

## Client Alert

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## China's securities regulator issues consultation papers to further liberalize QFII/RQFII investment in its securities market

On 31 January 2019, the China Securities Regulatory Commission (CSRC) issued the Notice on Public Consultation for the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors (Consultation Paper) (the "**Measures**") and the Provisions on Issues Concerning the Implementation of the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors (Consultation Paper) (the "**Implementation Provisions**", collectively the "**Consultation Papers**"). The Consultation Papers aim to boost the enthusiasm of overseas institutional investors to invest in the Chinese securities and futures market by significantly expanding the permissible investment scope of Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFIIs, each a "**qualified investor**"), as well as relaxing the eligibility requirements for qualified investors. The key points of the Consultation Papers are summarized as follows.

### 1. Consolidating the QFII and RQFII Schemes

The previous rules that separately governed the QFII and RQFII schemes will be consolidated into one set of unified rules. Going forward, an applicant only needs to make a one-time application for both QFII and RQFII licenses.

### 2. Relaxing QFII/RQFII Eligibility Requirements

The Consultation Papers also seek to unify the eligibility requirements for QFII and RQFII and to further relax such entry requirements to align them with the Bond Connect rules. Bond Connect has given foreign investors access to the China Interbank Bond Market (CIBM) using a combination of the clearing and settlement infrastructure of both China and Hong Kong since July 2017. Under the current QFII/RQFII rules, an applicant needs to satisfy certain hard requirements with respect to the length of its operating history and the size of its assets under management (subject to certain differences for applicants depending on the type of its financial license or nature of financial business). The Consultation Papers propose to abolish such hard requirements so as to allow a wide spectrum of foreign investors and investment managers to participate in the QFII/RQFII scheme. However, note that the other existing requirements (e.g., financial soundness, good credit standing, length of experience in securities and futures investments, sound and effective governance structure, internal control systems and compliance management, and a requirement that the applicant had no record of major regulatory penalties in the last 3 years or since the applicant's establishment) will continue to apply.



### 3. Expanding QFII/RQFII's Investment Scope

The Consultation Papers propose adding a variety of new investments to the menu of permissible investments for QFII/RFIIs: private securities investment funds, more derivative tools and other instruments. In particular, a qualified investor will be permitted to invest in the following instruments: (i) stocks listed on the National Equities Exchange and Quotations (NEEQ) (the Chinese counterpart of the OTC Bulletin Board (OTCBB)), (ii) bond repurchases, (iii) private securities investment funds<sup>1</sup>, (iv) financial futures, (v) commodity futures, (vi) options and (vii) on-exchange margin finance and stock lending transactions.

#### 3.1 Allowing WFOE PFM to Act as Fund Manager for QFII/RQFII

As mentioned above, a significant relaxation under the Consultation Papers is to allow a qualified investor to invest in private securities investment funds in China. It is notable that the investment of such private securities investment funds is subject to the “see-through” requirement, which means, the funds’ investment must comply with the investment scope of (a) stocks, depository receipts, bonds, bond repurchases, and asset-backed and securities traded or transferred on stock exchanges and (b) shares listed and transferrable through NEEQ..

Since 2016, the Chinese government began to allow foreign fund managers to manage private securities investment funds in China through the establishment of a locally incorporated entity in the form of a wholly foreign owned enterprise (WFOE). Before commencing its fund management business, the WFOE must obtain approval from the Asset Management Association of China (AMAC)<sup>2</sup> to register itself as a private fund manager (a “**WFOE PFM**”). To date, more than a dozen international managers have set up WFOE PFMs and issued private fund products in China. However, many of them had faced difficulties distributing these products given market conditions in China in recent years and the restriction that a WFOE PFMs may distribute only to Chinese investors. Permitting QFII/RQFIIs to invest in private funds in China opens a new source of funding for the WFOE PFMs. This relaxation may also help some WFOE PFMs to win over some most sought-after institutional investors in China, who normally require seed money from the manager’s offshore group.

#### 3.2 More Derivatives Contracts

A major disadvantage for QFIIs/RQFIIs in the past is the lack of derivative tools for risk management and execution of certain strategy for a portfolio. Currently, QFIIs/RQFIIs are only allowed to trade stock index futures. China's futures markets are among some of the most active in the world; other derivatives contracts currently listed in China (but not accessible to QFIIs/RQFIIs) include the government bond futures listed on the China Financial Futures Exchange, the commodities futures contracts covering a broad range of underlyings such as metal, energy and agricultural products,

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<sup>1</sup> Private securities investment funds are private funds regulated by the AMAC (as defined below) that primarily invest in listed securities in China (other than private equity funds, venture capital funds, etc.).

<sup>2</sup> The AMAC was formed in 2012 by the authorization of the State Council of the People's Republic of China and under the supervision of the CSRC to supervise the private fund industry in China.



as well as several commodities options, listed on the commodities exchanges in Shanghai, Dalian and Zhengzhou, and one ETF option contract listed on the Shanghai Stock Exchange. The Implementation Provisions require the relevant exchanges to recommend to CSRC the specific contracts eligible for QFII/RQFII investment for CSRC's approval, and CSRC shall consult with the People's Bank of China (the PBOC) for its opinion on the inclusion of any financial futures contracts (as well as repo agreements). We expect the specific types of derivatives contracts will be announced by the relevant exchanges shortly after the Consultation Papers are finalized and issued

In addition, the Consultation Papers reiterated the requirement that a QFII/RQFII shall trade financial futures for hedging purpose only.

#### 4. Allowing WFOE PFM to Provide Advisory Service to QFII/RQFII

Under the Consultation Papers, a qualified investor is also allowed to appoint its affiliated private securities investment fund manager in China as investment advisor for its China investment. Under current regulatory regime, such foreign-invested private securities investment fund managers can only take the form of WFOE PFM. Allowing a qualified investor to designate its affiliated WFOE PFM will not only enable such qualified investor to "internalize" its investment decision but also create an additional revenue stream for its affiliated WFOE PFM.

#### 5. Reporting and Disclosure of Interest and Investment Restrictions

The Consultation Papers impose new reporting requirements on a qualified investor, including (i) reporting to CSRC via its custodian bank the hedging positions it has entered into with offshore counterparties in relation to its onshore investment through its custodian bank and (ii) reporting to CSRC, PBOC and the State Administration of Foreign Exchange the change of its *de facto* controller. The Consultation Papers, on the other hand, propose to remove the reporting requirements regarding the change of legal representative/responsible officer, corporate M&A and the increase or decrease of registered capital of the qualified investor.

It is worth noting that, the Consultation Papers retain the disclosure of interest requirements under the previous QFII/RQFII rules, as well as the 10% limit on holdings in a listed company by an individual overseas investor and the 30% limit by all overseas investors.

#### 6. Relaxation on Custodian Banks

The restriction on the maximum number of custodian banks that a qualified investor may engage has been removed. The Consultation Papers also clarify that a qualified investor shall appoint a principal custodian bank to assist with its license application, reporting matters, etc.

From the custodian bank's perspective, the Consultation Papers propose to remove the requirement that a bank should obtain an approval from CSRC to act as QFII/RQFII's custodian; instead, a filing may now be made with CSRC after its appointment as custodian.



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The changes introduced by the Consultation Papers introduce an opportunity for foreign managers to gain broader access to the Chinese securities and futures market. Compared to the convenience of the China-Hong Kong Stock Connect scheme, the QFII/RQFII scheme has an advantage of broader investment scope, given in particular that a qualified investor may invest in private securities investment funds. In the meantime, managers who already have QFII/RQFII licenses should watch out for the final rules and assess what changes/updates need to be made to their business plans as well as policies and procedures in light of the change to be brought about by the final rules.

The deadline for submitting comments on the Consultation Papers is 2 March 2019. You can download the official English translation of the full text via the hyperlink below:

[http://www.csrc.gov.cn/pub/csrc\\_en/newsfacts/PressConference/201901/t20190131\\_350613.html](http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201901/t20190131_350613.html).

If you have any questions/comments on this alert, please feel free to contact us.

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