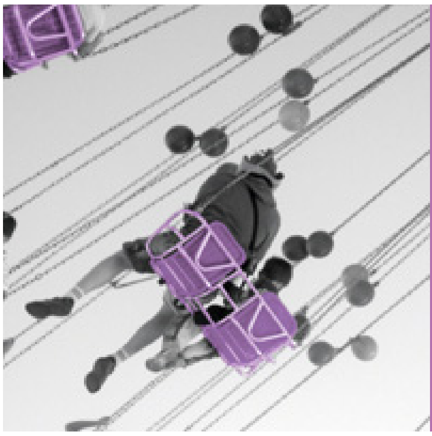

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From our Hong Kong Office

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QFII, R-QFII, Stock Connect 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 QFII, R-QFII and Stock Connect.

QFII can in principle be used to invest up to 35% of a UCITS' net assets in RMB securities. This limit set by the CSSF results from restrictions which apply to repatriations under QFII rules. UCITS open ended China funds willing to invest over 35% of their net assets in RMB securities have to provide the CSSF with additional information regarding the liquidity of their portfolio.

R-QFII can in principle 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 R-QFII UCITS funds. The recent recognition of Luxembourg as R-QFII centre opens new possibilities for Luxembourg UCITS.

Stock Connect may in principle be used by UCITS managers to purchase China A Shares dealt in Shanghai provided that (i) the necessary arrangements are put in place with the global custodian of the UCITS to ensure a proper segregation of the assets purchased through Stock Connect, (ii) no counterparty risk created as a result of pre-trade checking requirements and (iii) proper disclosure is included in UCITS documents.

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

In November 2013[1], the first Luxembourg R-QFII UCITS[2] 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[3] 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.

Numerous regulatory developments evidencing this willingness took place thereafter, such as the recognition of the China inter-bank bond market (the "**CIBM**") as a UCITS eligible market[4] and the authorisation granted to UCITS managers willing to make use of the Hong Kong – Shanghai through train (also known as northbound train or "**Stock Connect**") with their Luxembourg UCITS platform[5] and the recognition of Luxembourg as a R-QFII centre[6].

[1] See the press releases of Luxembourg For Finance and of the Association of the Luxembourg Fund Industry issued on 13 November 2013 (www.luxembourgforfinance.lu/fr/luxembourg-regulator-authorises-first-rqfii-ucits-fund;www.alfi.lu/node/2561)

[2] 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

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

[4] See our press release http://www.arendt.com/publications/pages/newsflash/china-interbank-bond-market-ucits-eligible.aspx

[5] See our press release http://www.arendt.com/publications/pages/newsflash/investments-in-china-a-shares-via-stock-connect.aspx

[6] See the press releases from Luxembourg for Finance and the Association for the Luxembourg Fund Industry:

As the PRC economy continues to mature and the PRC government is further opening up its capital markets, managers have seen an increasing number of opportunities and clear interest of investors in portfolios providing them exposure to China A Shares, RMB fixed-income securities dealt on the CIBM, financial indices or derivatives on those instruments.

The decision of Chinese authorities to further liberalise the access to China A Shares for foreign investors[7], the successive announcements regarding the possibility for financial indices such as the MSCI Emerging Markets Index to include China A Shares[8], the push of PRC authorities to clarify and harmonise the tax treatment of gains under the QFII scheme[9], and the allocation of RMB 30 to 80 billion R-QFII quotas to London, Paris, Singapore, South Korea, Frankfurt, Qatar, Canada, Australia, Switzerland, Luxembourg[10] and the launch of Stock Connect in November 2014[11] are as many examples of the fast pace at which the landscape of PRC direct investments and RMB internationalisation develop[12].

As more market players have now 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 **QFII, R-QFII** and **Stock Connect**, fit a Luxembourg **UCITS**, a **Part II fund**[13] or a **SIF**[14].

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 QFII, R-QFII and Stock Connect.

"*How making use of QFII and R-QFII quotas in Luxembourg structures? How making use of Stock Connect in 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 QFII quotas with a Luxembourg fund?

Since 2002, the PRC QFII scheme[15] 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 last round of amendments in 2012[16] facilitated the access to the PRC capital markets by, in particular, lowering the eligibility criteria to be met to apply for a QFII 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.

The main limitations for the use of QFII quotas with a Luxembourg fund were, and to a certain extent are still, 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 regarding open-end china funds, *i.e.* publicly offered open-end investment funds set up outside the PRC and

http://www.luxembourgforfinance.com/fr/rqfii-quota-granted-luxembourg ; www.alfi.lu/node/2913

[7] Reuters, 20 March 2014, "*China opens door further to foreign stock investors*"

[8] Reuters, 24 March 2014, "*MSCI hits resistence bringing China A shares into index - executive*"

[9] Reuters, 28 March 2014, "*China securities regulator says to improve rules for QFII scheme*"

[10] As well as Taiwan for RMB 100 billion

[11] See the announcement of the Hong Kong Stock Exchange in this respect in November 2014 www.hkex.com.hk/eng/newsconsul/hkexnews/2014/1411102news.htm

[12] In the beginning 2015, the PRC authorities had issued QFII quotas for about USD 72 billion and R-QFII quotas for approximately USD 53 billion see Asian Investor, 27 April 2015, "*QFII investors struggle with taxes as deadline looms*"

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

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

[15] 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

[16] 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

investing at least 70%[17] 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 weekly 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.

Specialised investment funds (**SIFs**), which are flexible regulated funds which may be distributed to well-informed investors[18], have been designed 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.

Regarding **Part II funds**, which are domestic retail funds which do not benefit from the UCITS passport[19], 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 have for years been used for direct investments or indirect investments in China A Shares through access products such as participatory-notes (**P-Notes**).

[17] 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

[18] According to the SIF Law, a well-informed investor is an institutional investor, professional investor or any other investor who meets the following conditions: (i) he has confirmed in writing that he adheres to the status of well-informed investor and (ii) he invests a minimum of EUR 125,000.- in the SIF or he has been the subject of an assessment made by a credit institution within the meaning of directive 2006/48/EC, by an investment firm within the meaning of directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments or by a management company within the meaning of the directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (recast) certifying his expertise, his experience and his knowledge in adequately appraising an investment in the SIF. See note 9 below regarding the passport available to Part II funds and which is also available to SIFs under similar conditions

[19] 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

However, considering the limits of the QFII rules before the 2012 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 thereof)[20].

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 preventing a UCITS from qualifying as Open-end China Fund and benefit from the flexibility provided thereby.

Further to the 2012 amendments of the QFII rules, such a limit would according to asset managers no longer be necessary in order for them to be able to structure a UCITS portfolio fulfilling the requirements of UCITS in terms, in particular, of the ability of the UCITS to accept redemption requests from investors at any time. The Luxembourg regulator has been approached with explanations on the above and the possible lifting of the 35% limit, and indicated that it could consider lifting this 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 removing the 70% PRC investments requirement would also facilitate the construction of a portfolio providing those guarantees.

It can be envisaged to deal with other QFII restrictions regarding the lock-up period or monthly limitations to repatriations through solutions involving *e.g.* intra-group financing, the listing or the conversion of the structure, deferred redemption mechanisms, among other things.

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.

[20] Please note that such a limitation was based on an administrative practice of the Luxembourg regulator

How to use R-QFII quotas with a Luxembourg fund?

Launched in December 2011[21] and amended several times thereafter[22], 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 in the PRC capital markets of RMB deposits outside the PRC, originally in Hong Kong.

Consistently with this approach, R-QFII licenses and quotas were made available by the CSRC[23] and the SAFE[24] respectively to Hong Kong based managers regulated by the Hong Kong SFC[25]. During the first phase, those licenses and what we can call "Hong Kong" R-QFII quotas[26] were delivered only to subsidiaries of Chinese fund management companies and securities companies, then extended to other SFC regulated asset managers.

The attractiveness of R-QFII for managers and investors is the following, provided that the product fulfills the conditions to qualify as open-end fund under R-QFII rules[27], (i) no lock-up period applies, (ii) remittances and repatriations may take place on a daily basis within the limits of the quota, without prior authorisation of Chinese authorities, and (iii) no limits apply to the aggregate amount which can be repatriated each month. Upon launching of the scheme, however, it was only possible to use "Hong Kong" R-QFII quotas with Hong Kong domiciled funds.

The milestone of the opening of R-QFII to UCITS was the amendments brought to, rather the recast of, the R-QFII rules, which took place in March 2013[28]. 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) are eligible to apply for a R-QFII license. In addition, the scope of eligible assets in which those R-QFII managers can invest has been widened (*see below*). Most importantly, the explicit requirement for such R-QFII managers to raise RMB in Hong Kong has been removed.

The fact that R-QFII managers were required for the first wave of R-QFII products to set up their fund in Hong Kong is consistent with the purpose of the scheme, *i.e.* allow managers to raise RMB held by the public in Hong Kong only. This restriction as to where RMB have to be raised disappeared in 2013, which is consistent with the perceived intention of PRC authorities to allow managers to raise RMB, not only in Hong Kong, but also in other rising RMB financial centres such as Singapore, London, Paris, Frankfurt or Luxembourg[29].

Thereafter, the R-QFII centre status itself has been granted by PRC authorities to financial centres other than Hong Kong, such as Singapore, London, Paris, South Korea, Frankfurt, Qatar, Canada, Australia, Switzerland, and Taiwan. On April 29, 2015, Luxembourg has been officially recognized as a R-QFII centre and received an overall R-QFII quota of RMB 50bn to be used by its fund managers and investment funds.

The key development for managers, which is linked to the emergence of those R-QFII centres, materialized in November 2013, when it was clarified that Hong Kong based managers could use their "Hong Kong" R-QFII quotas[30] 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

[21] Pilot Scheme for Domestic Securities Investment through Renminbi Qualified Foreign Institutional Investors which are Asset Management Companies or Securities Companies issued by the China Securities Regulatory Commission (CSRC), the State Administration for Foreign Exchange (SAFE) and the People's Bank of China (PBOC) on 16 December 2011

[22] 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

[23] The China Securities Regulatory Commission

[24] The State Administration for Foreign Exchange

[25] The Hong Kong Securities and Futures Commission

[26] Insofar those quotas are allocated to Hong Kong based managers to raise offshore RMB from the public in the Hong Kong S.A.R.

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

[28] 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

[29] RMB business in Luxembourg during as of the last quarter of 2014: RMB 296.30 billion in Luxembourg domiciled regulated funds, RMB 61.10 billion in offshore RMB loans from Luxembourg, RMB 61.50 billion in deposits, RMB 1,456.80 billion in trade finance activities, 45 issuances of *Dim Sum* bonds listed on the Luxembourg Stock Exchange amounting to RMB 34.70 billion (source: www.rmb-business.com)

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

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.

As we anticipated in April 2014, the same flexibility applied in relation to the allocation of the R-QFII quota linked to other R-QFII centres such as London, Paris or Singapore where R-QFII managers have used their local R-QFII quotas with Luxembourg-based funds and we expect that the same will apply for Frankfurt, South Korean, Qatar, Canadian, Australian, Swiss and Taiwanese R-QFII quotas. It would indeed be a natural choice for them as well to use their existing UCITS platforms in order to distribute their PRC strategies in the EU and abroad. This will obviously also be the case for "Luxembourg" R-QFII quotas to be 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.

As the total R-QFII quota allocated to Hong Kong managers is now fully used up and pending an increase of this overall "Hong Kong" R-QFII quota by PRC authorities, managers are looking for other ways to access RMB securities in particular through multi-manager structures (using managers located in R-QFII centres other than Hong Kong to pool their R-QFII quotas), recourse to QFII licenses and quotas and the new Stock Connect, as further described below.

How to use Stock Connect with a Luxembourg fund?

Although it has been reported that there is an intention of the PRC regulators to make the QFII and R-QFII regimes converge[31] and allocate to them more quotas, the licence and quota systems applicable raise a number of practical challenges for managers not having yet a QFII license, or not having yet an investment management arm in a R-QFII centre, or managers for which the quota granted (to the manager or to its jurisdiction) has simply been fulfilled.

Stock Connect, launched in November 2014, partially solved those challenges by granting managers a mutual market access through which they can deal in selected securities listed on a PRC stock exchange[32] through a platform organized by the Hong Kong Stock Exchange ("**HKEx**") using sub-custodian and a broker based in Hong Kong[33].

Practically, Stock Connect allows managers to increase their China A Shares exposure via an alternative channel without having or using their own QFII or R-QFII license or quota (instead the license and quota of their Hong Kong broker is used). Stock Connect also allows managers without a QFII or R-QFII 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 in the end of 2014 and the Luxembourg regulator communicated its positive decision to the industry through the Association for the Luxembourg Fund Industry (ALFI)[34].

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[35].

Those questions focused on (i) the holding and custody structure of China A Shares purchased through the Stock Connect platform[36], (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

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[31] Asian Investor, 26 march 2015, "*QFII, R-QFII merger to give investors 'best of both'*" ; as well as various announcements in relation to the possibility for the QFII regime to offer a daily liquidity

[32] Currently only the Shanghai Stock Exchange

[33] 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.

[34] For a copy of this note see www.alfi.lu/node/2820

[35] 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

[36] 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 QFII and R-QFII custody 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.

delivery obligations)[37] 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 a delivery versus payment (**DvP**) mechanism will be put in place in order not to create counterparty risks over the Hong Kong broker when confirming the availability of the China A Shares to be sold through the scheme. Specific disclosures have to be included in prospectuses and KIIDs to properly describe risks linked to Stock Connect to investors.

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.

Eligible assets under QFII, R-QFII, Stock 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 China inter-bank bond market (**CIBM**), subject still to certain limitations[38].

A QFII manager may use its QFII quotas with a **Part II fund** or a **SIF** 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), however, they do not benefit from the UCITS passport[39]. 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[40], extended thereafter to selected PRC financial indices to setup exchange traded funds (**ETFs**)[41]. 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.

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 **China inter-bank bond market (CIBM)** was necessary for asset managers and their investors to fully benefit from the exposure granted under R-QFII (or QFII) to PRC fixed income securities, most of which are indeed 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[42]. As we anticipated in April 2014, the CIBM was recognised as a UCITS eligible market and UCITS sponsors, after having made their own due diligence on the CIBM to

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

[38] 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

[39] They can however benefit from the AIFMD passport through their AIFMD

[40] Also known as R-QFII v1.0

[41] Also known as R-QFII v2.0

[42] Article 41 (1) (b) of the law of 17 December 2010 on undertakings for collective investment, as amended

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).

As far as **Stock Connect** is concerned, the Northbound Train gives for the time being access to China A Shares part of the SSE 180 and SSE 380 indices only. Those shares are as a principle eligible for UCITS investments and *a fortiori* for investments by Part II funds or SIFs. It is anticipated that the Stock Connect scheme might soon be extended to China A Shares dealt on the **Shenzhen Stock Exchange**.

As indicated above those shares are also eligible in principle and provided that the conditions regarding the trading and holding thereof through the HKEx platform, the segregation throughout the chain of custody and the recourse to DvP mechanism do not differ from those applicable to the current Northbound Train, there is no reason to believe that this "Westbound Train" to the Shenzhen Stock Exchange would be treated differently from a UCITS point of view.

It has also been reported that the Stock Connect scheme could be replicated in the RMB fixed income sphere with the creation of a "Bond Connect". This would possibly allow foreign investors to access the onshore RMB debt market without QFII or R-QFII license or quotas. To the extent such an access would be put in place e.g. through a Hong Kong platform, such as possibly the Central Money market Unit (CMU) of the HKMA and that holding mechanisms similar to those of Stock Connect (regarding in particular the segregation, counterparty risks, etc.) would be in place, we believe that it could be envisaged that this scheme could also be used by managers with their Luxembourg investment funds. It is however at this stage premature to look into this possibility.

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

Besides the eligibility of the assets under the QFII, R-QFII, Stock Connect 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 QFII or R-QFII 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 QFII or R-QFII 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, etc.[43].

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 QFII and/or R-QFII licenses and quotas, and now from Stock Connect, should feel encouraged to use Luxembourg funds to implement PRC strategies and raise money in the EU, the Middle-East, Latin America and Asia.

Certain limitations still apply, but they will progressively disappear as the PRC capital markets open up, the RMB becomes more international, the QFII and R-QFII regimes converge and other schemes such as Stock Connect are put in place.

The UCITS passport is available to those managers, as well as, under certain conditions the alternative investment fund managers directive passport (for Part II funds and SIFs), allowing a fast track distribution of those products across Europe.

New RMB financial centres will open and develop, including Luxembourg, which is already one of the largest RMB financial centres in Europe. New R-QFII fund centres will also open and Luxembourg will continue to offer adapted fund vehicles to raise RMB from the public in those centres and re-invest in the PRC capital markets.

[43] This list is not exhaustive and results from our various discussions with the CSSF in relation to the implementation of QFII, R-QFII and Stock Connect strategies by UCITS and other type of funds

A door has been opened with the approval in Luxembourg of this first R-QFII UCITS and a way has been paved with the subsequent approval of the CIBM as a UCITS eligible market, the authorization of the use of Stock Connect by UCITS and the recognition of Luxembourg as a R-QFII centre.

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.

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This note has been prepared to provide the reader with thoughts and information on recent developments interesting their business. This note is however not intended to constitute legal advice and does not substitute for the consultation with legal counsel required before any actual undertakings.

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