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Qualified Foreign Institutional Investor ("QFII") System Enacted – Large Foreign Investors Now Permitted Access to China's "A" Share Markets

On November 5, 2002 the China Securities Regulatory Commission ("CSRC") and the People's Bank of China ("PBOC") enacted the Interim Measures for the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors (the "QFII Measures" or "Measures"), which will come into effect on December 1, 2002. The Measures represent the first small breach in the wall restricting foreign participation in China's "A" share market -- publicly listed shares of Chinese issuers listed on Chinese stock exchanges that hitherto could be purchased and traded only by PRC persons using the not-fully-convertible Renminbi yuan.

Attached to this memorandum is the Paul, Weiss translation of the QFII Measures.

This very important enactment is patterned after a similar program in Taiwan and follows closely on the heels of other important reforms concerning foreign investment in China's capital markets announced just prior to the 16th National Congress of the Chinese Communist Party. These include, for example, the Notice Regarding Transfer to Foreign Investors of State-owned Shares and Legal Person Shares of Listed Companies ("State-owned Shares/Legal Person Shares Notice") issued by the CSRC, the Ministry of Finance and State Economic and Trade Commission, which allows foreigners for the first time since 1995 to purchase *unlisted* shares of Chinese issuers currently owned by the state or legal persons representing state owners.

The intent behind the Measures and the State-owned Shares/Legal Person Shares Notice is to breathe new life into China's domestic capital markets, notwithstanding high capitalization and approval and review thresholds, and perhaps onerous restrictions on repatriation of dividends and capital gains. Those factors, and the quality of China's "A" share issuers and the stock of listed equity available for actual investment, may make foreign institutions reluctant to take up this new opportunity. At present, the most attractive "A" share issuers also have "H" or "N" (Hong Kong-listed or New York-listed) shares outstanding, which are generally more liquid and not as expensive as their "A" share cousins. Until this domestic premium disappears -- perhaps with the implementation of a "Qualified Domestic Institutional Investor" or "QDII" program allowing PRC institutions to purchase overseas listed Chinese issuer shares or when "A" and "H/N" shares become entirely fungible -- there may be few foreign institutions legitimately interested in the new initiative.

Set forth below is a preliminary analysis of the QFII Measures and key aspects of their importance:

- Basic structure: The Measures set forth the regulatory structure for what is a new, dedicated channel for participation by foreign capital in China's capital markets, and also the first permitted participation by such foreign capital in China's "A" share markets ("A" shares are Renminbi denominated shares issued, purchased and traded in Renminbi, which -- until the promulgation of the Measures -- could be purchased and traded only by PRC persons). The Measures call for qualified foreign institutional investors ("QFIIs") to set up a custodial relationship with a single financial institution based in China, to establish a Renminbi bank account operated by the custodian initially to receive investment funds (converted from hard currency) and subsequently to collect investment proceeds and current income, and to appoint a single broker to purchase and sell "A" shares. Foreign investors are granted an "investment quota" by the State Administration of Foreign Exchange ("SAFE"), which is equal to the amount of investment "principal" that they are allowed to bring into China in hard currency, convert into Renminbi, and use to purchase listed "A" shares. This initial principal amount (or "quota") is a marker for the amount of Renminbi proceeds on the sale of "A" shares that can, after one (1) year for most investors and three (3) years for closed-end fund investors, be converted from Renminbi into hard currency and remitted abroad to the QFII.

- Special Renminbi account and capital call: The specialized channel for foreign investment in A shares is implemented through the creation of a special Renminbi account which the QFII funds in hard currency, and over which SAFE has supervisory authority. All proceeds remitted into China by the QFII must *immediately* be converted into Renminbi and deposited in the special Renminbi account. All proceeds that the QFII intends to use for investment -- the amount of "investment quota" granted to the QFII -- must be in China within three (3) months after the issuance of a QFII permit.

- High thresholds: As has been extensively reported, QFIIs under the Measures must be very significant players -- with a minimum of US$10 billion of assets under management for fund management companies, insurance companies, securities companies and commercial banks. There are also seasoning requirements for fund management companies (five years), insurance companies (thirty years), and securities companies (30 years), and a total assets threshold for commercial bank participants (they must be ranked in the "top 100" in total assets *in the world*). The Measures also set forth other prudential requirements with respect to credit standing, governance, professional qualifications, etc. To "attract medium and long-term investment", the Measures dictate that priority will be given to qualifying closed-end China funds, and "pension funds, insurance funds and mutual funds that have good investment records in other markets".

- Two regulators: Because the QFII program affects both the PRC securities markets and foreign exchange control, the CSRC and SAFE (the foreign exchange control agency under the PBOC) are empowered to examine and approve various aspects of QFII activity, qualification, investment and repatriation of revenues. The QFII candidate applies directly to the CSRC, while the QFII's appointed custodian applies, on behalf of the QFII, to SAFE. These approvals are separately considered and separately rendered -- thus, a QFII may win qualification as a QFII from the CSRC, yet not be permitted to actually make investments due to a lack of SAFE foreign exchange control approval or any approved "investment quota". If SAFE fails to approve quota for an already-qualified QFII within one (1) year of qualification of a foreign investor as a QFII, the CSRC-issued QFII qualification automatically lapses.

- Custodians: The Measures require that QFIIs appoint an in-country "custodian" which is to employ the QFII's "investment quota" for domestic securities investment through a single, dedicated settlement account established with the custodian, and a securities broker, which the custodian is to find and contract with directly. QFIIs may appoint only one custodian. These requirements directly implicate the PBOC, China's central bank authority, which is empowered to review and approve custodial business and qualification. The Measures contain explicit qualifications for such custodians -- including a Renminbi 8 billion paid-in capital requirement -- and also permit foreign financial institutions to participate, if they have done business through a China branch for at least three (3) years. Noteworthy is the large burden placed on custodians to report even the most minute aspects of QFII activity to the CSRC and SAFE, including activity in the Renminbi account established to receive and disburse investment for the Chinese securities markets, monthly and annual reports to the regulators, and notification of any violation of rules or law by approved QFIIs. Custodians are required to keep records regarding the QFIIs for fifteen (15) years.

- Investment operations: Renminbi bonds, convertible instruments, "other" financial instruments, and equities (other than "B" shares) are all permitted and appropriate subjects of investment for QFIIs. The justifiable prohibition on purchase of "B" shares (China-listed equities of Chinese issuers available to foreign investors) will probably hold for any future introduction of "China Depositary Receipts" or "CDRs", which are also being conceived as a way for offshore investors to hold equities in Chinese issuers, but through depositary receipts.

- Broker and investment advisor: The QFII must, through the custodian, mandate a PRC securities company to make purchases and sales of "A" shares. A QFII may appoint one, but only one, PRC securities company to manage investments on its behalf.

- Limitation on investment concentration and foreign investment: The Measures limit the investment any one QFII can make, and the amount of investment any listed company can take from QFIIs generally, so that (i) a single QFII may own no more than 10% of the "total amount of shares" of a listed issuer, and (ii) no single listed company may have more than 20% of its "total amount of shares" held by QFIIs. Note that the Measures speak to the "total amount of shares" of a listed issuer, not just the issuer's *listed* shares, allowing for a larger denominator and thus more QFII investment in a listed company. The various limitations on foreign investment in various sectors in China, as stipulated in the Ministry of Foreign Trade and Economic Cooperation, State Economic and Trade Commission and State Development Planning Commission-promulgated Guidance Catalogue for Foreign Investment in Industry ("Guidance Catalogue"), are to be respected even with respect to QFII investment. Thus, if the Guidance Catalogue mandates Chinese majority ownership or "relative control", this may present a further block to the amount of QFII investment in a given issuer.

- Repatriation of investment and profits: The Measures create a strict regime governing the repatriation of original investment capital amounts, and after-tax returns. Most QFIIs may apply to SAFE to repatriate invested capital only one (1) year after remittance of the same into the PRC, and in installments that may not exceed more than 20% of original investment amounts, with an interval of at least one (1) month between installments. QFIIs that are "closed end China funds" may apply to SAFE to repatriate invested capital only three (3) years after remittance of the same into the PRC. Additional approval is required to use Renminbi "realized after-tax profits" (i.e., amounts in excess of the incoming investment principal) to purchase hard currency and repatriate the same. For these repatriations, an application, audited financial statements, corporate resolutions, tax payment certificate and "other documents required by SAFE" are required. In addition, the state maintains the power -- through SAFE approvals -- to disallow such distributions if the state's "foreign exchange balancing" may be disturbed.

Order No.12
of
China Securities Regulatory Commission

People's Bank of China

The Interim Measures for the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors are hereby promulgated and will come into effect on December 1, 2002

Chairman: Zhou Xiaochuan
Governor: Dai Xianglong

November 5, 2002

The Interim Measures for the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors

Chapter One General Principles

Article 1. These Measures are formulated in accordance with relevant laws and administrative regulations to regulate the investment activities of qualified foreign institutional investors in the securities markets within the territory of China, and to promote the development of China's securities market.

Article 2. Qualified foreign institutional investors (hereinafter referred to as "Qualified Investors") described in these Measures refer to fund management institutions, insurance companies, securities companies and other asset management institutions outside the territory of China which meet the conditions stipulated in these Measures, are approved by China Securities Regulatory Commission (hereinafter referred to as "CSRC") to invest in the PRC securities market, and obtain the [investment] quota approval from the State Administration of Foreign Exchange (hereinafter referred to as "SAFE").

Article 3. Qualified Investors shall entrust domestic commercial banks as custodians to manage assets, and shall entrust domestic securities companies to handle securities trading activities within the territory of China.

Article 4. Qualified Investors must comply with laws, regulations and other relevant rules of the PRC.

Article 5. CSRC and SAFE will implement the supervision and administration of securities investment activities by Qualified Investors within the territory of China in accordance with law.

Chapter Two Qualification and Approval Procedures

Article 6. In order to qualify as a Qualified Investor, an applicant must meet the following conditions:

(1) The applicant is financially stable and of good credit, meet the CSRC's stipulated conditions for scope of assets and other conditions, and has a risk monitoring index

that complies with the stipulated legal requirements and requirements of securities regulatory institutions in the country or region where the applicant is located;

(2) Practitioners of the applicant are in compliance with relevant professional qualification requirements of the country or region where the applicant is located;

(3) The applicant has a sound corporate governance structure and system of internal controls, standard operating rules, and has not been subject to serious penalty by regulatory institutions in the country or region where the applicant is located during the most recent three (3) years;

(4) The country or region where the applicant is located has a complete legal and regulatory system, and the securities regulatory institution of such country or region has already signed a memorandum of cooperation and understanding with CSRC, and maintains an effective cooperation relationship with CSRC on supervision; and

(5) Other conditions prescribed by CSRC in accordance with the principles of prudential supervision and administration.

<u>Article 7.</u> The scope of assets condition and other conditions in the preceding Article shall have the following meanings:

Fund management companies: engaged in the funds business for more than five (5) years, with funds under management during the most recent fiscal year of no less than US$10,000,000,000;

Insurance companies: engaged in insurance business for more than thirty (30) years, with paid up capital of no less than US$1,000,000,000, and securities assets under management during the most recent fiscal year of no less than US$10,000,000,000;

Securities companies: engaged in securities business for more than thirty (30) years, with paid up capital of no less than US$1,000,000,000, and securities assets under management during the most recent fiscal year of no less than US$10,000,000,000; and

Commercial banks: shall be ranked in the first one hundred (100) in the world in total assets during the most recent fiscal year, with securities assets under management of no less than US$10,000,000,000.

CSRC may adjust the aforementioned scope of assets conditions and other conditions in accordance with development of the securities market.

<u>Article 8.</u> In order to apply for qualification as a Qualified Investor and for approval of investment quota, the applicant shall, through its custodian, submit the following documents to CSRC and SAFE respectively:

(1) An application (including basic information regarding the applicant, proposed investment quota, investment plan, etc.);

(2) Documents certifying compliance with the conditions set forth in Article 6 of these Measures;

(3) A draft custodian agreement executed with the custodian;

(4) Audited financial statements for the three (3) most recent fiscal years;

(5) An explanation of the source of funding and a commitment letter promising no withdrawal of investment during the approval period;

(6) A power of attorney issued by applicant; and

(7) Other documents required by CSRC and SAFE.

If the application documents required in the preceding provision are prepared in a foreign language, a Chinese translation or a Chinese summary shall be attached thereto.

Article 9. Within fifteen (15) business days after receipt by CSRC of the complete application documents, CSRC shall decide whether to approve or not to approve [the application]. If the application is approved, a Securities Investment Business Permit will be issued to the applicant; if the application is not approved, the applicant will be notified in writing.

Article 10. After obtaining of the Securities Investment Business Permit, the applicant shall, through its custodian, apply to SAFE for investment quota.

Within fifteen (15) business days after receipt by SAFE of the complete application documents, SAFE will decide whether to approve or not to approve [investment quota]. If approved, SAFE will send the applicant a written notice of approved investment quota and issue to the applicant a Foreign Exchange Registration Certificate; if investment quota is not approved, the applicant will be notified in writing.

If an applicant fails to obtain the Foreign Exchange Registration Certificate within one (1) year after it has obtained the Securities Investment Business Permit, the Securities Investment Business Permit shall automatically become invalid.

Article 11. In order to attract medium and long term investment, priority will be given during the approval process to closed-end PRC funds that meet the standards set forth in Article 6 of these Measures, or pension funds, insurance funds and mutual funds that have good investment records in other markets.

Chapter Three Custody, Registration and Settlement

Article 12. A custodian shall meet the following conditions:

(1) Have a dedicated custody department;

(2) Paid up capital of no less than RMB8,000,000,000;

(3) Have sufficient specialized personnel who are familiar with custodial business;

(4) Have conditions for safekeeping all fund assets;

(5) Have secure and efficient settlement and trading capabilities;

(6) Be qualified as a designated foreign exchange bank and to conduct RMB business; and

(7) Have no record of severe violations of foreign exchange administration rules in the most recent three (3) years.

A branch of a foreign commercial bank established in China engaged in business in China for more than three (3) consecutive years may apply to act as a custodian, with paid-in capital qualifications calculated with reference to its offshore head office.

Article 13. Qualification as a custodian must be examined and approved by CSRC, the People's Bank of China ("PBOC") and SAFE.

Article 14. A domestic commercial bank applying to qualify as a custodian shall submit the following documents to CSRC, PBOC and SAFE:

(1) An application;

(2) A copy of its Financial Business Permit;

(3) The system for administration of its custody business;

(4) Documents certifying that it has an efficient and high speed information technology system; and

(5) Other documents required by CSRC, PBOC and SAFE.

CSRC shall together with PBOC and SAFE examine the application documents, and make a decision on whether to approve or not to approve the application.

Article 15. The custodian shall undertake the following responsibilities:

(1) Safekeeping of all assets entrusted by a Qualified Investor;

(2) Handle Qualified Investor-related foreign exchange settlement, sale, receipt and payment, and RMB settlement business;

(3) Supervise investment operations of a Qualified Investor, and report to CSRC and SAFE in a timely manner if it discovers that Qualified Investor investment instructions violate relevant laws or regulations;

(4) Within two (2) business days after any remittance of investment principal or proceeds by a Qualified Investor in or out of the PRC, report to SAFE relevant information with respect to remittances in or out of the PRC, settlement and sale of foreign exchange;

(5) Within five (5) business days following the end of each month, report to CSRC and SAFE information concerning receipt and payments to and from the special RMB account of a Qualified Investor;

(6) Within three (3) months following the end of each fiscal year, prepare an annual financial report on the domestic securities investments of a Qualified Investor for the preceding year and submit the same to CSRC and SAFE;

(7) Preserve relevant materials with respect to the remittance of funds in or out of the PRC, conversion, receipt and payments of foreign exchange and funds activity, etc. of a Qualified Investor for no less than fifteen (15) years;

(8) Other responsibilities stipulated by CSRC, PBOC and SAFE in accordance with principles of prudential supervision and administration.

Article 16. The custodian shall strictly separate self-owned assets and the assets that it is entrusted to administer.

The custodian shall maintain a separate account for each different Qualified Investor, and implement separate account administration for entrusted assets.

Each Qualified Investor shall entrust only one custodian.

Article 17. A Qualified Investor shall entrust the custodian to apply on the Qualified Investor's behalf for the opening of a securities account at the securities registration and settlement institution. During the process of applying for opening of the securities account, the custodian shall hold valid documents such as a power of attorney and the Securities Investment Business Permit of the Qualified Investor, and shall file relevant information with CSRC for the record within five (5) business days after the opening of such securities account.

A Qualified Investor shall entrust the custodian to open a RMB funds settlement account at a securities registration and settlement institution to settle funds with such securities registration and settlement institution. The custodian shall be responsible for funds settlement of the Qualified Investor's domestic securities investment, and file relevant information with CSRC and SAFE within five (5) business days after the opening of such RMB account.

Chapter Four Investment Operation

Article 18. A Qualified Investor may invest in the following RMB financial instruments within the scope of its approved investment quota:

(1) Stocks listed and traded on stock exchanges, except for domestically listed foreign capital shares;[1]

(2) Treasury bonds listed and traded on stock exchanges;

(3) Convertible bonds and corporate bonds listed and traded on stock exchanges; and

(4) Other financial instruments approved by CSRC.

Article 19. A Qualified Investor may entrust a securities company established in the PRC to manage its domestic securities investments.

Each Qualified Investor shall entrust only one investment[2] company.

Article 20. Domestic securities investments by Qualified Investors shall comply with the following rules:

(1) An individual Qualified Investor shall own no more than 10% of the total amount of shares of a single listed company;

(2) The aggregate shares held by all Qualified Investors in a single listed company shall be no more than 20% of the total amount of shares of such listed company.

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1 At this time, only "B" shares; however, this could include CDRs in time.

2 Probably a typo – this should refer to the foregoing "securities company".

The CSRC may adjust the above ratios in accordance with the development of the securities market.

Article 21. The domestic securities investments of a Qualified Investor must comply with the requirements of the Guidance Catalogue for Foreign Investment in Industry.

Article 22. The period for which a securities company shall preserve records of consummated transactions and transaction activity materials, etc. of a Qualified Investor shall be not less than fifteen (15) years.

Chapter Five Funds Management

Article 23. After obtaining of approval from SAFE, a Qualified Investor shall open a special RMB account at the custodian's place of business.

The custodian shall report relevant information to CSRC and SAFE for the record within five (5) business days upon the opening of the special RMB account.

Article 24. The scope of receipts to the special RMB account shall include: settlement funds (foreign exchange funds sourced from abroad, the accumulated settled amount of foreign exchange funds not exceeding the approved investment quota), proceeds from the sale of securities, cash dividends, interest on current deposits, and interest on bonds. The scope of payments out of the special RMB account shall include: securities purchase price funds (including stamp duty, processing fees, etc.), domestic custodian and management fees, and funds used to purchase foreign exchange (for remittance of investment principal and returns abroad).

The funds in the special RMB account may not be used as loans or as security.

Article 25. A Qualified Investor shall remit principal [into the PRC] within three (3) months after obtaining of the Securities Investment Business Permit issued by CSRC; and such principal shall be directly deposited in the special RMB account after conversion of all of it [from foreign exchange into RMB]. The principal remitted [into the PRC] by a Qualified Investor shall be in any freely convertible currency approved by SAFE; the amount of such principal being limited to the investment quota approved by SAFE.

Should a Qualified Investor fail to remit [into the PRC] the full amount of its investment quota approved by SAFE within three (3) months after obtaining a Foreign Exchange Registration Certificate, its approved investment quota shall be the amount actually remitted. The difference between the actually remitted amount and the approved investment quota shall not be filled by any new remittance until approval has been gained for a new investment quota.

Article 26. If a Qualified Investor is a closed-end PRC fund management institution, such Qualified Investor may, three (3) years after full remittance [into the PRC] of principal, entrust the custodian to apply to SAFE with the required documentation for the purchase of foreign exchange to remit principal abroad by individually approved installments. The amount of each installment shall not exceed twenty percent (20%) of the total amount of investment principal, and the interval between two installments shall not be less than one (1) month.

Other Qualified Investors shall, one (1) year after full remittance [into the PRC] of principal, entrust custodians to apply to SAFE with the required documentation for the purchase of foreign exchange to remit principal abroad by individually approved installments. The amount of each installment shall not exceed twenty percent (20%) of the total amount of investment principal, and the interval between two installments shall not be less than three (3) months.

The overseas recipient of the aforementioned remittances must be the Qualified Investor itself.

Article 27. A Qualified Investor that has remitted principal [into the PRC] for more than three (3) months but less than one (1) year, may, upon submission of a transfer application and a transfer agreement to CSRC and SAFE, and obtaining their approval, transfer its investment quota to other Qualified Investors or other applicants that qualify under Article 6 of these Measures.

After the transferee obtains approval of investment quota from SAFE and a Securities Investment Business Permit, it may remit additional principal [into the PRC] if the value of the transferred assets are less than the SAFE approved investment quota.

Article 28. If a Qualified Investor needs to remit new principal [into the PRC] after a Qualified Investor has remitted abroad a part or all of the principal, it shall re-apply for approval of investment quota.

Article 29. In the event that a Qualified Investor needs to purchase foreign exchange to remit abroad the realized after-tax profits for the preceding fiscal year as audited by a PRC certified public accountant, it shall entrust the custodian to file an application with SAFE fifteen (15) business days before the proposed purchase by submitting the following documents:

(1) An application for remittance abroad;

(2) Annual financial statement for the year in which the profits have been realized;

(3) An audit report issued by a PRC certified public accountant;

(4) Resolutions or other valid legal documents for the profit distribution;

(5) Tax payment certificate; and

(6) Other documents required by SAFE.

The overseas recipient of the aforementioned remittance shall be the Qualified Investor itself.

Article 30. SAFE may adjust the period for remittance of principal and realized profits by a Qualified Investor to meet the demands of national foreign exchange balancing.

Chapter Six Supervision and Management

Article 31. CSRC and SAFE shall be responsible for annual review of the Securities Investment Business Permit and the Foreign Exchange Registration Certificate held by a Qualified Investor.

Article 32. CSRC, PBOC and SAFE may require Qualified Investors, custodians, securities companies, stock exchanges, and securities registration and settlement institutions to provide relevant materials and information with respect to the investment activities of Qualified Investors in the PRC. If necessary, CSRC, PBOC and SAFE may conduct on-site inspections.

Article 33. Stock exchanges and securities registration and settlement institutions may in accordance with different circumstances formulate new operational rules or revise existing operational rules with respect to the securities investments of Qualified Investors in the PRC. Such rules shall be implemented after being submitted to CSRC for approval.

Article 34. A Qualified Investor shall report to CSRC, PBOC and SAFE for the record within five (5) business days upon the occurrence of any of the following events:

(1) Change of custodian;

(2) Change of legal representative;

(3) Change of its controlling shareholder;

(4) Adjustment of registered capital;

(5) Litigation-related or other material events;

(6) Being subject to serious penalty outside the PRC; and

(7) Other circumstances stipulated by CSRC and SAFE.

Article 35. A Qualified Investor shall reapply for the Securities Investment Business Permit upon the occurrence of any of the following events:

(1) Change of the name of the Qualified Investor;

(2) Acquisition by or merger with another entity; and

(3) Other circumstances as stipulated by CSRC and SAFE.

Article 36. A Qualified Investor shall return the Securities Investment Business Permit and the Foreign Exchange Registration Certificate to CSRC and SAFE respectively upon the occurrence of any of the following events:

(1) All principal has been remitted outside the PRC;

(2) Investment quota has already been transferred;

(3) The legal entity is proposed to be dissolved, enter into bankruptcy proceedings, or its assets have been taken over by a trustee; and

(4) Other circumstances as stipulated by CSRC and SAFE.

The Securities Investment Business Permit and the Foreign Exchange Registration Certificate shall become invalid automatically if the annual review conducted in accordance with Article 31 of these Measures is not passed, whereupon the Qualified Investor shall return the Securities Investment Business Permit and Foreign Exchange Registration Certificate respectively in accordance with the above provision.

Article 37. Any Qualified Investor, custodian or securities company, etc. that violates these Measures shall be subject to warning or monetary fine from CSRC, PBOC or

SAFE according to their respective jurisdictions. However, the same violation of law shall not result in two (2) or more administrative punishments.

Chapter Seven Miscellaneous

Article 38. The stipulations of these Measures shall apply to institutional investors established in the Hong Kong Special Administrative Region, the Macao Special Administrative Region and the Taiwan Region that engage in securities investment in the PRC.

Article 39. These Measures shall become effective on December 1, 2002.