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Proposed Combination of China's QFII and RQFII Schemes to Attract International Investment

As part of China's ongoing efforts to open up its capital market, Chinese authorities plan to combine the country's Qualified Foreign Institutional Investors (QFII) scheme with its RMB Qualified Foreign Institutional Investors (RQFII) scheme in order to attract more long-term overseas capital investment. On January 31, 2019, the China Securities Regulatory Commission (CSRC) released consultation papers on the *Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* (the "Measures") and the *Provisions on Issues Concerning the Implementation of the Measures* (collectively, the "Consultation Papers").

In the years prior to the release of the Consultation Papers, the Chinese authorities had taken steps to gradually ease regulations on foreign investors making investments in China's capital market under the QFII/RQFII schemes in response to investors' comments and feedback. The process has accelerated in recent years as alternative investment channels for global investors to access China's capital market have become available, such as Stock Connect and Bond Connect. This initiative comes as global investors have commented that Stock Connect and Bond Connect have certain advantages, such as increased flexibility, over the QFII and RQFII schemes.

Expansion of Investment Scope

The Consultation Papers are viewed as a significant change to the existing QFII/RQFII rules. The most significant change under the Consultation Papers is the expansion of the investment scope. Currently, the primary investments available under the QFII/RQFII schemes are A-shares, bonds and warranties traded on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), fixed-income products traded in the China Interbank Bond Market, stock index futures traded on the China Financial Futures Exchange, and public securities. The Consultation Papers expand this investment scope to include the following areas:

1. National Equities Exchange and Quotations (NEEQ)

The NEEQ (commonly known as the "New Third Board") is an over-the-counter national securities trading market providing a financing platform for small-and-medium-sized enterprises, and is generally regarded as a pre-listing or startup exchange with less stringent requirements for listing (e.g., a lower capital threshold). According to the notice published by the NEEQ on February 1, 2019, supporting policies will be announced to facilitate QFII/RQFII investment in stock listed on the NEEQ.

2. Bond Repo in SSE and SZSE

A bond repurchase agreement, or "bond repo," is a form of short-term financing on interbank markets or stock exchanges collateralized with bonds. There are two types of bond repo in China:

collateral repo and outright repo. The major difference is that outright repo requires the transfer of bond ownership during the repo period, while collateral repo does not.

3. Private Securities Investment Funds

According to the Consultation Papers, investors under QFII/RQFII will be able to invest in private securities investment funds whose underlying assets fall within a permissible investment scope. In addition, QFII/RQFII investors can engage their affiliated private securities investment fund managers ("PSFM") to provide investment advisory services for their investments in China.

Foreign asset managers have been permitted to register as wholly foreign-owned PSFMs and issue onshore private securities fund products since 2016. The proposed opening-up of the private fund sector will likely be welcomed by QFII/RQFII investors whose affiliates have already been registered as PSFMs in China.

4. Futures and Options

(i) Financial futures contracts listed on China Financial Futures Exchange (CFFEX)

The CFFEX is a demutualized exchange dedicated to the trading, clearing and settlement of financial futures, options and other derivatives. Financial futures contracts currently listed on the CFFEX include CSI 300 Index Futures, CSI 500 Index Futures, SSE 50 Index Futures, 2-year Treasury Bond Futures, 5-year Treasury Bond Futures, and 10-year Treasury Bond Futures. Specific financial future products in which QFII/RQFII investors will be allowed to invest will be published by the CFFEX after obtaining consent from the CSRC.

(ii) Commodity futures contracts listed and traded on futures exchanges approved by CSRC

These exchanges include the Zhengzhou Commodity Exchange, Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange and any other exchanges that the CSRC may approve in the future. Specific commodity futures products in which QFII/RQFII investors will be able to invest will be published by the relevant exchanges after obtaining consent from the CSRC.

(iii) Options listed and traded on futures exchanges approved by the State Council or the CSRC

These include the Zhengzhou Commodity Exchange, Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange, the CFFEX and any other exchanges that the State Council or the CSRC may approve in the future. Specific options futures products in which a QFII/RQFII investor will be able to invest will be published by the relevant exchanges after obtaining consent from the CSRC.

5. Margin Trading and Securities Lending

Margin trading and securities lending will allow QFII/RQFII investors to (1) borrow cash from licensed securities firms in China in order to buy permitted stocks on the SSE and the SZSE, or (2) borrow permitted stocks from such securities firms, and then sell them. Under the mechanisms of margin trading and securities lending, investors must provide a deposit to securities firms in order to borrow cash or stocks.

The opening-up of margin trading may also boost fund utilization. When the common settlement date for global stock exchanges is T+2, the delay between selling on a foreign market and the purchase of China A-shares may be reduced through margin trading.

Other Highlights

In addition to the expansion of the investment scope, the Consultation Papers also propose to consolidate the two long-established inbound investment programs, to unify and simplify application procedures, and to remove restrictions on the number of custodians with whom a QFII/RQFII investor may engage.

The Consultation Papers propose to unify the qualification requirement for applicants for both schemes, so that foreign institutional applicants only need to submit a single qualification application. The vetting process would be streamlined significantly, whereby the CSRC will decide whether the applicant should be granted admission to the onshore securities and futures market and the State Administration of Foreign Exchange will determine the granted investment quota, and whether an investor can invest with offshore RMB. It should be noted that, for those countries or jurisdictions where the RQFII scheme is not yet available, qualified investors may still trade Chinese securities using RMB converted from foreign currencies.

The Consultation Papers further propose to remove quantitative criteria, such as the required minimum term of operation and minimum size of assets under management, that are currently required for QFII applicants.

With respect to investors' domestic custodians, the Consultation Papers have also proposed to implement a more organic, hierarchical structure, whereby up to three specialty custodians may be appointed under relevant professional categories (e.g., two custodians for securities, and three for futures/options) and one principle custodian shall be designated.

Our Observations

While the Consolidation Papers were closed to further public comment on March 2, 2019, the discussion over the issues raised in the comments has just begun. For instance, the Consultation Papers emphasize "penetrative supervision and administration," which is reflected in a proposed disclosure obligation for foreign investors, whereby they would be required to consolidate and calculate all of a company's stock listed or quoted for trading in China, as well as that of any of the company's overseas listed equities. Such requirement may be deemed by foreign investors to be difficult to comply with.

The Consultation Papers reflect the determination of Chinese regulators to facilitate the opening-up of China's capital market, and to promote the inward flow of foreign capital.