



China Securities and QFII

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With thousands of years of history, it is surprising to learn that China has developed and built its securities market in only the last fourteen of those years. December 1990 marked the beginning of the Chinese securities industry with the Shanghai Stock Exchange being the first to open for operations. One year later, the Shenzhen Stock Exchange opened with the expectation that these two markets would bring China into the international trading community.

The original focus was on serving the retail community through the 'A'-share market. Soon to follow, in early 1992, the first 'B' share listing for the market place was released. Momentum was building and 12 years later, China announced its development of the Qualified Foreign Institutional Investors (QFII) scheme to introduce foreign participants to the Chinese market. Launched on 1 December 2002, participation has increased beyond expectations with the list of QFII participants growing by the month.

The China market

In order to better understand the Chinese market and its movement to include foreign investors, we must first look at its growth over the years. By 1993, only two years after the start of operations at the Chinese exchanges, China had 177 A-share listed companies in its market place. By 2002, that number had grown to 1,199 listed companies.

If we look at this from a market-capitalization perspective, we can see that the 1993 starting position of RMB332 bn reached RMB3,753 bn by the end of 2002. In addition to this year over year growth, the year 2000 marked the peak of the

market at RMB4,746 bn. Not only was the market place correct in its belief that China represents one of the largest emerging markets, but we could see the evidence in the numbers.

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As we look deeper into the market, we see some more interesting developments. From a shareholding structure review, we realize that only 27% of the total holdings are in A shares. State-owned shares constitute the largest holding at 51%, with legal person's shares at 19% and the remaining 3% for the 'B'-share market. This clearly shows that the government still holds the majority ownership and yet the retail investor is gaining quickly in terms of percentage share.

What does this all mean from a regional perspective? In just 14 years, the Chinese securities market has become the

second-largest market in the Asia region. Japan, with a 55-year-old exchange, leads the region with a US\$2,000 bn market, with China in second place, with about US\$500 bn. China may only be one-quarter the size of the Japanese market, but it is clear through growth projections and what has been accomplished over the past 14 years, that time is the only factor holding the Chinese back. These two markets, with regard to market size, are then followed closely by Hong Kong and Korea.

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Another interesting statistic is that of market capitalization by sector. The largest sector in China is machinery, at approximately RMB484 bn, followed by metals & non-metals at RMB393 bn and then petrochemicals, mining, utilities, transportation and information technology.

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QFII

The original objectives of the QFII scheme were many and yet they obviously focused around the building of the A-share market. By encouraging the growth of the institutional investor community, China is confident that its markets can continue to grow at a pace that meets global expectations, as well as domestic requirements. It is also believed that the introduction of the QFII scheme would help to strengthen the understanding and regimen of the Chinese professional investor, as well as develop China's

corporate governance and market transparency to meet global levels. In the end, and at the very least, the introduction of foreign investors to the Chinese market place will guarantee the introduction of best practices into a developing environment.

To qualify for the QFII scheme requires a long list of criteria to be met, as well as an intensive application process. Obviously, the requirements vary depending on the organization applying for status. For example, fund management companies need a minimum of five years' experience and at least US\$10 bn of assets under management. Insurance companies need a minimum of 30 years' experience, paid in capital of US\$1 bn and assets under management of US\$10 bn. For the final category of eligible companies, securities companies, the qualification requirements are equal to those of insurance companies.

Once these qualifications are met, the application process must be completed; this is no easy task. There are six steps involved in the process before investing can begin. Step one is the designation of a custodian. Once the custodian has been chosen, documents must be prepared as per the China Securities Regulatory Commission (CSRC) requirements. The approval process is then started with an expectation of a 15-day review period for both the CSRC and the State Administration of Foreign Exchange Control (SAFE). After the minimal 30-day wait, the applicant will or will not receive investment permission from CSRC and an investment quote from SAFE. Next, an account must be opened and SAFE must approve the account details. Final approval must be granted by the People's Bank of China (PBOC). The fifth step in this process is the injection of capital by the applicant into the market. The period for injection is a minimum of three months, with the first injection amount to be 20% of the quota. After the capital has been injected, the final stage is that of designating a local broker for trading. This local broker is chosen and contracted with the agreement of the QFII participant and the designated custodian. Once this arrangement is in place, a securities account must be opened with the China Securities Depository and Clearing Corporation Limited (CSDCC) and the exchanges of both Shanghai and Shenzhen.

After all of the above qualifications have been met, and the risk associated with the broker appointment has been assessed, the organization must review the complicated

measures around actual trading that affect the business. Capital repatriation rules, accounting structure and review (down to the sub account level), taxation, settlement cycles, currency conversion and the increase of quota's all lead to complications and difficulties in the trading environment. Is this getting easier? Yes. China is well aware of the concerns and the issues facing foreign investors. With the understanding that QFII is a testing scenario, China is hoping to improve these processes and address these concerns in order to encourage the qualified investor to invest in China. In the meantime, however, frustrations exist.

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Once QFII status has been granted, the foreign organization is granted the right to trade listed stocks, government bonds (only if registered and traded on stock exchanges), convertible bonds (again, if listed on stock exchanges), open-ended and closed-ended funds and last but not least the highly targeted IPOs of the developing markets of China.

QFII issues

Of the many issues that foreign entities face, two of the most discussed issues remain the repatriation of principal and the repatriation of realized profit. With regard to the repatriation of principal, closed-ended funds are allowed to be repatriated, on the investment principal, after three years of fund injection. That said, an entity can only repatriate 20% at each action and with an interval of one month between any two transfers. For other institutions, the repatriation of the investment principal can occur one year after injection with no more than 20% each time and in this instance with an interval of at least three months or more between two transfers.

Repatriation of realized profit within the QFII scheme is rather straightforward. Realized profit, after tax, can be repatriated 'as of the last accounting year after it is audited by a Certified Public Accountant in China'. This would follow in step with the end of the Chinese financial year, i.e., 31 December. This transaction can occur any time after the year-end and once all details have been submitted to SAFE.

Another issue facing the foreign investor, other than taxation and unknown tax exposure, is that of the single cash account structure. The QFII outline suggests that cash comingles across business lines, sub-funds and client accounts. The profit itself is calculated based on average cost and netting across capital gains, dividend, interest, fees and all other expenditures. This obviously creates an additional amount of effort for reconciliation.

Market infrastructure

As a result of China's market infrastructure being built and based on retail activity, foreign investors come up against many operational complications that must be reviewed and solutions developed against. Settlement in China is based on the trade execution. The local broker executes the trade, which is then settled by the clearinghouse on TD against the trade execution. For the foreign investor, this process must be reviewed and procedures put in place for the proper reporting cycle within the organization's operations.

The short settlement cycle must also be reviewed and accounted for. For cash settlement it is TD + 1, while on the securities side of the cycle it is simply TD. For many investors, this implies the restructuring of operations to handle the speed of the cycle. In many cases, this may also cause limitations for high volumes, due to the operational processing of these trades.

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As well as the above two market infrastructure concerns, a new participant in the Chinese market place must review the market fail trade mechanism. At present, the market place is structured to ensure that securities will settle directly into an investor's account on TD for any error trades that exist. The burden the foreign investor is then forced to review and account for is rather large. Arrangements must be made for reconciliation of error trade rectification between brokers and custodians with operational guidelines established before trading. The foreign investor must also establish a mechanism to identify the error trade before the market closes so that all

required procedures to ensure the settlement on TD occur as per market requirements.

FIX leads the way for electronic trading in China

What role does FIX play in the QFII process? The first role played by FIX in the QFII process is the exploration of the use of FIX as a means of electronic execution between the QFII participant and its Chinese local broker/dealer. This has already begun and in some cases has been effectively implemented. The Chinese broker/dealers have been eager to be nominated as counter-parties to the QFII participant. To show this eagerness, they have been exploring the use of FIX and preparing themselves to be FIX-enabled in order to capture more foreign order flow once a QFII partner has been found.

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Another area where FIX is under review is in the domestic market. China is plagued by a number of proprietary standards that have been introduced by the local broker/dealer community and the technology houses that support this community. As the QFII scheme influences the trading environment of China, the urgency to consolidate these standards and develop a simple flow between the broker/dealers, the exchanges and the banks becomes even more important. China has reacted to this need to consolidate these standards by evaluating FIX and its possible use in China.

The initial evaluation of this protocol disparity led to the creation of a Chinese prototype known initially as CFIX. CFIX, which has now been developed into STEP's – the Securities Transaction Exchange Protocol – and is a subset of FIX with certain nuances that are designed specifically for the Chinese market place.

The Securities Association of China (SAC) began reviewing and translating FIX as early as 2000. Only four years later and it is clear that the Shanghai Stock Exchange will add FIX, via STEP, to the exchange's latest platform build. Upon completion of this build in late 2005-06 it is believed

that FIX will rest on a strong foundation in China and thus increase the opportunities for electronic trading for both domestic brokers and QFII participants. This is reinforced further by China's recent decision to build a Chinese FIX Protocol Limited committee to continue the commitment to the use of FIX in China and its integration to the rest of the global FIX community.

Moving forward

With the introduction of QFII, all market participants in China face higher expectations with regard to their roles and responsibilities. The stock exchanges, clearing houses and of course the regulators must be willing to build and accept new regulations as well as operational procedures in order to ensure that the regulations are met. The custodians must grow to fill new shoes relative to the Chinese market, as well as champion the cause of the QFII investor in China. The broker/dealer must also properly assess the strengths and weaknesses of the Chinese market place, build services and infrastructure to support this new developing market and continue to promote electronic trading tools such as FIX.

Overall, the introduction of the QFII scheme brings many changes to the Chinese market, but it also brings many opportunities. The Chinese will benefit from the foreign investors' regulatory knowledge, operational knowledge, trading knowledge and product knowledge. The investor will gain access to one of the strongest developing markets in the world. It is believed that over time and through experience gained, procedures around the QFII scheme such as repatriation restrictions, taxation, account structure, regulatory procedures and a T+1 cycle will be re-assessed. As well as operational growth during this period, it is expected that product enhancements will occur that will encourage the building of greater breadth and depth to the Chinese market place. **FIX**