CHINA COMBINES QFII AND RQFII REGIMES AND EXPANDS INVESTMENT SCOPE

Following the landmark removal of the investment quota for both QFII and RQFII regimes in May 2020, PRC regulators have released official regulations to combine the two current parallel regimes of QFII and RQFII with a unified set of rules applicable to all QFIIs and RQFIIs (collectively "**QFIs**"). This represents China's latest step to open up key areas of the onshore financial markets to international investors.

The People's Bank of China ("**PBoC**"), the China Securities Regulatory Commission ("**CSRC**") and the State Administration of Foreign Exchange ("**SAFE**") jointly released the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors (QFII) and RMB Qualified Foreign Institutional Investors (RQFII) (the "**Measures**") on 25 September 2020, together with implementing rules (the "**Implementing Rules**"). The effective date of both the Measures and the Implementing Rules is 1 November 2020.

This briefing summarises the key changes under the Measures and the Implementing Rules and looks ahead to further developments related to the new QFI regime.

SIMPLIFIED MARKET ACCESS PROCESS

The eligibility requirements for QFIs will be relaxed by removing quantified criteria, such as the requirements relating to track record, paid-in capital and assets under management ("**AUM**").

The application process is also further streamlined and electronic filing will be enabled. CSRC has committed to a shorter review period of 10 working days to decide whether to grant a QFI licence (currently a 20-working-day period). Both the Measures and the Implementing Rules no longer expressly require an investment plan. If, in practice, regulators do not require QFI applicants to represent in advance how they will use the QFI programme and instead rely on ongoing compliance monitoring, we expect that further investment flexibility will become available under the new QFI regime.

QFII and RQFII licence holders should be converted into QFI licence holders, but such existing licence holders should check with their PRC custodian on the relevant formalities and logistics.

Key issues

- The eligibility requirements for QFIs will be relaxed. The application process for QFI licences will also be further streamlined with electronic filing enabled.
- The investment scope of QFIs will be expanded and more listed investment products, China Inter-bank Bond Market products, and exchange-traded derivatives will become available to QFIs.
- The corresponding compliance obligations applicable to QFIs are also reinforced. Among others, QFIs should (i) disclose detailed information of the underlying investors involved in the omnibus account for clients; (ii) report offshore hedging positions as required by CSRC; and (iii) monitor the securities holdings of foreign investors under its QFI licence and ensure such foreign investors strictly comply with the relevant PRC rules on disclosure of interests.

EXPANDED INVESTMENT SCOPE

The investment scope of QFIs will be expanded, and more investment products on stock exchange market ("**SEM**"), China Inter-bank Bond Market ("**CIBM**"), and exchange-traded derivatives market ("**EDM**") will be available to QFIs. Meanwhile, regulators are going to apply consistent rules on over-the-counter derivatives for foreign exchange risk hedging. The table below sets out the amendments to the current regimes:

Market Segment	Current QFII/RQFII regime	New under QFI regime
SEM	shares, bonds and warrants	• depositary receipts and asset-back securitisation products (the Measures and Implementing Rules clarify that asset-backed securities are permitted investments for QFIs) • securities borrowing and margin trading • securities lending to securities finance company • bond repo • shares and other type of securities admitted on the National Equities Exchange and Quotations
CIBM	cash bonds	derivatives linked to bonds, interest rate and FX
EDM	stock index futures	other futures and listed options
Funds / Asset Management Products	public securities investment funds	private investment fund

Securities borrowing and margin trading

QFIs will finally be permitted to access the onshore margin trading and securities borrowing facilities offered through PRC brokers, which will provide QFIs with more flexible ways of utilising cash and hedging stock price risks. Critically, this will also permit international investors to structure and offer more types of investment products referencing A-shares outside China.

However, international investors should note that China's securities borrowing market (which also includes securities lending to the China Securities Finance Corporation Limited (which acts as a quasi-central counterparty)) is quite different from securities borrowing in the international markets. For example, the PRC securities borrowing market involves a "central counterparty" role, and securities borrowing / lending between end investors is still not permitted for the time being. Please also note that "naked short selling" is not permitted in the PRC market.

Securities lending to securities finance company

In contrast to the consultation paper for the Measures and the Implementing Rules released in January 2019 (the "**Consultation Paper**") which only permits QFIs to access securities borrowing and margin trading facilities, the finalised regulations further permit QFIs to directly lend securities to the China Securities Finance Corporation Limited, under the current regime of securities on-lending ("转融通" in Chinese). This may be of particular interest for long-term institutional investors (such as pension funds and international organisations), as this initiative can provide an additional mechanism to monetise their PRC securities holdings.

Although the Measures and the Implementing Rules become effective on 1 November 2020, before QFIs can commence margin trading, securities borrowing and securities lending, it will be necessary for PRC regulators to provide further detailed guidance on how this will work in practice.

We anticipate that regulators will either (i) confirm that QFIs shall trade under the same framework applicable to onshore investors and be subject to the same rules such as requirements on eligible collateral and collateral maintenance levels; and/or (ii) promulgate separate new rules for QFIs (which may occur after 1 November 2020). QFIs will also need to negotiate the relevant transaction documentation with their brokers and set up internal systems to take advantage of such new trading opportunities.

CIBM products

For a long time, QFIIs/RQFIIs were only permitted to trade cash bonds on the CIBM while overseas institutional investors under the direct access regime were permitted to participate in a more diversified range of products, including bond forwards, bond lending, forward interest rate transactions and interest rate swaps. This difference in treatment will now be bridged with the introduction of more CIBM products under the Implementing Rules, which will take effect from 1 November 2020.

On a more general level, international investors should note that the PRC regulators (PBoC and CSRC) have been making efforts to consolidate the different access programmes to CIBM (mainly QFIs and the direct access regime – although there are discussions ongoing at present on how PRC regulators will reform the Bond Connect scheme), including the recent relaxation of non-trade transfer for investors who are using both access programmes. We have also noted that PBoC has proposed to introduce a multi-layer custody arrangement to the CIBM (rather than insisting on accounts being opened in the name of the end investor) to better synchronise with international practice, which will be able to better interface the custody arrangements under the QFI regime.

Other futures and listed options

China's commodity futures market is already open to direct participation by international investors, although this is limited to specific products (the first product was crude oil futures on the Shanghai International Energy Exchange). International investors will now be able to increase their participation in the PRC futures markets through the QFI regime.

According to the Implementing Rules, the specific types of futures and listed options as well as methods for trading are to be determined by exchanges and CSRC in due course.

Besides stock index futures listed on China Financial Futures Exchange ("**CFFEX**"), another type of financial futures on CFFEX (i.e., China government bond futures), may also become available for trading by QFIs in the near future.

As for commodities futures, we would expect, based on the types of domestic commodity futures currently available to foreign investors, crude oil, iron ore, PTA, low sulfur fuel oil and TSR20 futures are likely to be among the first batch of permitted products.

We expect that regulators will promulgate detailed rules in the coming months to clarify the permitted investment scope in this area.

Private investment funds

Under the Measures and the Implementing Rules, QFIs can also invest in private investment funds launched by (i) PRC securities companies, fund management companies, futures companies and their respective subsidiaries engaging in private asset management business, and (ii) private fund managers registered with the Asset Management Association of China, so long as the investment scope of such private investment funds does not extend beyond the permitted investment scope of QFIs.

We note that CSRC has been unifying the private asset management business following the guiding opinion on asset management business issued by central financial regulators, such as by issuing the Administrative Provisions on the Operation of Private Asset Management Plans by Securities and Futures Business Institutions (2018). Given different terminologies are still being used in the market, such as "private investment funds", "asset management plans", "separate account plans" and "collective investment schemes", and that this market segment is being reformed, we would expect further clarification from CSRC on this issue in due course.

Non-trade transfer mechanism

CSRC has clarified that non-trade transfer of securities can be effected by QFIs for "investment operational efficiency and to simplify account structure", which will bring additional convenience to international investors. To date, on-market transfers have had to be utilised due to the absence of a non-trade transfer mechanism, which has demanded substantial internal and external resources for the institutions involved, and, in our experience, would have been significantly simpler had a non-trade transfer mechanism been available. We expect implementing rules from stock exchanges and ChinaClear on this issue.

Cooperation with PFM WFOE

According to the Implementing Rules, a QFI can engage an affiliated private fund manager incorporated in the PRC ("**PFM**") which is controlled by or under common control with the QFI to provide investment advisory services for the QFI. This would benefit international asset managers who hold QFII/RQFII licence and also have set up a wholly foreign owned entity ("**WFOE**") in China as a PFM. Through intra-group cooperation with a PFM WFOE (including both direct investment in private funds and advisory service), QFIs could better integrate internal resources such as research, investment management and risk management, and help develop onshore asset management capability in the PRC by contributing internal AUM.

ENHANCED COMPLIANCE OBLIGATIONS OF QFI

With the broadened investment scope, the Measures and the Implementing Rules also reinforce the corresponding compliance obligations applicable to QFIs, including more transparency of QFIs' investment activities for regulators:

Discouragement of omnibus account

In terms of account structure, "QFI-Fund" accounts and "QFI-Client Name" accounts are permitted, while QFIs are not encouraged to open omnibus accounts for its clients. If a QFI wants to maintain omnibus accounts for clients, it must disclose detailed information of the underlying investors involved.

Reporting of offshore hedging position

According to the Implementing Rules, CSRC has the right to require QFIs to report information on its offshore hedging positions and other information related to its securities and futures investment in the PRC. We note that this requirement should be interpreted in conjunction with the speech delivered in June 2020 by the Vice Chairman of CSRC, Mr. Xinghai FANG, who acknowledged and supported market participants engaging in offshore derivatives products referencing A-shares. We take the view that while it is generally accepted for QFIs to trade derivatives referencing China securities in the offshore market, this is conditional upon among others providing PRC regulators with sufficient transparency for them to keep market order and crack down on misconduct.

DOI obligation

The Implementing Rules require any foreign investor of a QFI to assume disclosure of interest ("**DOI**") obligations under the PRC regime if it triggers any DOI thresholds. QFIs should therefore monitor the securities holding of foreign investors under its QFI licence and ensure such foreign investors strictly comply with the relevant PRC DOI rules.

It becomes important for QFIs to enhance their awareness and practices in respect of compliance matters under the new QFI rules with the deeper involvement in the China market. The establishment and implementation of an effective internal control and compliance management system is also a key obligation of QFIs as provided under the Measures. As a practical consideration, it is recommended for QFIs to maintain a new and consolidated compliance checklist setting out key compliance matters under the Measures and Implementing Rules (including investment restrictions and filing/reporting requirements, as well as mechanisms to monitor shareholding limits and obligations on disclosure of interest) and keep these updated.

OUTLOOK

We believe this milestone reform establishing the QFI regime will remove many of the obstacles that have restricted QFIIs/RQFIIs from expanding their China business and/or applying more diversified and flexible investment strategies. With the introduction of further operational rules and regulatory guidance in respect of the newly added investment products in the coming months, we look forward to international investors exploring new opportunities in the quickly expanding PRC financial markets.

CONTACTS

BEIJING

Kimi Liu
Counsel

T +86 10 10 6535 2263
E kimi.liu
@cliffordchance.com

SHANGHAI

Ying White
Partner

T + 86 10 6535 2218
E ying.white
@cliffordchance.com

Christine Li
Associate

T + 86 21 2320 7376
E christine.li
@cliffordchance.com

HONG KONG

Mark Shipman
Partner

T + 852 2825 8992
E mark.shipman
@cliffordchance.com

Francis Edwards
Partner

T + 852 2826 3453
E francis.edwards
@cliffordchance.com

Matthias Feldmann
Partner

T + 852 2825 8859
E matthias.feldmann
@cliffordchance.com

Terry Yang
Partner

T + 852 2825 8863
E terry.yang
@cliffordchance.com

Rocky Mui
Partner

T + 852 2826 3481
E rocky.mui
@cliffordchance.com

Viola Lui
Partner

T + 852 2825 8842
E viola.lui
@cliffordchance.com