



INVESTMENT COMPANY INSTITUTE

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SENIOR COUNSEL

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Dear Dr. Sun and Dr. Zheng:

On behalf of the US mutual fund industry,¹ we are writing to commend China for taking steps to open its domestic securities markets to foreign institutional investors by establishing a qualified foreign institutional investor (QFII) regime. The creation of deep, liquid securities markets can be a powerful engine for economic growth, and foreign investors often are an important component of that depth and liquidity.

We would encourage China, however, to view the QFII system as transitional. QFII systems have been used to gradually and successfully open markets in Taiwan, Korea and India.² Following the model of those markets, we hope that China will progressively liberalize the restrictions the new rules impose on QFIIs and eventually abolish the QFII regime altogether, allowing all investors, foreign and domestic, full and equal access to the Chinese securities markets.

¹ The Investment Company Institute is the national association of the US investment company industry. Its membership includes 8,664 open-end investment companies (commonly referred to as "mutual funds"), 601 closed-end investment companies, 106 exchange-traded funds and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about US\$6.967 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

² Taiwan abolished its QFII regime on October 2, 2003. Korea and India still maintain systems of licensing foreign institutional investors, but both countries significantly liberalized their systems in recent years. The Institute has provided all three of these countries with recommendations for improvements in their regimes, most recently in a letter to the Securities and Exchange Board of India. A copy of that letter is attached.

We understand that full liberalization will take time and may be linked to the free convertibility of the Chinese currency. We also understand that China may have concerns about the impact of liberalization on the stability of its markets. While we appreciate these concerns, mutual funds are the type of long-term investors that can provide stability to an emerging market. As our research has shown, mutual fund investments in an emerging market are not "hot money." Our analysis of the behavior of mutual fund shareholders and portfolio managers during the Mexican peso crisis and the Asian financial crisis demonstrates that mutual fund shareholders did not redeem and portfolio managers did not sell securities during market downturns.³ For this reason, even if full liberalization remains years away, we hope that the CSRC and SAFE will review the operation of the new QFII rules and seek ways to eliminate or revise those features of the system that make it unattractive to mutual funds and other long-term foreign institutional investors.

With this in mind, we have set out below several recommendations that we believe could significantly increase the number of long-term foreign institutional investors that would seek to apply for QFII licenses and participate in the Chinese securities markets. We hope that the CSRC and SAFE will take these recommendations into consideration.

Recommendations

A. Percentage Limitations on Foreign Ownership of Chinese Equities

Article 20 of the CSRC's QFII rules⁴ sets percentage limits on investments in Chinese listed companies by QFIIs. Article 20(1) prohibits any QFII from individually owning more than 10% of the total outstanding shares of a company, and Article 20(2) prohibits all QFIIs in the aggregate from owning more than 20% of the total outstanding shares of any company.

The Shanghai Stock Exchange implementing rules⁵ and the Shenzhen Stock Exchange implementing rules⁶ set forth relevant procedures with respect to these limits, specifying the procedures that the Exchange must follow in notifying QFIIs that limits have been exceeded and the procedures that QFIIs must take to reduce their positions to conform to the limits. The rules also require the Exchange to identify those companies

³ See John Rea, "U.S. Emerging Market Funds: Hot Money or Stable Source of Investment Capital?" *Perspective* Vol. 2, No. 6 (December 1996) and Mitchell A. Post and Kimberlee Millar, "U.S. Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets," *Perspective* Vol. 4, No. 2 (June 1998). Copies of these studies are attached.

⁴ The Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII) 《合格境外機構投資者境內證券投資管理暫行辦法》 (November 5, 2002) jointly promulgated by the CSRC and PBOC.

⁵ The Shanghai Stock Exchange Implementing Rules for Securities Transactions by Qualified Foreign Institutional Investors 《上海證券交易所合格境外機構投資者證券交易實施細則》 (December 1, 2002).

⁶ The Shenzhen Stock Exchange Implementing Rules for Securities Transactions by Qualified Foreign Institutional Investors 《深圳證券交易所合格境外機構投資者證券交易實施細則》 (December 1, 2002).

whose securities are close to the aggregate QFII investment limit, noting instances where QFII investment has exceeded thresholds of 16%, 18% and 20%.⁷ In instances where the 20% limit has been exceeded, the Exchange will notify the QFIIs through the relevant securities companies and custodian banks that they have to divest their holdings within five trading days using a last-purchase, first-sale method.

For a number of reasons, this strict quota system is likely to reduce institutional demand for Chinese securities. First, on a macroeconomic level, the quota arbitrarily limits a significant source of capital – QFIIs – by preventing those investors from making investments beyond a certain point. Second, on a more microeconomic level, the possibility of forced divestment is a major factor for institutional investors to consider in deciding whether to purchase a Chinese security. Since the stock exchanges notify QFIIs that the 20% threshold has been exceeded only after the close of the trading day, QFIIs have no way to know whether a purchase will cause the 20% threshold to be exceeded (in which case they would have to sell that position within five trading days). This uncertainty will reduce both the price the QFII is willing to pay for any particular security (*i.e.*, its market value) and the overall demand for it. Third, a hard cap will cause excess volatility in securities where QFII ownership is nearing the limit, since QFIIs may rush to purchase securities that are close to the limit and will be forced to sell securities that are over the limit. For all of these reasons, we believe that the 20% maximum limit on the aggregate ownership of Chinese securities by QFIIs should be removed. If that is not possible, we would strongly recommend increasing the limit to at least 50%.⁸ We would further recommend that China adopt a monitoring mechanism by the exchanges to facilitate compliance checks prior to the execution of trades when the 20% limit for QFIIs is approaching, similar to those employed by Korea and, until recently, Taiwan.

B. Minimum Account Size and Procedures for Remittances

The SAFE rules⁹ require each QFII to commit total investments of at least US\$50 million to a special dedicated QFII account. First, we would recommend that China reduce or eliminate the minimum account requirement. Given the current limited size of the Chinese market and the percentage limits on investments by QFIIs, this minimum account provision may operate as a practical matter as a barrier to entry for QFIIs. In any event, it likely will serve as a disincentive to investment in China since many of the institutional investors that may be in the best position to invest in the Chinese markets

⁷ Article 7 of both the Shanghai Stock Exchange Implementing Rules and the Shenzhen Stock Exchange Implementing Rules requires the Exchange after close of the trading day to publicly announce the total number and percentage listed A-shares held by QFIIs for any company where QFIIs hold more than 16% of the total outstanding shares and similarly at every 2% increment thereafter.

⁸ We note that under similar circumstances, Korea imposed a 20% limit on foreign portfolio investment in the early stages of opening its market in 1992, which it incrementally raised to 50% and ultimately removed completely in 1998.

⁹ The Provisional Regulations for Foreign Exchange Control of Investment in Domestic Securities by Qualified Foreign Institutional Investors 《合格境外機構投資者境內證券投資外匯管理暫行規定》(November 28, 2002).

may be smaller, more specialized asset management firms. These firms may be unable, or it may be unwise for their portfolios, to allocate \$50 million to investment in China, despite being appropriately sophisticated and committed to the Chinese markets. A smaller minimum account size (or no minimum at all) would encourage these types of institutional investors to apply for QFII licenses.

Second, we recommend extending the deadline for remitting initial funds to China. The QFII rules and SAFE rules¹⁰ require that remittance of funds to China must be completed within three months of the QFII receiving the investment quota and foreign exchange license. The Institute's members had a difficult time managing similar deadlines in Taiwan. Based on that experience, we believe that this period is extremely short and should be extended.

The QFII rules¹¹ further require that the principal amount committed and remitted to the QFII account must remain in China for a period of time. For fund management institutions (and therefore open-end funds), this period is one year. For closed-end funds, it is three years. Even after the initial lock-up period has ended, the SAFE rules¹² state that the repatriation of invested principal is subject to SAFE's review and approval. These lock-up provisions significantly impair the liquidity of investments in the Chinese markets and raise regulatory issues for open-end funds such as US mutual funds. The US Securities and Exchange Commission requires all mutual funds to invest substantially all of their assets in liquid securities in order to remain ready to satisfy redemption requests.¹³ Lock-up provisions like those in the QFII rules raise concerns among mutual funds as to whether the affected securities should be treated as illiquid because the proceeds from their sale cannot be converted into US dollars and used to satisfy redemption requests. Mutual funds are also required to value the investments in their portfolios in US dollars at least once each business day.¹⁴ It is difficult for mutual funds to perform this valuation with respect to securities that they cannot reduce to their base currency.

In addition, lock-up provisions raise concerns for US mutual funds as to whether the affected investments would be consistent with their fiduciary duties to their shareholders. Repatriation restrictions severely limit investment managers' ability to adjust their portfolios when they deem it to be appropriate or to liquidate investments in response to contractual or regulatory obligations. They also are seriously at odds with

¹⁰ Article 25 of the QFII rules and Article 9 of the SAFE rules.

¹¹ Article 26 of the QFII rules.

¹² Article 20 of the SAFE rules.

¹³ Section 22(e) of the Investment Company Act prohibits mutual funds from suspending redemptions of their shares (subject to certain extremely limited exceptions) or delaying payments of redemption proceeds for more than seven days. In part to facilitate compliance with this provision, the SEC requires that all mutual funds invest at least 85% of their assets in liquid securities. (We understand that many mutual funds maintain significantly higher percentages of liquid assets.) A security is generally deemed to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the mutual fund has valued the security.

¹⁴ Rule 22c-1(b) under the Investment Company Act.

international investment management norms. Consequently, a portfolio manager that chooses to commit client funds to such a market must carefully consider, as a fiduciary, whether such an investment can be justified in light of available alternatives.

Given these concerns, the QFII lock-up provisions may substantially limit US mutual funds' ability to participate in the A-share market.¹⁵ We therefore recommend significantly shortening them.¹⁶

C. Qualification Standards

Article 7 of the CSRC rules require fund management institutions to have operated a fund business for over 5 years and to manage assets of at least US\$10 billion in order to qualify for a QFII license. While we understand the need for minimum qualifications for QFIIs, both the time-in-existence and minimum asset requirements could prove problematic for certain institutional investors that would be appropriate QFIIs.

On a more technical level, we note that the rules do not specify how the US\$10 billion figure is to be calculated. We would recommend that the CSRC calculate this requirement by including all assets under management by the investment fund management institution, whether in registered mutual fund products or other types of client accounts (such as pension funds or separate accounts).

D. Transparency in the Licensing Process

Article 11 of the QFII rules states that, in order to encourage medium and long-term investments, the CSRC will give preference to institutions managing closed-end Chinese funds or pension funds, insurance funds and mutual funds with "good investment records" in other markets. This provision lacks any specific criteria to be applied in making priority determinations and we are concerned by its subjectivity. Regulations that lack transparency or provide broad discretion to officials in approving applications create uncertainty for foreign firms that wish to enter foreign markets and thus effectively operate as barriers to entry. Transparent regulations and administrative practices, by contrast, ensure that foreign firms will not be treated in an arbitrary manner and that approvals of applications will be based on objective and fair criteria and on rules to protect investors. We believe this type of regulatory environment would help attract global asset management firms to China. We therefore would strongly encourage the CSRC to use specific objective criteria in processing applications for QFII licenses and not to rely upon provisions such as this one that lack transparency.

¹⁵ For a more complete discussion of the impact of these types of restrictions on US mutual funds, see the Institute's letter to Malaysia responding to the imposition of capital controls in 1998. A copy of that letter is attached.

¹⁶ For reference, we understand that Taiwan set its initial investment lock-up period at three months when it introduced its QFII regime in 1991.

E. Appointment of Domestic Securities Companies

Article 3 of the QFII rules requires that a QFII must appoint a securities company to conduct trading activities. Article 19 further requires that each QFII may only appoint one securities company. These provisions pose difficulties for US mutual funds, since their internal control and counter party risk monitoring policies generally require them to use multiple local brokers to execute trades. We therefore suggest that these rules be revised to allow QFIIs to use multiple brokers.

F. Documentation Requirements

Article 8 of the QFII rules describes the documentation that must accompany an application for a QFII license. This section provides that the supporting documentation, if written in languages other than Chinese, must be accompanied by Chinese translations or Chinese extracts.

Although we fully understand the need for a QFII license application to be translated into Chinese, the requirement to translate supporting documentation into Chinese could prove to be quite burdensome. For example, a US mutual fund may wish to demonstrate that it has a sound management structure and internal control system as required by Article 6(3) of the QFII rules by providing a copy of the code of ethics required under US law. These codes often are based on model codes published by the Institute and, although quite lengthy, tend to be very similar in terms of content. As a result, the CSRC may conclude that Chinese translations of these documents are not necessary to allow it to evaluate a QFII application from a US mutual fund. It could require instead that the fund certify (in Chinese) that it has adopted policies and procedures designed to ensure compliance with applicable law and attach a copy of its English-language code of ethics. The CSRC could take a similar approach to other supporting documentation in appropriate circumstances or, at a minimum, could indicate the key documentation which needs to be translated.

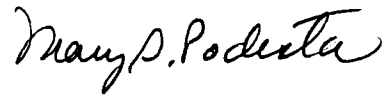
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We appreciate the opportunity to provide these recommendations on possible ways to improve the attractiveness of China's markets to foreign institutional investors. As we said at the outset of this letter, the establishment of a QFII regime is an important first step in the creation of deep and liquid securities markets. We commend China for taking that first step, and hope that our views prove helpful in the future.

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We will be traveling to Beijing later this month and would welcome the opportunity to speak to you directly about these comments and recommendations. In the meantime, if you would like to discuss them or if you would like additional information, please feel free to contact me at 202-326-5826 (phone), 202-326-5841 (fax) or podesta@ici.org (e-mail), or Bob Grohowski at 202-371-5430 (phone), 202-326-5841 (fax) or rcg@ici.org (e-mail).

Sincerely,

A handwritten signature in cursive script that reads "Mary S. Podesta".

Mary S. Podesta
Senior Counsel

Attachments