OnPoint Dechert LLP

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Foreign Exchange Rules Related to Qualified Foreign Institutional Investors (QFIIs) Released as Expected in China

The QFII program, as a principal means for foreign investors to invest directly in China's securities market, has undergone significant changes in the past year. Most recently, the State Administration of Foreign Exchange of the PRC released the revised foreign exchange rules related to QFIIs[1] on December 7, 2012, which became effective on the same date. As illustrated in detail below, the revised QFII foreign exchange rules include three major changes: (i) allowing QFIIs to open RMB special deposit accounts for the purpose of trading futures (Futures Trading Accounts), (ii) allowing QFIIs that launch China Open-ended Funds[2] to inject funds into the QFIIs' accounts or repatriate the same outside China on a weekly basis, and (iii) abolishing the limit on the total investment quotas for three types of QFIIs. Not surprisingly to industry players in the QFII sector, the revised QFII foreign exchange rules continued the Chinese government's efforts toward QFII liberalization made throughout the entire year of 2012.

I. Key Changes

1. Bank Accounts

Allowing QFIIs to open Futures Trading Accounts marks a big step in paving the way for QFIIs to trade futures. This change is reflected in the annex titled the New Tentative Guideline Regarding Opening and Management of QFIIs' Bank Accounts (the Guideline), which is attached to the revised QFII foreign exchange rules.

As background, a guideline providing general requirements on QFIIs' participation in the trading of stock index futures had been in place since early 2011[3]. However, QFIIs are technically incapable of trading futures in accordance with that guideline because they are not able to open futures margin accounts, which is a prerequisite to futures trading. Now, the Guideline specifically allows QFIIs to open Futures Trading Accounts in a futures margin depository bank. Since a Futures Trading Account could be used as a futures margin account, it is deemed to have resolved the most crucial issue related to futures trading by QFIIs.

Currently, only five state-owned commercial banks are licensed to provide futures margin depository services[4]. The Guideline stipulates that in the event the custodian bank of a QFII is one of these five qualified futures margin depository banks, such QFII may use its RMB special account for securities trading, which was opened in that custodian bank, for futures trading as well. Thus, in certain cases it will not be necessary for a QFII to open a new Futures Trading Account.

Although implementation and procedural rules regarding the opening of QFII's Futures Trading Accounts and futures trading have yet to be clarified, industry players do not expect any significant obstacles to prevent QFIIs from trading stock index futures. Media reports indicate that some QFIIs have been liaising with the China Financial Futures Exchange in order to prepare for the day when all the issues in connection with futures trading of QFIIs have been resolved.

2. Liquidity

An important change in terms of liquidity is that China Open-ended Funds, as one category of QFIIs, are allowed to repatriate or inject QFII funds on a weekly basis, as opposed to only once a month, as previously required. Other QFIIs are allowed to repatriate the investment principal and proceeds in installments, but no specific timetable has been provided.

On the other hand, a new limit is that the monthly repatriation or injection of QFIIs cannot exceed 20% of the total QFII assets as of the end of last year. The revised QFII foreign exchange rules apply this limit to China Open-ended Funds as well as to other types of QFIIs. Moreover, an initial lock-up period which prohibits the repatriation of investment principal for a certain time after its injection, as stipulated in a previous regulation, remains intact at this time[5]. These limitations on the liquidity of QFIIs suggest the Chinese government's desire to retain the QFIIs' investment principal and proceeds within the PRC in order for them to make further investments in the future.

3. Limit of Investment Quota

The new rules scrap the old ceiling for investment quotas of US$ 1 billion in total for the following three types of QFIIs: sovereign funds, central banks and monetary authorities. Indeed, Hong Kong Monetary Authority, Norges Bank, Government of Singapore Investment Corporation Pte Ltd, Temasek Fullerton Alpha Investments Pte Ltd, and Qatar Holding LLC had all reached the US$1 billion limit as of November 30, 2012. However, the other types of QFIIs are still subject to the current US$ 1 billion limit on the total investment quotas.

II. Observation

Along with the promulgation of the revised foreign exchange rules related to QFIIs, we have seen numerous positive changes throughout the past year, including the revised QFII implementation rules and a number of practical measures taken by the Chinese authorities. We expect this trend to remain unchanged in 2013. However, as seen by the limitations on liquidity explained above, the ultimate goal of the Chinese government to foster the growth of the Chinese securities market may have a negative impact on foreign investors' investment to a certain extent.

Footnotes

[1] These rules are the Provisions of Foreign Exchange Administration Regarding Domestic Securities Investment of Qualified Foreign Institutional Investors. They were promulgated on September 29, 2009 and revised on December 27, 2012.

[2] Article 9 of these rules defines a "China Open-ended Fund" as an open-ended securities investment fund which is formed by a QFII outside of the PRC through a public offering and at least 70% of the assets of which are invested in the securities market of the PRC.

[3] The Guideline on the Participation of Qualified Foreign Institutional Investors in Stock Index Futures Trading was issued and became effective on May 4, 2011.

[4] These five banks are the Bank of China, the Industrial and Commercial Bank of China, the Agricultural Bank of China, the China Construction Bank, and the Bank of Communications.

[5] According to these rules, QFIIs that are pension funds, insurance funds, charity funds, endowment funds, governments, monetary authorities, and China Open-ended Funds may not repatriate their investment principal within the first three months of their injection into the QFII's accounts. QFIIs of other types are subject to a similar initial lock-up period of one year.

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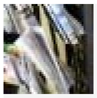

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