shares (shares of PRC companies listed in the PRC), which, in turn, will lead to more demand for quotas under both the QFII and RQFII programs.

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 PBOC 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.

Ms. Tan is a partner in K&L Gates, the Hong Kong office of K&L Gates LLP.

NOTES

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.

2 The process of applying for the necessary license or recognition as an asset manager in a Relevant Jurisdiction can take between four and 12 months, possibly more, depending on the Relevant Jurisdiction. In Hong Kong, the performance pledge for processing of such applications is 15 weeks, in Singapore, 12 weeks and in London, between three and six months from receipt of a completed application, although the timetable can be extended by further information requests.

3 *See* paragraph 10 of Table 1.

4 Although the QFII requirements do not specifically target these entities (*i.e.*, sovereign wealth funds, family offices and large institutions), in practice, the understanding has been that these types of institutional investors enjoy preference in the application process in line with the CSRC's intention to market the QFII program to fundamental long-term investors.

5 *See* paragraph 10 of Table 1.

6 *See* paragraphs 13 and 14 of Table 1.

7 *See* paragraphs 11 and 13 of Table 1.

8 *See* paragraph 14 of Table 1.

9 *See* paragraphs 11 and 13 of Table 1.

10 *See* paragraph 11 of Table 1.

11 Ironically, the CSSF's restriction inadvertently resulted in UCITS not qualifying as a QFII

open-ended Chinese fund, which might have otherwise granted them greater flexibility and, therefore, the liquidity required by the CSSF to remove that same restriction.

12 CSOP Source FTSE China A50 UCITS ETF—Jan 2014.

13 Harvest Global Investors and CSOP Asset Management are managers—name of ETF yet to be disclosed.

14 DB-X Trackers Harvest CSI 300 ETF on the New York Stock Exchange—accesses Chinese equities through its investment manager Harvest Fund Management's RQFII quota.

15 Hong Kong has been the traditional home for ETFs, being the first jurisdiction to launch such products. However, with the removal of the RQFII 80 percent fixed income/20 percent equities permitted investments in March 2013 (a restriction in the original RQFII rules that limited investments of an RQFII holder to not more than 80 percent in PRC fixed income and 20 percent in PRC equity), Hong Kong has seen a shift from passively managed funds to active products, with approval being granted by the Securities and Futures Commission in Hong Kong at the end of 2013 for a balanced fund and in January 2014 for a pure equities fund (Da Cheng International Asset Management Company and Harvest Global Investments, respectively).

16 *See* paragraph 3 of Table 1.

17 *See* paragraph 15 of Table 1.

<table>
<tr><th colspan="9">Table 1—The following table summarises the key features of the two schemes based on the current regulatory framework as at April 2014:</th></tr>
<tr><th></th><th colspan="2">QFII</th><th colspan="6">RQFII</th></tr>
<tr><td>1. Relevant Laws/ Regulations</td><td colspan="2">• Administrative Measures on Domestic Securities Investments by Qualified Foreign Institutional Investors
• Provisions on Issues in relation to the Implementation of the “Administrative Measures for Domestic Securities Investment by Qualified Foreign Institutional Investors”
• Foreign Exchange Administration of Domestic Securities Investments by Qualified Foreign Institutional Investors</td><td colspan="6">• Measures for the Pilot Program of Securities Investment in China by RMB Qualified Foreign Institutional Investors
• Provisions on the Implementation of the Measures for the Pilot Program of Securities Investment in China by RMB Qualified Foreign Institutional Investors
• Notice on Relevant Issues on the Pilot Domestic Securities Investments by RMB Qualified Foreign Institutional Investors
• Notice on Relevant Matters on Implementing the Pilot Domestic Securities Investments by RMB Qualified Foreign Institutional Investors</td></tr>
<tr><td rowspan="4">2. Regulators</td><td>CSRC</td><td>SAFE</td><td>CSRC</td><td>SAFE</td><td>PBOC</td><td colspan="3">Regulators in Relevant Jurisdiction</td></tr>
<tr><td rowspan="3">• approves QFII status
• regulates onshore securities investments by QFIIs</td><td rowspan="3">• approves and allocates QFII investment quota
• regulates QFIIs’ onshore accounts
• monitors and regulates repatriation/remittance of funds</td><td rowspan="3">• approves RQFII status
• regulates onshore securities investments by RQFIIs</td><td colspan="2" rowspan="2">• monitors and regulates repatriation/remittance of RMB funds</td><td>Hong Kong</td><td>London</td><td>Singapore</td></tr>
<tr><td rowspan="2">The Securities and Futures Commission</td><td rowspan="2">The Financial Conduct Authority</td><td rowspan="2">The Monetary Authority of Singapore</td></tr>
<tr><td>• approves and allocates RQFII quota</td><td>• regulates onshore RMB accounts
• regulates investment by RQFIIs</td></tr>
</table>

<table>
<tr><td rowspan="6">3. Eligible applicants</td><td colspan="4">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.</td><td>Eligible applicants in Hong Kong, London & Singapore (the Relevant Jurisdictions)[1]</td></tr>
<tr><td>Applicant</td><td>Operating History</td><td>Asset Held or Managed (during the preceding account year)</td><td>Others</td><td>• Subsidiaries in Relevant Jurisdictions of
- PRC fund management companies
- PRC securities companies
- PRC commercial banks
- PRC insurance companies</td></tr>
<tr><td>Asset management institution</td><td>≥2 years</td><td>≥US$500m</td><td>N/A</td><td rowspan="3"></td></tr>
<tr><td>Insurance company</td><td>≥2 years</td><td>≥US$500m</td><td>N/A</td></tr>
<tr><td>Securities company</td><td>≥5 years</td><td>≥US$5b</td><td>≥US$500m net assets</td></tr>
<tr><td>Commercial bank</td><td>≥10 years</td><td>≥US$500m</td><td>≥US$300m tier one capital</td><td rowspan="2">• Financial institutions with a principal place of business in that Relevant Jurisdiction that have:
- obtained an asset management license issued by a regulator in the Relevant Jurisdiction[2]; and
- already conducted relevant asset management business[3].</td></tr>
<tr><td></td><td>Other institutional investors (e.g. pension funds, charitable foundations, donation funds, trust companies, government investment management companies, etc.)</td><td>≥2 years</td><td>≥US$500m</td><td>N/A</td></tr>
<tr><td>4. Application process</td><td colspan="4">• 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</td><td>• 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</td></tr>
</table>

continued

	QFII	RQFII
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)
9. Minimum investment requirement	• The minimum investment capital amount is USD20 million	N/A
10. Lock-up period[7]	• 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 utilized

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
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]

[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.

[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 authorized 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 three to four months to review and approve RQFII license.

[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 PBOC is required.

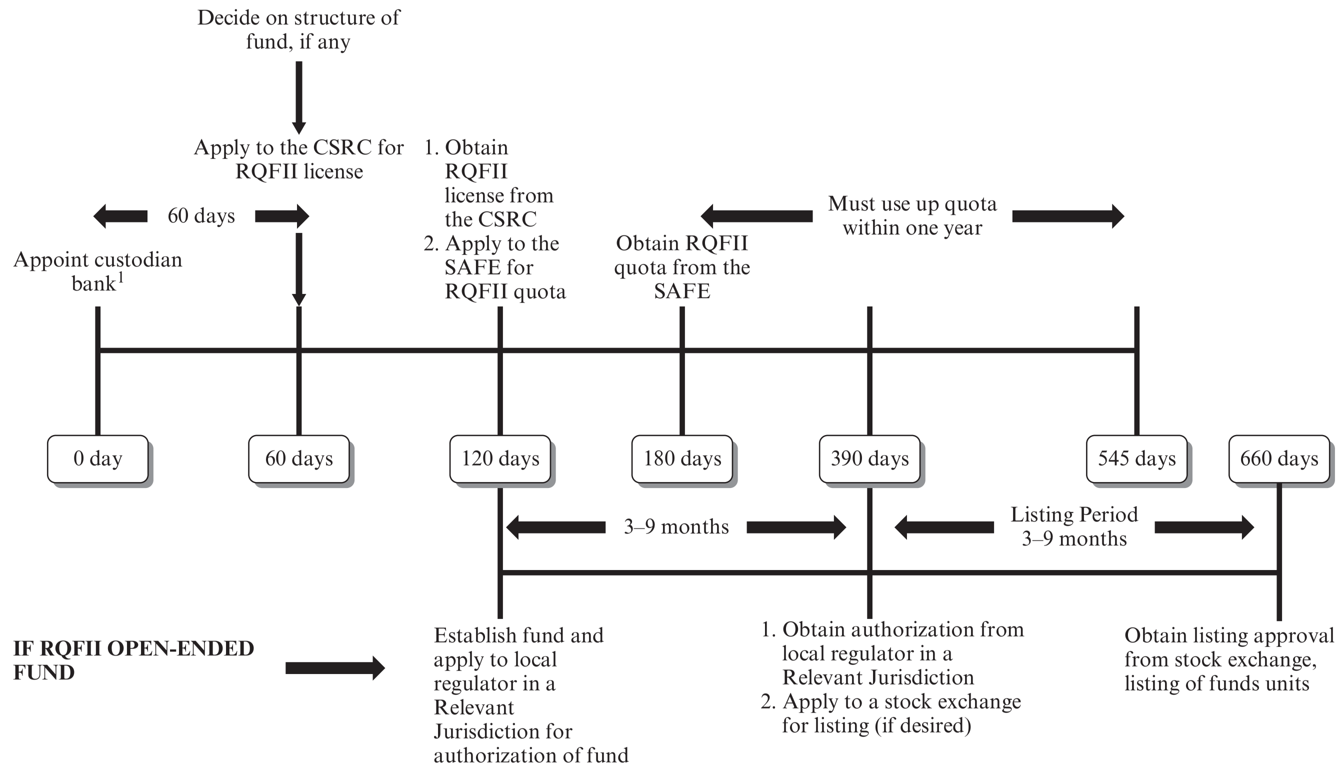
[6]There is no specific definition in RQFII rules for open-ended fund which should, in any event, be distinguished from the definition of "open-ended China fund" in QFII rules as "China" is specifically excluded from all references to this type of fund. In practice, so long as the fund is publicly-offered 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.

[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.

[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.