

The Expanding RQFII Regime: Key Legal Issues for Offshore Investors.

On 25 May 2015, the People’s Bank of China (“**PBOC**”) announced that the Renminbi Qualified Foreign Institutional Investor (“**RQFII**”) regime has been further expanded to cover Chile. Prior to this, the RQFII regime already covered not only most of the offshore RMB centres but also other significant hubs including Hong Kong, Singapore, London, France, Korea, Germany, Qatar, Australia, Switzerland and Luxembourg. Over 130 entities have now obtained the relevant RQFII qualification with a total investment quota of well over RMB380 billion.

The RQFII regime is fundamentally based on the Qualified Foreign Institutional Investor (“**QFII**”) regime, which was launched in 2003 to give foreign institutional investors access to Mainland China securities markets. The RQFII regime is different from the QFII regime in that funds are remitted into Mainland China in offshore RMB, rather than in a foreign currency such as US dollars. The RQFII regime was formally launched in December 2011 with the promulgation of RQFII rules jointly by the China Securities Regulatory Commission (“**CSRC**”), the PBOC and the State Administration of Foreign Exchange (“**SAFE**”). Further rules were promulgated by these authorities in early 2013 to enhance and develop the RQFII framework, including the extension of the investment scope to include the Mainland China inter-bank bond market. Under the current framework, the CSRC grants the RQFII qualification to eligible applicants, SAFE administers the investment quotas of RQFIIs, and the PBOC regulates the onshore RMB cash accounts of RQFIIs.

Offshore investors who do not have an RQFII qualification may access the Chinese securities markets through various arrangements with RQFIIs. The two most widely used methods are entering into an investment management agreement with an RQFII (the “**IMA Structure**”) and subscribing to an open-ended fund issued and managed by an RQFII (the “**Open-ended Fund Structure**”).

This Bulletin discusses the key legal issues frequently raised by offshore investors who gain access through the IMA Structure and the Open-ended Fund Structure.

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China Legal Issues

Onshore Asset Segregation

One major concern for such investors is the bankruptcy risk of the RQFII. The key issue is whether Mainland China law will recognise that such investors have a proprietary right to the assets held by the RQFII in Mainland China for the investors or the open-ended fund, and that such assets are segregated from the RQFII's own assets, particularly when the RQFII is insolvent.

- Onshore Account Structure:* It should be noted at the outset that an RQFII is required to open a basic RMB deposit account and one or more specific cash accounts at an onshore custodian bank. An RQFII is also required to open a securities account with each relevant Chinese central securities depository (“**CSD**”). More specifically, for each of the exchange market, inter-bank bond market and the futures market in which the RQFII intends to invest, the RQFII is required to open a specific cash account and a corresponding securities/futures account, as summarized in Diagram 1.

Diagram 1 – Relevant Accounts for Trading and Settlement Purposes

Account Market	Cash Account	Securities Account
Exchange Market	Specific Cash Account for Exchange Market at the custodian bank	Securities Account at China Securities Depository and Clearing Corporation Limited (“ ChinaClear ”)
Inter-bank Bond Market	Specific Cash Account for Inter-bank Bond Market at the custodian bank	Bond Account at China Central Depository and Clearing Co., Ltd. (“ CCDC ”)
		Bond Account at Shanghai Clearing House (“ SCH ”)
Stock Index Futures Market	Specific Cash Account for Stock Index Futures at the custodian bank	Stock Index Futures Account at China Financial Futures Exchange (“ CFFEX ”)

- Segregation under IMA Structure:* The onshore cash accounts and securities accounts in which an RQFII holds client funds and client assets will be opened in the following name: “[name of the RQFII] – client money account”. This reflects the legal nature of such assets under Mainland China law – such assets do not form part of, but are segregated from, the RQFII's proprietary assets. Accordingly, the cash and assets held in such accounts do not form part of the bankruptcy assets of the RQFII when the RQFII becomes insolvent. However, these accounts are typically opened as “omnibus” accounts, in which

the cash or assets for different offshore investors are commingled and held in an undivided pool. Therefore, the assets of a particular client are not “individually segregated” and are subject to fellow client risks (in that it would not be possible for any client to physically identify any particular assets in the omnibus account as belonging to it).

- *Segregation under Open-ended Fund Structure:* The onshore cash accounts and securities accounts that hold the funds and assets of an open-ended fund will be opened in the following name: “[name of the RQFII] – [name of the open-ended fund]”. In other words, the RQFII is required to open separate cash and securities accounts for each open-ended fund. In contrast to the cash and assets held in the client accounts under the IMA Structure, which consist of the commingled cash and assets of different investors, the cash and assets held in each such account for an open-ended fund are not only segregated from the proprietary assets of the RQFII but are also segregated from the assets of other clients of the RQFII and other open-ended funds issued and managed by the RQFII. As a result, under Mainland China law, the cash and assets held in each such account will be beneficially owned by the open-ended fund. For other features of the Open-ended Fund Structure, please see the discussions below under the section headed “Open-ended Funds”.

Quota Transfer

It is now well known that “Rent-a-QFII/RQFII” (or the transfer or resale of investment quota by a QFII/RQFII to another institution) is an activity expressly prohibited by Mainland China regulations. A breach of such regulations could potentially result in the confiscation of the relevant onshore cash and/or assets by the authorities, which would have a significant financial impact on the offshore investors. Accordingly, a key question at the outset is whether the particular transaction structure could be construed as the RQFII transferring or reselling its investment quota to offshore investors.

The prohibition against transfer or resale of investment quota should not be understood to rule out offshore investors entrusting funds to the RQFII (and becoming economically exposed to Mainland China financial assets) since this is precisely the asset management service contemplated and approved by the Chinese authorities under the RQFII regime. Importantly, the prohibition has been interpreted to relate to the exercise of investment decision-making and discretionary power in the sense that such power and discretion must be exercised by the RQFII as the investment manager. There is a real risk of a transaction structure being construed as quota transfer or quota sharing if the RQFII does not have investment discretion and has to comply with every instruction given by the offshore investors or their advisors.

Accordingly, special attention should be given to “delta one” cash products where the RQFII acts solely as an “execution broker” which does not exercise

any investment discretion in practice. It has also been raised whether offshore investors who are themselves QFII/RQFII holders could invest in Mainland China markets through a third party RQFII.

Open-ended Funds

Current RQFII rules are silent on the definition of “open-ended fund”. A similar term “open-ended China fund” is defined under the QFII regime as an open-ended securities investment fund which is launched by a QFII through a public offering in an offshore market, with at least 70% of its fund assets invested in the Mainland China market. In practice, it is not uncommon for the authorities to specifically remove the 70% requirement in its approval for a particular RQFII.

The RQFII rules provide more flexibility under the Open-ended Fund Structure as compared to the IMA Structure. The table below (Diagram 2) summaries the key advantages enjoyed under the Open-ended Fund Structure.

Diagram 2

	IMA Structure	Open-ended Fund Structure
Quota management	Repatriation of principal outside Mainland China will reduce the investment quota.	Repatriation of principal outside Mainland China will not reduce the investment quota. However, the net principal remitted into Mainland China shall not exceed the approved RQFII quota.
Lock-up period	1 year	No lock-up period
Repatriation/ Remittance	On a monthly basis	On a daily basis
Segregation	Typically omnibus account	Individual segregation for each open-ended fund

Offshore Local Law Issues

In addition, certain legal issues are subject to the law of the jurisdiction of the RQFII and the local law of the relevant investment management agreement or open-ended fund product.

- *The insolvency of the RQFII:* If the RQFII is subject to insolvency proceedings, the laws of the place of incorporation/principal business of the RQFII would apply. Accordingly, such laws would determine whether the offshore funds or assets of the RQFII are beneficially owned by the investors or form part of the bankruptcy estate of such RQFII, and how liquidation proceeds will be distributed to the offshore investors.
- *Law governing Open-ended Fund Product:* The due establishment of the open-ended fund product may be governed by the law of the place where the fund is launched/offered. In such case, whether the requirements under Mainland China law for such fund to be “open-ended” and/or “public” is to be determined under such law. Accordingly, if an open-ended fund offered to the public in Hong Kong has been accepted as such in Hong Kong (having gone through the usual authorization process), Mainland China law will not normally question such characterization.

Other Related Issues

With further development of the RQFII regime, a number of other related issues may also require further analysis depending on the facts. In certain cases, the CSRC has granted an RQFII qualification to a holding company and required the holding company to carry out the relevant RQFII business through a subsidiary or affiliate which holds an asset management service license outside of Mainland China. In these cases, the contractual relationship is between the offshore investors and the offshore asset management company, while the assets are held in Mainland China through the RQFII (i.e. the holding company). The additional layer in the holding structure could make the evaluation and analysis of the issues of the investors' rights in respect of the onshore assets slightly more complex.

There are also requests for RQFII transactions to build in certain safeguards for offshore investors, including allowing for the porting of onshore assets to another RQFII and the pledging of assets held in the onshore accounts to expedite the disposal of the onshore assets if the relevant RQFII fails to perform its obligations.

Looking Ahead

With the successful launch of the China (Shanghai) Pilot Free Trade Zone and the Shanghai-Hong Kong Stock Connect, further steps are being taken by the Chinese government to open up its financial markets. To this end, the RQFII regime looks set to continue its remarkable growth as the internationalization of RMB accelerates in the coming years, and Linklaters will continue to monitor further developments to the RQFII regime for our clients. Stay tuned!

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