

MEMO# 15394

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CHINA ADOPTS QFII REGIME; ALLOWS FOREIGN INVESTORS TO PARTICIPATE IN DOMESTIC A-SHARE MARKET

[15394] November 26, 2002 TO: INTERNATIONAL MEMBERS No. 31-02 INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 58-02 RE: CHINA ADOPTS QFII REGIME; ALLOWS FOREIGN INVESTORS TO PARTICIPATE IN DOMESTIC A-SHARE MARKET The China Securities Regulatory Commission (CSRC) recently adopted a qualified foreign institutional investor (QFII) regime that will allow foreign investors access to China's A-share market.¹ The new rules come into effect on December 1, 2002. Gaining access to the A-share market for foreign investors has been a long-standing Institute priority in China. These rules (which do not appear to have been issued for public comment prior to their adoption) appear to be a first step towards the opening of China's domestic securities market. They are similar in many respects to early versions of Taiwan's QFII regime, which presented a number of difficulties for foreign investors.² The CSRC's unofficial English translation of the new QFII rules is attached and summarized below.³ General Provisions Overseas fund management institutions, insurance companies, securities companies and other assets management institutions can apply to become QFIIs. If approved by the CSRC, QFIIs will be granted an investment quota by the State Administration of Foreign Exchange (SAFE). 1 "Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII)," adopted by the CSRC and People's Bank of China on November 5, 2002 (the "Rules"). 2 For example, like Taiwan's original QFII rules, China's Rules appear to require each fund management company to obtain a license as a QFII on behalf of all of the funds that it manages, rather than allowing individual funds to obtain their own QFII licenses. This requirement raises custody and other issues for some foreign funds, including U.S. mutual funds. These issues led Taiwan to amend its QFII rules in 1996 to allow individual funds to obtain their own QFII licenses. 3 The attached version of the Rules has been reformatted. The original unofficial translation can be found at <http://www.csrc.gov.cn/CSRCsite/eng/enews/efi20021114.htm>. 2 QFIIs must use Chinese commercial banks as custodians and Chinese securities companies as brokers for their Chinese securities trading. Qualifications, Criteria and Approval Procedures In order to qualify as a QFII, a foreign financial institution must meet a number of general criteria set forth in the rules, such as being in sound financial and credit status and having a sound management structure and internal control system.⁴ In addition, fund management companies must have operated a fund business for over five years and have assets under management of not less than US\$10 billion as of the most recent accounting year-end. The CSRC may adjust this figure in response to developments in the Chinese securities market. The Rules outline the documents necessary to apply for QFII status.⁵ These documents should be submitted to the CSRC and SAFE through the fund's custodian and, if written in

languages other than Chinese, must be accompanied by Chinese translations or extracts. The Rules require the CSRC to determine whether to grant approval of a QFII application within 15 working days from the date the full set of application documents are received. Successful applicants will receive a “securities investment license.” Written notices will be given to those applicants whose applications have been rejected. After obtaining the securities investment license, applicants then must apply to SAFE for an investment quota. Similar to the application for the license, the Rules require SAFE to make a determination within 15 working days. Again, written notices will be given to those applicants whose applications have been rejected. Successful applicants will be issued a “foreign exchange registration certificate.”⁶ The Rules state that, in order to encourage medium and long-term investments, preference will be given to, among other types of investors, “mutual funds with good investment records in other markets.”

Custody, Registration and Settlement The Rules spell out in detail the qualifications for and responsibilities of a custodian, and explain the process by which a bank can apply to the CSRC, SAFE and the PBOC for custodian status.⁷ The Rules require each QFII to select a single custodian for its Chinese securities.

⁴ See Article 6. ⁵ See Article 8. ⁶ The securities investment license will automatically become void if an applicant is unable to obtain a foreign exchange registration certificate within one year after its securities investment license is granted. See Article 10. ⁷ See Articles 12-17.

3 Investment Operations Subject to the approved investment quota, QFII can invest in the following renminbi- denominated (RMB) financial instruments: 1. Shares listed in China’s stock exchanges (excluding B shares); 2. Treasuries listed in China’s stock exchanges; 3. Convertible bonds and enterprise bonds listed in China’s stock exchanges; and 4. Other financial instruments as approved by CSRC. Investments in Chinese securities are subject to a number of other requirements. For example, QFIIs cannot hold more than 10% of the total outstanding shares of any one listed company individually or 20% in the aggregate. In addition, investments in particular industries are limited or prohibited. QFIIs must select a single Chinese broker to manage their domestic securities investments.

Fund Management Upon receiving a foreign exchange registration certificate from SAFE, each QFII must open an RMB special account with its custodian. The special account will be used to facilitate trading and settlement in Chinese securities and the repatriation of principal and proceeds from securities transactions. Within three months of receiving its foreign exchange registration certificate, the QFII must fund the special account. If it does not fund the account up to the amount of its quota within that time, the actual amount used to fund the special account will be deemed as the QFII’s approved quota.⁸ The Rules allow QFIIs to apply to SAFE to repatriate principal from the special account in batches no more frequently than once every three months. Each batch repatriation cannot exceed 20% of the total principal balance in the account. However, it appears that a repatriation of principal from the account will serve to lower the QFII’s investment quota.⁹

Regulatory Issues The CSRC and SAFE will annually review each QFII's securities investment license and foreign exchange registration certificate. The CSRC, PBOC and SAFE all have records and on- site inspection authority under the Rules. ⁸ See Article 25. ⁹ See Article 28 (requiring QFIIs to reapply for their investment quota after repatriations).

⁴ Notice must be provided to the CSRC, PBOC and SAFE within five working days of any other following occurrences: 1. A change of custodians; 2. A change of legal representatives; 3. A change of controlling shareholders; 4. An adjustment of registered capital; 5. Litigation and other material events; and 6. The imposition of substantial penalties overseas. In addition, a QFII must reapply for its securities investment license if the QFII changes its business name or is acquired by or merged with another institution. A QFII must surrender its securities investment license and foreign exchange registration certificate to the CSRC and SAFE if it repatriates all of the principal in its special account, transfers its investment quota, or winds up its affairs in

bankruptcy. Effective Date The new rules come into effect on December 1, 2002. Robert C. Grohowski Associate Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 15394, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15394. Attachment (in .pdf format)

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