July 19, 2012

China Securities Regulatory Commission Proposes to Lower QFII Threshold

On June 20, 2012, the China Securities Regulatory Commission ("CSRC") published a draft regulation (the "Draft Regulation") relating to the qualified foreign institutional investor ("QFII") scheme for public consultation[1]. This Draft Regulation proposes to relax the entry criteria under the QFII scheme and is intended to replace the qualification requirements for a foreign investor to apply for QFII status in China that are currently in place since the issuance of the circular issued on August 24, 2006[2] (the "2006 Circular").

Background

The QFII scheme was introduced by Chinese regulators in 2002 to allow foreign qualified investors to invest in A-shares listed on the Shanghai and Shenzhen stock exchanges (previously open only to mainland China investors) and other financial products as approved by the CSRC. Since the RMB is not freely convertible, the objective of the QFII scheme is to provide a channel for funds from overseas to flow into China's capital markets. As of June 2012, China has awarded QFII licenses to 172 foreign investors, among which 145 have been granted quotas in aggregate of $27.26 billion[3]. In particular, since Mr. Guo Shuqing, the new president of the CSRC, took office in October 2011, the CSRC and the State Administration of Foreign Exchange ("SAFE"), the other major QFII regulator, have shortened the timeframe for QFII approvals, granting $5.62 billion in quotas to 51 QFIIs since December 2011[4]. The Draft Regulation is seen by many as an ongoing attempt by the CSRC to further liberate the Chinese domestic capital markets. According to the CSRC, the Draft Regulation is "to further introduce long-term capital from abroad, strengthen domestic market confidence and promote stable growth in China's capital markets and their opening-up to foreign investors".

[1] The Draft Regulation (Chinese version) is published at CSRC's official website.
See: http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201206/t20120620_211650.htm.

[2] *Circular of CSRC on the Relevant Issues Concerning the Measures for the Administration of Securities Investment by Qualified Foreign Institutional Investors in China*, issued on August 24, 2006.

[3] CSRC issued an explanation letter attached to the Draft Regulation which provides the relevant statistics about QFIIs.
See: http://www.csrc.gov.cn/pub/zjhpublic/G00306201/201206/t20120620_211650.htm.

[4] See: http://finance.sina.com.cn/stock/zldx/20120622/022612378673.shtml.

Draft Regulation

The Draft Regulation includes the following major revisions to the 2006 Circular:

- Lowering the qualification threshold for a foreign investor to apply for QFII status.

TYPE OF INSTITUTION	MINIMUM YEARS OF OPERATION		CAPITAL / ASSETS		ASSETS UNDER MANAGEMENT (IN PREVIOUS FISCAL YEAR)	
	2006 CIRCULAR	DRAFT REGULATION	2006 CIRCULAR	DRAFT REGULATION	2006 CIRCULAR	DRAFT REGULATION
Fund managers	5	2	—	—	US$5 billion	US$500 million
Insurance companies	5	2	—	—	US$5 billion	US$500 million
Securities companies	30	5	paid-in capital no less than US$1 billion	net assets no less than US$500 million	US$10 billion	US$5 billion
Commercial banks	—	10	—	Tier 1 capital no less than US$300 million	US$10 billion and ranked in top 100 worldwide	US$5 billion
Other institutional investors	5	2	—	—	US$5 billion	US$500 million

- Widening the investment scope by allowing QFIIs to enter China's inter-bank bond market. This is a further step after the CSRC permitted QFIIs' participation in stock-index futures in 2011.
- Relaxing the shareholding limit of QFIIs. The cap on the combined stake in a listed company held by QFIIs is increased to 30 per cent from the current 20 per cent. However, the cap on the stake in a listed company held by one single QFII remains unchanged.
- Permitting QFII to set up multiple investment accounts. Under the 2006 Circular, a QFII is permitted to set up only one investment account with China's stock clearance company for trading in each of Shanghai Stock Exchange and Shenzhen Stock Exchange, respectively.

Implications

By substantially lowering the qualification requirements for QFII status, the Draft Regulation effectively expands the number of potential qualified applicants for QFII status. In addition, these adjustments with respect to QFII's investment scope and shareholding limit offer QFIIs with more diversified and flexible investment choices. The Draft Regulation also proposes to streamline the administration of QFII investment accounts, which would further facilitate QFII operation and investment in China.

In its explanation of the Draft Regulation, the CSRC believes that the QFIIs' shareholdings account for roughly only 1.1 percent of the total capitalization in China's A-share markets. As such, there is still much potential for the future growth of the QFII scheme in China. It is also worth noting that the CSRC, the SAFE and People's Bank of China ("PBOC"), China's central bank, have announced on April 3, 2012 that the total reserved quota for QFIIs has been increased from $30 billion to $80 billion, representing a substantial increase. Together with the Draft Regulation, it appears that the Chinese regulators are undertaking to make a strategic and positive move for the QFII scheme. For foreign investors interested in investing in China's domestic capital markets, especially those who are not qualified under the current rules, it may be a good time to evaluate the implications of the Draft Regulation.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. Please note that under current law of the PRC, foreign lawyers such as ourselves are not permitted to practice law in the PRC and thus are not permitted to render formal legal opinions on matters of PRC law. This summary is for your reference only.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Lorna Xin Chen
Hong Kong
+852.2978.8001
lorna.chen@shearman.com

Azam H. Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Nathan J. Greene
New York
+1.212.848.4668
ngreene@shearman.com

John W. Finley III
New York
+1.212.848.4346
sean.finley@shearman.com

Paul S. Schreiber
New York
+1.212.848.8920
pschreiber@shearman.com

Laura S. Friedrich
New York
+1.212.848.7411
laura.friedrich@shearman.com

Alan Seem
Shanghai
+86.21.6136.5018
alan.seem@shearman.com

Lee Edwards
Beijing
+8610.5922.8001
lee.edwards@shearman.com

Paul Strecker
Hong Kong
+852.2978.8000
pstrecker@shearman.com

Shuang Zhao
Hong Kong
+852.2978.8002
shuang.zhao@shearman.com

Richard Metsch
Hong Kong
+852.2978.8010
rmetsch@shearman.com

Pang Lee
Hong Kong
+852.2978.8005
pang.lee@shearman.com

Bill Murdie
London
+44.20.7655.5149
bill.murdie@shearman.com

John Adams
London
+44.20.7655.5740
john.adams@shearman.com