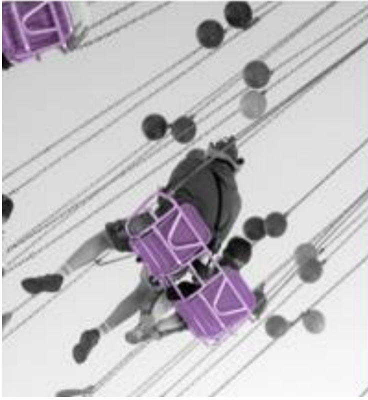

From Hong Kong Office

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QFI, Stock Connect, Bond Connect, CIBM Direct Access and Luxembourg Funds

Executive Summary

This note summarizes the regulatory practice of the Luxembourg financial regulator (CSSF) in relation to the conditions to be met in view of implementing PRC strategies in Luxembourg funds, in particular, UCITS funds, using QFI, Stock Connect, CIBM Direct Access and Bond Connect.

QFII and R-QFII now referred to generally as QFI under PRC law can be used to invest up to 100% of a UCITS' net assets in RMB securities. After the Shanghai Stock Exchange and the Shenzhen Stock Exchange, the China inter-bank bond market has been recognized as a UCITS eligible market and, as a result, RMB bonds dealt on this market may also be invested by QFI UCITS funds.

Stock Connect can be used by UCITS managers to purchase certain eligible securities dealt in Shanghai and Shenzhen provided that (i) the necessary arrangements are put in place with the depository of the UCITS to ensure a proper segregation of the assets purchased through Stock Connect, (ii) broker models limiting counterparty risk are put in place and (iii) proper disclosure is included in UCITS documents.

CIBM Direct Access can as well be used by UCITS managers in order to access RMB fixed income securities dealt on the CIBM without requiring them to make use of QFI.

Bond Connect, based on the same architecture as Stock Connect, can be used by UCITS managers in order to access RMB fixed income securities dealt on the CIBM without requiring them to make use of QFI or the CIBM Direct Access scheme, especially after the launch of R-DvP in 2018.

Finally, investments in RMB securities remain subject to specific disclosures in the fund documentation and express CSSF approval.

In November 2013, the first Luxembourg R-QFII UCITS[1] allowing for a 100% China A Shares strategy was approved by the Luxembourg *Commission de Surveillance du Secteur Financier* (the "**CSSF**").

This announcement gave a strong message that Luxembourg, as traditional fund centre and rising *Renminbi* ("**RMB**") financial centre[2] was determined to keep its first mover advantage regarding People's Republic of China ("**PRC**") strategies and was willing to encourage Asian, US and European asset managers to use the Luxembourg UCITS brand to market their PRC strategies in the EU and abroad.

Since 2013, numerous regulatory developments took place evidencing this willingness, such as the recognition of Luxembourg as a R-QFII centrethe approval of the China inter-bank bond market (the "**CIBM**") as a UCITS eligible market[3], the authorisation granted to UCITS managers to use **Stock Connect**, the **CIBM Direct Access** and **Bond Connect** with their Luxembourg UCITS platform.

As the PRC economy continues to mature and the PRC government is further opening up its capital markets, managers have seen an increasing

[1] Undertaking for collective investment in transferable securities subject to part I of the law of 17 December 2010 on undertakings for collective investment, as amended

[2] For more information on the Luxembourg RMB financial centre please refer to www.rmb-business.com/en

[3] See FAQ of the CSSF https://www.cssf.lu/fileadmin/files/Metier_OPC/FAQ/FAQ_Law_17_December_2010_020919.pdf

number of opportunities and clear interest of investors in portfolios providing them exposure to China A Shares, RMB fixed-income securities as well as financial indices or derivatives on those instruments.

The decision of Chinese authorities to further liberalise the access to China A Shares for foreign investors in March 2014[4], the push of PRC authorities to clarify and harmonise the tax treatment of gains under the QFII scheme in November 2014[5], the new QFII quota management rule in Febuary 2016[6], the allocation of R-QFII quotas to 18 R-QFII jurisdictionsbesides Hong Kong[7], the launch of Stock Connect in November 2014[8] and of Bond Connect in July 2017[9], the further relaxation of removing the lock-up period and monthly outbound remittance cap in June 2018[10], the inclusion of China A Shares in the MSCI Emerging Markets Index in June 2018[11], and the inclusion of Chinese bonds in the Bloomberg Barcalys Global Aggregate Bond Index in April 2019[12], the removal of QFII/R-QFII quota limitations and simplification of the outbound remittance process in May 2020[13], and finally the consolidation of QFII/R-QFII rules under the same legislation in September 2020 are as many examples of the fast pace at which the landscape of PRC direct investments and RMB internationalisation develop[14]. These large inflows, accompanied with a relatively stable RMB and capital markets, also permitted the reopening of the QDII, QDIE and QDLP schemes and allocation of new quotas since 2018[15].

In September 2020, rules regarding QFII and R-QFII have been consolidated under the same legislation[16]. Foreign managers are invited to apply as Qalified Foreign Investors ("**QFIs**") and existing QFII and R-QFII managers are automatically considered as QFIs and benefit from the new regime. Practically, the only difference remaining is whether a manager will raise offshore RMB to reinvest in the PRC or another convertible currency. The new QFI rules relaxed the requirements to be eligible to apply for a QFI license, expanded the type of managers eligible to apply as well as the investments permitted by a QFI manager (to include shares traded OTC on the NEEQ, currency and interest derivatives traded on the CIBM, depositary receipts, bonds repo, ABS, financial and commodity futures, options and allow for margin trading). It also streamlined and fastened the application process.

As more market players have been granted access to the PRC capital markets, the manner in which those players will offer those PRC strategies to their clients in the EU, Latin America, the Middle-East or Asia has been in the center of discussions with many asset managers willing to make the main access channels to the PRC capital markets, namely QFI, the CIBM Direct Access, Stock Connect and Bond Connect fit a Luxembourg **UCITS**, a **Part II fund**[17], a **SIF**[18], a **RAIF**[19] or a **SLP**[20].

Favourable regulatory developments in relation to those schemes in the PRC have brought them towards a greater compatibility with UCITS rules and made possible the approval of products such as UCITS funds making use to the fullest extent possible QFI, the CIBM Direct Access, Stock Connect and Bond Connect.

"*How making use of QFI with your Luxembourg structures? How making use of Stock Connect, Bond Connect or the CIBM Direct Access in*

[4] See Shanghai Stock Exchange *"Implementing Rules of the Shanghai Stock Exchange for the Trading of Securities by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors http://english.sse.com.cn/start/rules/related/qfii/c/4940399.pdf*

[5] China State Taxation Administation Caishui [2014] No.79, http://www.chinatax.gov.cn/n810341/n810755/c1305363/content.html

[6] See the announcement of State Administration of Foreign Exchange Announcement No. 1 [2016]: http://www.safe.gov.cn/en/2016/0314/1194.html

[7] United Kingdom, France, Singapore, South Korea, Germany, Qatar, Canada, Australia, Switzerland, Luxembourg, Malaysia, Chile, Hungary, UAE, Thailand, Ireland, United States and Taiwan

[8] See the announcement of the Hong Kong Stock Exchange in this respect in November 2014 https://www.hkex.com.hk/News/News-Release/2014/141117news?sc_lang=en

[9] See the announcement of the Hong Kong Stock Exchange in this respect in July 2017 https://www.hkex.com.hk/news/news-release/2017/170703news?sc_lang=en

[10] See the announcement of State Administration of Foreign Exchange Announcement No. 1 [2018]: http://www.safe.gov.cn/en/2018/0612/1455.html

[11] See MSCI: https://www.msci.com/china

[12] See Bloomberg: https://www.bloomberg.com/professional/product/indices/bloomberg-barclays-indices/#/

[13] See the press conference of State Administration of Foreign Exchange Announcement: http://www.safe.gov.cn/en/2020/0507/1677.html

[14] As of 31 Jan 2020, the PRC authorities had issued QFII quotas for about USD [111.9] billion and R-QFII quotas for approximately USD [99.7] billion, according to SAFE.

[15] See SAFE press release on 11 April 2018 http://www.safe.gov.cn/en/2018/0605/1434.html, and 24 April 2018 http://www.safe.gov.cn/en/2018/0605/1435.html,

[16] See the No. 176 Order of China Securities Regulatory Commission http://www.csrc.gov.cn/pub/zjhpublic/zjh/202009/t20200925_383650.htm

[17] Undertaking for collective investment subject to part II of the law of 17 December 2010 on undertakings for collective investment, as amended

[18] Specialised investment fund subject to the law of 13 February 2007 on specialised investment funds, as amended (the "**SIF Law**")

[19] Reserved alternative investment funds subject to the law of 23 July 2016 on reserved alternative investment funds, as amended (the "**RAIF Law**")

[20] The special limited partnership subject to the law of 10 August 1915 on commercial companies ("**1915 Law**")

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Luxembourg structures? What are the main questions to have in mind when considering such a project? And what will be next?" are questions which we would like to touch on in this note.

How to use QFI with a Luxembourg fund?

Since 2002, the QFII scheme[21] permits non-PRC asset managers (i) to obtain the authorisation to make direct investments in the PRC capital markets with monies raised outside the PRC and (ii) to apply for a quota within which they can convert monies raised outside the PRC, *i.e.* EUR, USD, etc., into RMB in order to perform those direct investments.

QFII rules have been amended several times by the PRC authorities since 2002. The amendments in 2012[22], 2016[23], 2018[24] and finally 2020[25], facilitated the access to the PRC capital markets by, in particular, lowering the eligibility criteria to be met to apply for a license, broadening the scope of eligible applicants, clarifying investment restrictions and the scope of their permitted investments, and, most importantly, adding flexibility to the rules applicable to remittances and repatriations of monies in and out of the PRC.

Before 2020, the main limitations for the use of QFII quotas with a Luxembourg fund were relating to this last aspect.

Foreign exchange controls practically limited the ability of the QFII manager to repatriate monies from the PRC after investment thereof. This was due in particular to (i) the existence of a lock-up period during which repatriation of monies from the PRC simply could not take place, (ii) the requirement for administrative approval for repatriation of monies, after such a lock-up, and (iii) ceilings setting maximum amounts which could be repatriated over a given period of time.

The amendment of the QFII rules[26] regarding open-end China funds, *i.e.* publicly offered open-end investment funds set up outside the PRC and investing at least 70%[27] of their assets in the PRC capital markets (hereinafter "**Open-end China Funds**"), allowing them to benefit from a shorter lock-up period (as low as three months), the ability to repatriate on a daily basis without prior approval from Chinese authorities and within lowered limits (20% of the QFII quota allocated to the relevant fund in aggregate on a monthly basis), made possible a wider use of QFII quotas with Luxembourg structures. The later relaxation on QFII rules in 2018[28] waiving the lock-up period as well as the approval and limits of outward remittance have further permitted the use of QFII with Luxemburg structures.

Specialised investment funds ("**SIFs**"), which are flexible regulated funds which may be distributed to well-informed investors[29], have been structured by managers in order to qualify as QFII Open-end China Funds, benefit from the flexibility described above and invest a substantial portion of their assets in the PRC capital markets.

The non-regulated version of the SIF, the **RAIF** has also been used together with QFI to structure China access products.

Regarding **Part II funds**, which are domestic retail funds which do not benefit from the UCITS passport[30], possibilities to structure them as Open-end China Funds and implement a similar investment strategy are the same as for SIFs.

For **UCITS**, QFII quotas were used for direct investments or indirect investments in China A Shares through access products such as participatory-notes ("**P-Notes**").

However, considering the limits of the QFII rules before the 2012 and 2016 amendments and uncertainties as to the liquidity of the China A Shares market, the Luxembourg regulator, the CSSF, took the view that a limitation on those investments should be respected and set such a limit at 35% of the assets of the UCITS (or sub-fund

[21] Temporary Regulation on Domestic Investment by Qualified Foreign Institutional Investor dated 2002, replaced by the Regulation on Domestic Investment by Qualified Foreign Institutional Investor dated August 24, 2006 ; the Administration on Domestic Securities Investment by Qualified Foreign Domestic Institutional Investors Regulation dated August 24, 2006; the Notice of Regulations Regarding the Implementation of the Administration on Domestic Securities Investment by Qualified Foreign Domestic Institutional Investors Regulation dated August 24, 2006

[22] The Provisions on Foreign-Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors issued by the State Administration for Foreign Exchange in December 2012

[23] Refer to 8

[24] Refer to 12

[25] Refer to 16

[26] Refer to 8

[27] It has been reported in November 2013 that SAFE did remove the requirement to invest at least 70% of its assets in the PRC capital markets from the definition of Open-end China Fund under QFII rules

[28] Refer to 8

[29] Refer to Circular CSSF 07/283: https://www.cssf.lu/en/documentation/regulations/circulars/info/article/1483/

[30] Part II funds and SIFs may however qualify as alternative investment funds subject to the law of 13 July 2013 on alternative investment fund managers (AIFM) and their AIFM may benefit from a passport allowing them to sell those funds across the EU to professional investors, subject to the provisions of the directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

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thereof)[31].

Considering the definition of an Open-end China Fund under the QFII rules, such a 35% limit to investments in China A Shares (or other PRC assets) was at that time preventing a UCITS from qualifying as Open-end China Fund and benefitting from the flexibility provided thereby.

The Luxembourg regulator was approached at the time and indicated that it could consider lifting its 35% limit provided that the necessary guarantees be provided by the UCITS regarding, in particular, the liquidity of the portfolio. The fact the PRC authorities would be adding flexibility to the definition of Open-end China Fund under the QFII rules by formally removing the 70% PRC investments requirement also facilitated the construction of a portfolio providing those guarantees.

Those developments further opened the door to the possibility to structure QFII UCITS investing in *e.g.* China A Shares to up to 70% in order to qualify as Open-end China Fund and liquid assets (in RMB or other currencies) for the remaining part of the portfolio to have sufficient liquidity as to ensure that the overall liquidity of the portfolio of the UCITS be guaranteed.

In February 2016 [32] the SAFE issued an announcement by which a number of QFII rules were amended as to improve the accessibility to the PRC capital account and promote cross-border investments. Among the changes made further to this announcement, (i) holders of QFII licences will be awarded a *base quota* of between USD 200 million and USD 5 billion depending on their assets under management, (ii) funds are no longer required to make their investments within 6 months of receiving their quota, and (iii) Open-end China Funds will be able to redeem their investments on a daily, rather than weekly, basis.

This move, which was motivated to a certain extent by the willingness to permit the inclusion of China A Shares in the MSCI EM indices, goes in the direction of a greater convergence between QFII and R-QFII and therefore greater compatibility of QFII with UCITS.

On June 2018[33], the SAFE and the PBoC issued new QFII rules, as well as new R-QFII rules, cancelling the 20% limits on outward remittance for QFII, removing the lock-up period on repatriation of investment principal for QFII (and R-QFII for funds not qualifying as Open-ended China Funds, which were not subject to lock-up) and allowed QFII and R-QFII to make use of onshore FX derivative instruments.

With the China State Council's approval in September 2019[34], the SAFE decided to lift the investment quota restrictions for QFII to deepen the reform and serve the different parttern of comprehensive opening up of China's financial market.

In May and September 2020, the relevant PRC authorities released detailed measures to consolitdate QFII and R-QFII under the same legisltation and remove most of the other restrictions still applicable before then[35].

A QFII manager would, further to the September 2020 amendments, benefit from the new QFI rules and as a principle be able to use its license with a UCITS.

Launched in December 2011 [36] and amended several times thereafter [37], the R-QFII scheme differs in its philosophy and purpose from the QFII scheme, insofar it is not designed to allow foreign managers access the PRC capital markets, but rather to encourage the re-investment of RMB deposits outside the PRC, originally in Hong Kong in the PRC capital markets.

Consistent with this approach, the first batch of R-QFII licenses and quotas were made available by the CSRC and the SAFE to Hong Kong based managers regulated by the Hong Kong SFC.

Those licenses and "Hong Kong" R-QFII quotas[38] were delivered first to subsidiaries of Chinese fund management companies and securities companies, then extended to other SFC regulated asset managers.

Provided that the product fulfills the conditions to

[31] Please note that such a limitation was based on an administrative practice of the Luxembourg regulator
[32] Refer to 12
[33] Refer to 12
[34] Refer to 15
[35] Refer to 13
[36] Refer to PBOC [2011] No.321: http://www.pbc.gov.cn/en/3688253/3689012/3709797/index.html; SAFE Circular : http://www.safe.gov.cn/en/2012/0215/733.html
[37] The Notice of the People's Bank of China on the Relevant Matters concerning the Implementation of the Pilot Measures for Domestic Securities Investment Made by the RMB Qualified Foreign Institutional Investors, issued by the PBOC and effective from May 2, 2013; The Pilot Scheme for Domestic Securities Investment through Renminbi Qualified Foreign Institutional Investors, issued by the CSRC, the PBOC and the SAFE and effective from March 1, 2013; The Implementation Rules for the Pilot Scheme for Domestic Securities Investment through Renminbi Qualified Foreign Institutional Investors, issued by the CSRC and effective from March 6, 2013; The Circular on Issues Related to the Pilot Scheme for Domestic Securities Investment through Renminbi Qualified Foreign Institutional Investors, Huifa 2013 No. 42 issued by SAFE and effective from March 21, 2013
[38] Insofar those quotas are allocated to Hong Kong based managers to raise offshore RMB from the public in the Hong Kong S.A.R.

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qualify as open-end fund under R-QFII rules[39], (i) no lock-up period applies, (ii) remittances and repatriations may take place on a daily basis within the limits of the quota, (iii) without prior authorisation of Chinese authorities, and (iv) without limits applying to the aggregate amount which can be repatriated each month.

Upon launching of the scheme, however, it was only possible to use those “Hong Kong” R-QFII quotas with Hong Kong domiciled funds. The breakthrough for UCITS managers came in March 2013[40] with the recast of R-QFII rules.

Further to those amendments, in addition to the Hong Kong subsidiaries of Chinese asset management companies and securities firms, Hong Kong subsidiaries of Chinese commercial banks and insurance companies, or other financial institutions regulated by the SFC (with at least a *Type 9 asset manager* license) were recognized as eligible to apply for a R-QFII license.

In addition, the scope of eligible assets in which those R-QFII managers could invest had been widened (*see below*). And most importantly, the explicit requirement for such R-QFII managers to raise RMB in Hong Kong had been removed.

The fact that the first batch of R-QFII products were domiciled in Hong Kong is consistent with the purpose of the R-QFII scheme, which was designed to allow managers to raise RMB held by the public in Hong Kong only.

This restriction as to where RMB had to be raised disappeared in 2013 to allow managers to raise RMB, not only in Hong Kong, but also in other rising RMB centres such as Singapore, London, Paris, Frankfurt or Luxembourg, however, still using “Hong Kong” R-QFII quotas.

The key development for UCITS managers took place in November 2013 when it was clarified that Hong Kong based managers could use their “Hong Kong” R-QFII quotas[41] with a Luxembourg-based UCITS structure.

This gave Hong Kong managers a much broader perspective in terms of distribution of their R-QFII products, an access to the UCITS passport in the EU as well as the benefit of wide recognition of UCITS outside the EU, thus allowing them to reach a much a larger number of investors willing to gain exposure to the PRC capital markets and benefit from their unique expertise.

This possibility to use “Hong Kong” R-QFII quotas with Luxembourg funds has been extensively used since the end of 2013 and not long after, the R-QFII status itself has been granted by PRC authorities to financial centres other than Hong Kong including Luxembourg which was officially recognized as an R-QFII centre and received an overall R-QFII quota of RMB 50bn[42].

As we anticipated in April 2014, the same flexibility regarding the allocation of the R-QFII quota to a Luxembourg fund applied in relation to R-QFII quota linked to other R-QFII centres such as London, Paris, South-Korea or Singapore where R-QFII managers have used their local R-QFII quotas with Luxembourg-based funds. This obviously is also the case for “Luxembourg” R-QFII quotas used in Luxembourg funds.

The additional flexibility of the R-QFII rules removed most of the obstacles which were traditionally preventing UCITS managers from implementing 100% PRC strategies under the QFII rules. The possibility to use R-QFII quotas in a Luxembourg UCITS was therefore a key development.

The total R-QFII quota allocated to Hong Kong managers was fully used up for a number of years and managers were then using “Hong Kong” R-QFII quotas together with quotas available in other R-QFII centres in particular through multi-manager structures. The “Hong Kong” R-QFII quota has been substantially increased in 2017 [43] and R-QFII quotas are rather available in the majority of R-QFII centres[44].

In June 2018[45], the SAFE’s and the PBoC’s new issuance of the RQFII rules allowed RQFII to make use of the onshore FX derivative instruments, and further in 2019[46], to cancel the R-QFII quota to deepen the market open-up.

As indicated above, in May and September 2020, the relevant PRC authorities issued detailed measures to consolitdate QFII and R-QFII under the same QFI legislation and remove most of the restrictions applicable before then.

A R-QFII manager would further to the September 2020 benefit from the new QFI rules and continue being able to use its license with a UCITS. It is anticitaped that the Luxembourg regulator will

[39] Which is to be distinguished from the concept of Open-end China Fund under the QFII rules

[40] Refer to CSRC Decree No.90: http://www.csrc.gov.cn/pub/csrc_en/laws/overRule/Decrees/201303/t20130327_222793.html

[41] R-QFII quotas issued in relation to a R-QFII licensed manager based in Hong Kong

[42] This recognition took place on April 29, 2015, https://pekin.mae.lu/fr/node_21047/Luxembourg-RQFII-Quota-Granted-by-PBOC

[43] See HKMA press release: http://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170704-4.shtml

[44] Refer to 9

[45] Refer to 8

[46] Refer to 15

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going forward approve the use of a QFI license in a similar manner and under similar conditions as it was approving R-QFII UCITS in the past.

Sponsors of QFII and R-QFII funds, UCITS in particular, are currently reviewing their prospectus risk section as to take into account the consolidation of the QFII and R-QFII rules under the new QFI regime.

How to use Stock Connect with a Luxembourg fund?

Although the QFII and R-QFII (now QFI) regimes have moved towards a greater convergence over time especially the detailed measures released by the PBOC and SAFE in May and September 2020[47], among which includes the standardization and simplification of administrative requirements on outbound remittances as well as currency exchange, the use of those scheme raised in the past a number of practical challenges and the application process was considered time consuming by managers. A more plug-and-play and easy to implement solution was also deemed necessary, back then, in view of accelerating the decision of MSCI to include China A Shares in their MSCI EM indices.

A rather innovative solution consisting in an inter connection between the Hong Kong Stock Exchange ("**HKEx**") and Shanghai Stock Exchange ("**SSE**"), baptised **Stock Connect**, was engineered by Hong Kong and PRC authorities and launched in November 2014.

Stock Connect is a mutual market access through which investors, and asset managers, could deal in selected securities listed on PRC stock exchange (SSE and in 2016 the Shenzhen Stock Exchange, "**SZSE**") through a platform organized by the HKEx using sub-custodian and brokers based in Hong Kong[48].

Practically, Stock Connect allows asset managers to increase their China A Shares exposure via an alternative channel without having or using their own QFI license. Stock Connect also allowed managers without a QFI licence to increase their China A Shares direct exposure without having to rely on more expensive China A Shares access products.

Applications to use Stock Connect in a UCITS environment were filed with the CSSF in the end of 2014 and the CSSF communicated its positive decision to the industry through the Association for the Luxembourg Fund Industry (ALFI) [49] in December 2014.

A number of **key questions regarding Stock Connect** were raised by the Luxembourg regulator and Luxembourg global custodians, which had to be positively answered before the first UCITS could effectively use Stock Connect[50].

Those questions focused on (i) the holding and custody structure of China A Shares purchased through the Stock Connect platform[51], (ii) the role of the Hong Kong clearing house ("**HKSCC**"), the Hong Kong broker, and the PRC clearing house (ChinaClear) in the process; (iii) whether any of these entities would have a right of recourse in case of default of a market participant in Hong Kong or the PRC, (iv) whether additional risks, in particular, counterparty risks, could result from the specificities of Stock Connect (such as pre-trade delivery obligations and the applicable settlement cycle)[52] and (v) the manner in which the recourse to this mechanism and risks in relation thereto would be communicated to investors and reflected in the UCITS documentation.

When submitting an application to use Stock Connect with their UCITS, UCITS sponsors and global custodians are expected to provide the regulator supporting evidence of the proper segregation of the assets of the UCITS throughout the chain of custody and that the settlement cycle, in particular, in case of sale of securities by the UCITS through Stock Connect, will not create an additional counterparty risk for the UCITS.

Specific disclosures have to be included in prospectuses and KIIDs to properly describe risks linked to Stock Connect to investors.

It is worth mentioning that since the launch of the scheme, the Hong Kong and PRC authorities have taken into account a number of questions raised by the industry regarding the compatibility of Stock

[47] Refer to CSRC: http://www.csrc.gov.cn/pub/csrc_en/newsfacts/PressConference/201901/t20190131_350613.html

[48] It has to be noted that Stock Connect also gives access to Hong Kong listed shares to PRC based investors under similar conditions, but for the purpose of this note which covers China A Shares investments, only the Northbound Train will be considered.

[49] See ALFI press release: https://www.alfi.lu/en-gb/article/first-luxembourg-ucits-receives-authorisation-to-u

[50] Please find the press release of Investec Asset Management www.investecassetmanagement.com/document/pdf/Investec-Asset-Management-announces-use-of-Stock-Connect-in-UCITS-fund-range-Press-Release.pdf

[51] In this respect, it has to be noted that the system put in place for the Northbound Train by which shares are held on a nominee account of the HKSCC, differs substantially from QFIcustody models under which the same shares would be held by a PRC custodian appointed by the global custodian of the fund, the fund itself and/or the licensed manager. This custody structure raised a number of regulatory concerns that had to be addressed.

[52] Which potentially exposes the fund to a counterparty risk over the broker to which shares would have been delivered without receiving simultaneously the cash counterparty

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Connect and the evolution thereof with UCITS, going forward.

Various Stock Connect models have been elaborated. One model is the "**integrated model**" whereby the local sub-custodian of the UCITS and the broker are part of the same group, which made possible for the broker to confirm the availability of the securities without transfer thereof and a settlement in the books of the local sub-custodian with the guarantee that the securities will only be delivered once the payment of the consideration will be made (hence the name "*synthetic DvP*").

Another model, prevailing today, is the "**multi-broker model**" or "**SPSA model**" whereby, in addition to a local sub-custodian, not only one but up to 20 brokers can be appointed. This model was made possible after the creation of the special segregated accounts ("**SPSA**") mechanism by Hong Kong authorities in March 2015[53] by which local sub-custodians were allowed to open an SPSA, directly with the HKSCC, with each investor identified by a particular ID number, allowing to confirm that the securities are available for delivery without having to pre-deliver the securities to one particular broker. In the context of the classic SPSA "multi-broker model", a risk may result from the settlement cycle as the cash consideration for the sale of securities by a broker for one of its client will be credited to the client only a few hours (see below) after the delivery of the securities.

It is worthwhile noting that certain service providers were offering Stock Connect solutions allowing to make use of multiple brokers, typically three to five, with the same architecture as the above "integrated model" and a "synthetic DvP", permitting the UCITS not to bear any counterparty risk. Those models were variations of the SPSA model.

In April 2016, the HKEx implemented a new system by which RMB transactions through Stock Connect can be settled intra-day, with a gap of only a few of hours[54].

The industry looked into this time gap and based on the fact such gap would not be different from the one applicable to the trading of any other Hong Kong listed securities, it was deemed acceptable in a UCITS environment with the proper disclosure included in the UCITS documents.

In this respect, upon the extension of the Stock Connect Scheme to eligible shares dealt on the Shenzhen Stock Exchange, the ALFI reminded the conditions to make use of the scheme in particular the preference for "broker models limiting counterparty risk"[55], departing from the *synthetic DvP* requirement and leaving room for SPSA models to be approved as well as variations thereof.

In November 2017, the HKEx[56] introduced real time DvP for Stock Connect dealings, making possible the use of the SPSA model without need for external synthetic DvP or particular concern over the time gap referred to above.

The integrated model still remained for a while the preferred model as a result of the relative simplicity of the mechanism allowing to annihilate the counterparty risks, although the possibility to trade only with one designated broker raised questions in relation to the capability of this broker to deal with the volume required as well as best execution requirements.

Since November 2017 and in anticipation of the MSCI EM inclusion multi-broker or SPSA models became more popular among UCITS sponsors.

The use of Stock Connect by funds other than UCITS such as Part II funds or SIFs would raise similar questions and would require similar solutions to be put in place.

How to use CIBM Direct Access with a Luxembourg fund?

The CIBM Direct Access is another access channel to the CIBM, opened to foreign managers in May 2016[57] further to the implementing rules issued by the People's Bank of China (the "**PBoC**") Shanghai Head Office and the SAFE.

Contrary to existing license and quotas systems, the CIBM Direct Access allows manager to invest in RMB fixed income securities dealt on CIBM without particular license or individual quota.

As further described below, at the time of the introduction of the CIBM Direct Access, RMB fixed income securities dealt on the CIBM were already accessible through QFI, thus requiring a license and a quota.

[53] See the circular of the HKSCC here: www.hkex.com.hk/eng/market/partcir/hkscc/2015/Documents/ce078_2015.pdf

[54] See the announcement of the HKSCC here: www.hkex.com.hk/eng/market/partcir/hkscc/2015/Documents/CE_244_2015.pdf

[55] See the ALFI press release: https://www.alfi.lu/en-gb/article/launch-of-shenzhen-hong-kong-stock-connect-new-opp

[56] See the HKEx announcement in this respect, https://www.hkex.com.hk/News/News-Release/2017/1711062news?sc_lang=en

[57] Refer to PBOC Notice No.2 [2016]: http://www.pbc.gov.cn/en/3688253/3689009/3788480/3780480/index.html

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In the move to further liberalize the access to the PRC capital market and in particular the bond and credit market, PRC authorities extended the CIBM Direct Access regime, which at first was only available to selected investors (mostly sovereign investors) to public and private fund management companies.

UCITS managers could therefore consider accessing CIBM dealt RMB fixed income securities through this new platform.

Local requirements are similar to those applicable under R-QFII and questions raised by the Luxembourg regulator to authorize UCITS managers to access the CIBM with their UCITS were inspired by those raised in relation to R-QFII. Among local requirements, managers willing to access the CIBM through this new platform are required to appoint a bonds settlement agent ("**Bonds Settlement Agent**"), which applies on behalf of the relevant manager to the PBoC for the account opening authorisation and having access to the scheme. In the application, the volume to be invested through the CIBM Direct Access as well as the investment horizon need to be disclosed to the PBoC among other things.

Once the PBoC has granted its approval, the relevant manager may open its account with the books of its PRC custodian (often the same entity as the Bonds Settlement Agent) and start trading on the CIBM through the CIBM Direct Access.

It is worthwhile noting that the account opening structure is following similar rules as the R-QFII and a number of aspects regarding the functioning of the CIBM Direct Access have been inspired by R-QFII. Those aspects have to be described and explained in the application to be filed with the CSSF when the UCITS manager is willing to use the CIBM Direct Access with its UCITS.

The prospectus as well as the KIIDs of the relevant UCITS will have to be completed as to indicate that the use of CIBM Direct Access is contemplated and particular risks must be included in relation thereto.

For QFI managers willing to use the scheme, it has been confirmed that they may do so and apply for a CIBM Direct Access with the PBoC through their Bond Settlement Agent. It is worthwhile noting, that securities purchased through QFI and CIBM Direct Access were as a principle not be considered fungible and shall therefore be held in separate accounts, managers wiling to switch to the CIBM Direct Access had to sell their positions under QFI in order to purchase those securities through the CIBM Direct Access.

In October 2019[58], in order to further facilitate investments by foreign institutions, PBoC and SAFE have developed rules allowing non-trading transfers between bonds invested via CIBM Direct Access and bonds invested through the then QFII or RQFII by the same foreign investor, also allowing direct transfers between corresponding capital accounts.

How to use Bond Connect with a Luxembourg fund?

As from the launch of the Stock Connect in November 2014 it was clear that it would sooner or later be replicated in the RMB fixed income sphere with the creation of a "Bond Connect" allowing foreign investors to access the CIBM without QFII or R-QFII license or quotas.

The anticipation was that to the extent such an access to the CIBM would follow similar mechanisms as for Stock Connect (regarding in particular the segregation, counterparty risks, etc.) it would be relatively straightforward to have approved in a UCITS environment.

Bond Connect was launched in July 2017 as an access platform organized by the Hong Kong Monetary Authority ("**HKMA**") and allowing participating institutions in Hong Kong to trade CIBM dealt RMB fixed income securities directly from Hong Kong.

In a nutshell and looking at Bond Connect through the prism of Stock Connect, one could note that the architecture of Bond Connect and of Stock Connect were rather similar with the HKMA's central money market unit ("**CMU**") platform having the same function as the HKEx, the Bond Connect Company Limited ("**BCCL**")[59] taking a similar role as the HKSCC, and RMB fixed income accessed on the CIBM through PRC participating dealers and settled through the China Central Depository and Clearing ("**CCDC**") and the Shanghai Clearing House ("**SCH**").

In order to participate, investors must appoint a Hong Kong custodian which qualifies as a Bond Connect participant registered as such in the CMU and obtain a proper ID from the China Foreign Exchange Trading System ("**CFETS**"). Investors can then use online trading platforms[60] to deal with PRC based market makers and buy/sell RMB fixed income securities onshore.

[58] Refer to SAFE Circular http://www.safe.gov.cn/en/2019/1030/1583.html

[59] BCCL is a joint venture created by the Hong Kong Stock Exchange and the China Foreign Exchange Trading System (CFETS).

[60] Currently TradeWeb and Bloomberg, others to become available in the future

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Reviews of information available regarding Bond Connect prior to its launch were extremely encouraging for UCITS managers insofar most hurdles they faced to use Stock Connect seem to have been addressed, in particular, since the assumption was that R-DvP would be available for dealings through Bond Connect on day one.
On the day of the launch of Bond Connect however R-DvP was only available for bonds settled through the SCH and not those settled through the CCDC, representing most of the CIBM dealt fixed income securities.

The absence of R-DvP restarted the discussion on counterparty risk, similar to the discussion on Stock Connect, as without such a R-DvP an onshore market maker would only give instruction to CCDC to deliver the securities to the buyer thereof after having received the cash consideration for such a trade.

A UCITS manager willing to purchase RMB fixed income securities for the UCITS would therefore be required to pay out of the UCITS' assets the cash consideration and make the UCITS take full counterparty risk over the market infrastructure and the market maker until the CCDC would deliver the relevant securities, upon instruction of the onshore market maker.

Industry players were reluctant to create and market an integrated model solution according to which an onshore market maker part of the same group as the sub-custodian in Hong Kong would be taking the risk of requesting CCDC to deliver the securities to the UCITS as the relevant cash consideration would be transferred from the UCITS account only then, again, creating a DvP mechanism outside the market, or synthetic DvP.

Taking a very pragmatic approach, the CSSF confirmed that it would be possible to have Bond Connect included in the UCITS documentation, on a case by case basis. If an integrated model (or another ad hoc system covering entirely the counterparty risk for the UCITS, such as guaranties or other mechanisms) is put in place by the manager, the CSSF may approve to have Bond Connect included in the UCITS documentation and used immediately.

If no such model /system is put in place, then the CSSF may still accept to have Bond Connect included in the UCITS documentation however subject to the condition that it will not be used before R-DvP is made available across the board in Bond Connect (and provided further that CIBM access is not essential but only optional to the strategy or that other ways are available to the manager to access the CIBM).

UCITS managers have started including Bond Connect options and disclosures in their UCITS prospectuses, subject to the conditions set forth by the CSSF, as described above before R-DvP makes available for CIBM dealings settled through the CCDC.

In 24 Augest 2018[61], R-DvP settlement has been fully implemented in Bonc Connect and thus settlement risk is contained.

Eligible assets under QFI, Stock Connect, CIBM Direct Access, Bond Connect and Luxembourg rules, how to reconcile the requirements?

As far as **QFII** is concerned, since 2012, the rules allow for investments in a wide range of securities such as *e.g.* China A Shares, indices on China A Shares, RMB debt instruments or other fixed-income securities listed in Shanghai or Shenzhen or traded over-the-counter ("**OTC**") on the CIBM, subject still to certain limitations[62].

A QFII manager may use its QFII licence with a **Part II fund**, a **SIF,** a **RAIF** or a **SLP** to implement a PRC equity, fixed-income or balanced strategy. It is also possible for the same manager, subject to the limitations above, to structure a **UCITS** portfolio which would to a large extent invest in those securities, subject to their eligibility in the light of UCITS rules.

In the past already, QFII managers have structured Luxembourg funds (primarily SIFs) so that they would qualify as Open-end China Funds (and therefore benefit from the flexibility of this particular type of QFII funds) and therefore invest a substantial portion of their assets in the PRC capital markets, keeping the remaining portion of the portfolio invested in liquid assets as to ensure the overall liquidity of their portfolio.

As far as **R-QFII** is concerned, should the R-QFII manager wish to raise RMB from the public, then such a manager would be using either a **Part II fund** or a **UCITS**. Part II funds will not raise particular questions from a Luxembourg investment eligibility standpoint (only the R-QFII eligibility requirements would have to be reviewed),

[61] Refer to HKMA press release : https://www.hkma.gov.hk/eng/news-and-media/press-releases/2018/08/20180824-4/

[62] Circular on the Relevant Issues of QFIIs Investing in China Interbank Bond Market issued by the People's Bank of China, Ying Fa [2013] No.69 ; Please note that on February 24, 2016 the People's Bank of China (PBoC) made an announcement suggesting that investments in bonds dealt on the CIBM would be open to foreign institutional investors without quota see: www.pbc.gov.cn/goutongjiaoliu/113456/113469/3021203/index.html

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however, they do not benefit from the UCITS passport[63]. UCITS on the other hand benefit from such a passport but their investments have to comply with UCITS eligibility requirements. From an investment eligibility standpoint, R-QFII managers willing to make use of UCITS will thus have to combine UCITS requirements and R-QFII requirements.

R-QFII rules originally restricted R-QFII managers, which could only invest in portfolios comprising 80% fixed-income and 20% equity securities[64], extended thereafter to selected PRC financial indices to setup exchange traded funds (**ETFs**)[65]. Since 2013, R-QFII managers may invest with much more flexibility in a wider range of RMB equity and fixed income securities listed in Shanghai or Shenzhen, or traded OTC on the inter-bank bond market, or in derivatives on those instruments, to a certain extent and subject to limitations from a PRC perspective.

PBoC and SAFE have jointly issued the consulation paper[66] on 13 December 2019 with regard to the further relaxation of the QFII and R-QFII channel, among which includes derivatives trading for headging purposes. The detailed measures have been issued in May 2020 providing for more flexibility regarding outbound remittance for both QFII and R-QFII.

The new QFI rules of September 2020 expanded the investments permitted by a QFI manager to include shares traded OTC on the NEEQ, currency and interest derivatives traded on the CIBM, depositary receipts, bonds repo, ABS, financial and commodity futures, options and allowed margin trading.

Furthermore, on October 15, 2021, the CSRC released the *Announcement on Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors Participating in Financial Derivative Trading* ([2021]No.24) allowing QFIs to trade commodity futures contracts, commodity options, and stock index options, effective from November 1, 2021.

The UCITS eligibility of China A Shares or RMB debt instruments listed on the Shanghai or Shenzhen stock exchanges does generally not raise particular issues since those stock exchanges are recognised as regulated markets under the UCITS rules. Financial indices and derivatives on those securities are also acceptable insofar such indices and derivatives fulfill the eligibility criteria of UCITS regulations, as any other indices or derivatives.

The recognition of the UCITS eligibility of the CIBM was necessary for asset managers and their investors to fully benefit from the exposure to PRC fixed income securities, most of which are traded OTC or the CIBM.

UCITS requirements relate in particular to the regulated character of the CIBM, the fact it is organised and supervised, transparent, operates regularly, with an order matching system and open to the public[67]. As anticipated, the CIBM was recognised as a UCITS eligible market and UCITS sponsors, after having made their own due diligence on the CIBM to support their own assessment of the eligibility of this market, may invest in RMB fixed income securities dealt on the CIBM up to 100% of their portfolio (using R-QFII).

RMB fixed income securities dealt on the CIBM may therefore by accessed through QFI, the CIBM Direct Access and Bond Connect.

As far as **Stock Connect** is concerned, the Northbound Train gives the access to China A Shares all the constituent stocks of the SSE 180 Index and the SSE 380 index in Shanghai as well as SZSE Component & SZSE Small/Mid Cap Innovation indexes in Shenzhen, as well as certain dual listed securities[68].

The trading of Stock Connect eligible securities is generally open to all Hong Kong and overseas investors including institutional and individual investors. Since February 2021, securities of the Shanghai STAR market and the Shenzhen ChiNext have been included in the scope of Stock Connect eligible securities, however, for institutional professional investors only. Although the UCITS eligibility of these markets has to be ascertained on a case by case basis, which have not yet been officially recognized by the CSSF as UCITS eligible markets through their annual report, we noted that a number of UCITS able to use Stock Connect have included the relevant risk disclosures regarding those two markets.

On 4 July 2022, the SFC and the CSRC issued a joint announcement on the inclusion of Exchange Traded Funds (ETFs) in the list of eligible assets for Stock Connect. Since then, PRC and Hong Kong investors have been able to trade eligible ETFs listed on each other's exchanges through local securities houses using Stock Connect. 83

[63] They can however benefit from the AIFMD passport through their AIFMD
[64] Also known as R-QFII v1.0
[65] Also known as R-QFII v2.0
[66] Refer to SAFE notice: http://m.safe.gov.cn/safe/2019/1213/14887.html

[67] Article 41 (1) (b) of the law of 17 December 2010 on undertakings for collective investment, as amended
[68] Please refer to the FAQ regarding Stock Connect on the HKEX website: https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/FAQ/FAQ_En.pdf

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ETFs listed on the SSE and SZSE have been included in the Northbound Stock Connect route. These include in particular ETFs tracking the CSI300 and ChiNext indices. Southbound, 4 ETFs listed on the HKEx have been added to the Southbound Stock Connect route and can be traded by PRC investors[69].

As far as **Bond Connect** is concerned, the Northbond route gives the access to all securities traded in CIBM, either through primary subscription or secondary trading, with the possible access extension in the future of bond repo, bond lending, bond futures as well as IRS, FRA, etc.[70].

Those securities and instruments are as a principle eligible for UCITS investments and *a fortiori* for investments by Part II funds, SIFs, RAIFs or SLPs.

As indicated above, those securities are also eligible in principle and acceptable for investment by Luxembourg UCITS provided that the conditions regarding the trading and holding thereof through the HKEx platform, the segregation throughout the chain of custody and the dealing model (integrated, SPSA, variations thereof, with R-DvP) are ascertained and proper disclosure in the UCITS documents included.

As of the date of this note, all China markets access channels are therefore available to UCITS managers which will have to take into account the possibility to use one or the other scheme, the ongoing costs and complexity in relation thereto and the securities eligible under each particular scheme in order to select which one they will use.

Managers used to reserve their quota-based China access channels (such as the former QFII and R-QFII) for securities ineligible under Stock Connect, the CIBM Direct Access and Bond Connect, *i.e.* equity securities not part of the various indices eligible under Stock Connect and listed RMB fixed income securities not dealt on the CIBM. Now that there are no quota requirements, the choice is whether the relevant manager is satisfied with the range of securities it can access with Stock Connect or Bond Connect and, if not whether it would like to use QFI, possibly CIBM Direct, to complement these plug and play connect schemes.

What are the other aspects to consider when setting up the above funds?

Besides the eligibility of the assets under the QFI,Stock Connect, Bond Connect, the CIBM Direct Access and the relevant Luxembourg rules (applicable to UCITS, Part II and SIFs) other aspects need to be carefully considered and, as one may expect, the Luxembourg regulator raises questions and requests confirmations in relation thereto during the approval process.

Among those aspects are (i) the eligibility of the PRC securities to be invested in as well as the markets on which those securities are traded (relevant in particular for UCITS), (ii) the overall liquidity of the portfolio of the fund, which needs to allow the manager to perform redemption requests as provided for in the fund documents (practically daily for UCITS), (iii) risks associated with investments in those securities in particular tax risks and risks relating to the loss by the QFI manager of its license, (iv) PRC custody aspects and guarantees as to the segregation of the assets of the fund from other assets held by the PRC custodian and as to the fact those assets are not exposed in case of bankruptcy of the PRC custodian, the QFI manager, the PRC broker, etc. (v) risk management aspects and guarantees as to the fact that the latter has been adapted as to encompass specific risks linked to investments in PRC securities, (vi) experience of the investment manager in relation to investments in RMB fixed income securities dealt on the CIBM (if contemplated), (vii) confirmations regarding the Stock Connect or Bond Connect model in place (if contemplated), etc.[71].

Practically, the timing of the approval process as well as the sequence of approvals to be granted by the Luxembourg and Chinese regulators for the setting up of the structure and the allocation of the quotas are other aspects which require particular attention.

Conclusion and perspectives

Managers benefitting from QFI licenses, and now from Stock Connect, Bond Connect and the CIBM Direct Access, should feel encouraged to use Luxembourg funds to implement PRC strategies and raise money in the EU, the Middle-East, Latin America and Asia.

Few limitations still apply as the PRC capital markets keep opening up, the RMB becomes more international, the QFII and R-QFII regimes have converged and other schemes such as Stock Connect, Bond Connect and the CIBM Direct Access are increasingly used by market players.

The UCITS passport is available to those managers, as well as, under certain conditions the

[69] Please refer to https://www.hkex.com.hk/News/News-Release/2022/220628news?sc_lang=en

[70] Please refer to the PBOC Q&A: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3331208/index.html

[71] This list is not exhaustive and results from our various discussions with the CSSF in relation to the implementation of

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alternative investment fund managers directive passport (for Part II funds and SIFs), allowing a fast track distribution of those products across Europe.

The door has been further opened with the approval in Luxembourg of the first R-QFII UCITS in 2013 and since then a way has been paved with the approval of the CIBM as a UCITS eligible market, the authorization of the use of Stock Connect, the CIBM Direct Access and Bond Connect by UCITS. The consolidation of QFII and R-QFII rules undera same legislation will further facilitate the use of fthese schemes with Luxembourg funds.

Luxembourg has positioned itself to fully take advantage of this as well as future developments. It is actively involved in those developments, and aims at continuing giving managers the ability of using its robust and recognised vehicles to structure and distribute those PRC strategies on a global basis.

Stephane Karolczuk, is a Partner of Arendt & Medernach S.A. and Head of Arendt & Medernach's Hong Kong office, registered in Hong Kong as foreign lawyer (Luxembourg) since the establishment of the office in 2009.

Contact details
Stephane Karolczuk
Investment Management
Partner, Arendt & Medernach S.A.
Head of Hong Kong Office
Tel: +852 28 01 58 08
stephane.karolczuk@arendt.com

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