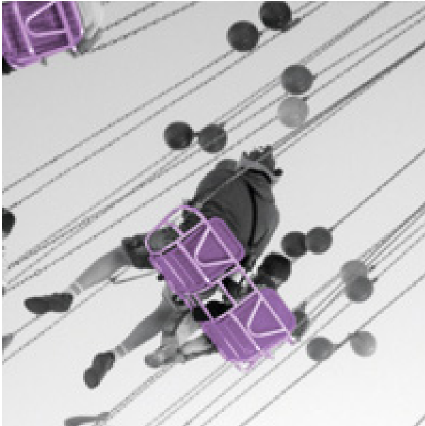

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From our Hong Kong Office

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QFII, R-QFII and Luxembourg Funds

As widely reported in November 2013[1], the first Luxembourg R-QFII UCITS[2] allowing for a 100% China A-Shares strategy has been approved by the Luxembourg *Commission de Surveillance du Secteur Financier* (the "**CSSF**").

This announcement was expected and highly anticipated by the industry in both Hong Kong and Luxembourg. It gave a strong message that Luxembourg, as traditional fund centre and rising *Renminbi* ("**RMB**") financial centre[3], is determined to keep its first mover advantage regarding People's Republic of China ("**PRC**") strategies and is 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.

As the PRC economy matures and the PRC government is 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 China inter-bank bond market (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[4], the recent announcement regarding the possibility for financial indices such as the MSCI Emerging Markets Index to include China A Shares[5], the push of PRC authorities to clarify and harmonise the tax treatment of gains under the QFII scheme[6], and the allocation of a RMB 80bn R-QFII quota to France[7], which all took place in Mach 2014, are as many examples of the fast pace at which the landscape of PRC direct investments and RMB internationalisation develop.

As of end of February 2014, the PRC authorities have issued QFII quotas for about USD 52.3 billion and R-QFII quotas for approximately USD 29 billion [8].

As more market players have now access to the PRC capital markets, the manner in which those players will connect 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 two main access channels to the PRC capital markets, namely **QFII** and **R-QFII**, fit a Luxembourg **UCITS**, a **Part II fund**[9] or a **SIF**[10].

Recent regulatory developments of those two schemes in the PRC have brought them towards a greater compatibility with UCITS rules and made possible the approval of new products such as the R-QFII UCITS referred to above.

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

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

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

[7] Reuters March 28, 2014 "*China gives France a quota for investing in its capital markets*"

[8] As of the date of this note, Hong Kong has the largest quota with RMB 270bn, followed by the UK and France with RMB 80bn each and Singapore with RMB 50bn

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

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

"*How making use of QFII and R-QFII quotas 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, which aims at being more practical than legal.

How to use QFII quotas with a Luxembourg fund?

Since 2002, the PRC QFII scheme[11] 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[12] 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 investing at least 70%[13] 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[14], 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[15], 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**). 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

[11] 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

[12] 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

[13] 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

[14] 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

[15] 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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respected and set such a limit at 35% of the assets of the UCITS (or sub-fund thereof)[16].

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.

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

Launched in December 2011[17] and amended several times thereafter[18], 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[19] and the SAFE[20] respectively to Hong Kong based managers regulated by the Hong Kong SFC[21]. During the first phase, those licenses and what we can call "Hong Kong" R-QFII quotas[22] 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[23], (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[24]. 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

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

[17] 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

[18] 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

[19] China Securities Regulatory Commission

[20] State Administration for Foreign Exchange

[21] Securities and Futures Commission

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

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

[24] 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

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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 willingness 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, Taiwan, London, Paris, Frankfurt or Luxembourg[25]. Hence, the R-QFII scheme itself has been extended to financial centres such as Singapore, Taiwan, London[26] and now Paris[27], for which the use of a Hong Kong based fund would not be appropriate.

The ability of Hong Kong based managers to use their "Hong Kong" R-QFII quotas with a Luxembourg UCITS structure is key in the evolution of R-QFII. It gives them 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.

One may reasonably anticipate that the same will apply when London, Paris or Singapore based managers will receive their first R-QFII licenses and R-QFII quotas and will be looking for the right vehicle to raise efficiently money and fill such R-QFII quotas. It would indeed be a natural choice for them to use their existing UCITS platforms in order to distribute their PRC strategies in the EU and abroad.

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 use of R-QFII quotas by a Luxembourg UCITS, as announced in November, was therefore a development which was expected and highly anticipated.

Eligible assets under QFII, R-QFII 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 (since more recently[28]) traded over-the-counter (**OTC**) on the China inter-bank bond market (CIBM), subject still to certain limitations.

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 (*see below the description in relation to R-QFII*).

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[29]. 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.

[25] RMB business in Luxembourg during as of the last quarter of 2013: RMB 256.4 billion in Luxembourg domiciled regulated funds, RMB 53.8 billion in offshore RMB loans from Luxembourg, RMB 64 billion in deposits, RMB 86,8 billion in trade finance activities, 45 issuances of Dim Sum bonds listed on the Luxembourg Stock Exchange amounting to RMB 30.8 billion (source:www.rmb-business.com)
[26] China agreed to allocate London an initial quota of RMB 80 billion (see www.bloomberg.com/news/2013-10-15/china-u-k-agree-on-yuan-pound-direct-trading-investment-quota.html)
[27] Reuters March 28, 2014 "*China gives France a quota for investing in its capital markets*"

[28] 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
[29] They can however benefit from the AIFMD passport through their AIFMD

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R-QFII rules originally restricted R-QFII managers, which could only invest in portfolios comprising 80% fixed-income and 20% equity securities[30], extended thereafter to selected PRC financial indices to setup exchange traded funds (**ETFs**)[31]. 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[32]. 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 UCITS eligibility of the China inter-bank bond market (CIBM) is the next step in order for asset managers and their investors to fully benefit from the exposure granted under R-QFII (or QFII) to PRC fixed income securities which are traded OTC.

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[33]. Other similar OTC bonds markets in the US or the *dim sum* bonds market in Hong Kong have been analysed and the conclusion has been reached that they were fulfilling the conditions to the regarded as eligible markets under UCITS rules and therefore allow investments in securities traded thereon. It is likely that the CIBM will be recognised as a UCITS eligible market as well in the foreseeable future.

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

Besides the eligibility of the assets under the QFII, R-QFII 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.[34]

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 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 and the QFII and R-QFII regimes converge.

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 centre in Europe. New R-QFII fund centres will also open and prior to becoming one of them, 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.

[30] Also known as R-QFII v1.0
[31] Also known as R-QFII v2.0
[32] Shanghai and Shenzhen stock exchanges are members of the world federation of exchanges
[33] Article 41 (1) (b) of the law of 17 December 2010 on undertakings for collective investment, as amended

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

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A door has been opened with the approval in Luxembourg of this first R-QFII UCITS and 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 by **Stephane Karolczuk,** Head of Arendt & Medernach's Hong Kong office and registered foreign lawyer, who advises clients based in the Asia Pacific region regarding their Luxembourg legal and regulatory questions.*

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This note is an updated version of the note on the same topic issued in December 2013.

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