Your bridge between Europe and China:
Luxembourg

September 2014
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I. Executive summary

We learn from our on-going dialogue with Chinese asset managers that expanding overseas is one of their highest short to medium term priorities. This publication aims to provide some key information for Chinese asset managers who are considering establishing their international presence via Luxembourg. It provides brief background information on the qualified domestic institutional investors (QDII) and the qualified foreign institutional investors (QFII) regimes. It sets out the reasons for choosing Luxembourg as the “hub” from which funds may be distributed to European and international investors. In addition it provides some information on the different fund structures available in Luxembourg for creating UCITS, covering traditional equity, fixed income, money market and ETF types of products and for creating alternative fund products such as private equity, hedge, real estate, debt and infrastructure. We have also provided some examples of typical fund structures and discuss the use of Hong Kong as the gateway between Luxembourg and China.
II. QDII and QFII

To open up the Chinese securities market to foreign investors while also allowing Chinese investors to make investments outside China, the Chinese government introduced two programs, the Qualified Domestic Institutional Investors (QDII) program and the Qualified Foreign Institutional Investors (QFII) program. Luxembourg and China have been able to mutually benefit from these programs. Given its traditional strength as a fund domicile and distribution hub, Luxembourg is a natural gateway for investment flows in and out of China. China’s QDII program gives investors access to markets outside the country. Luxembourg’s Memorandum of Understanding (MoU) qualifies Luxembourg regulated investments funds as eligible investments for QDII investing. The QFII program offers foreign investors access to securities markets in China. International asset managers generally enter the Chinese market through joint ventures with local Chinese partners. Launched in December 2011, the RMB Qualified Foreign Institutional Investor (RQFII) pilot scheme has been welcomed by China’s asset management companies which aim to further expand their international business by offering offshore Renminbi products.

A. QDII

Since April 2006, China’s Qualified Domestic Institutional Investors (QDII) program has given Chinese investors access to markets outside the country, opening new opportunities for investment funds.

The regulations for QDII program was outlined in a brief document issued by the People’s Bank of China (PBOC) in April 2006. This sets out the framework for investments by commercial banks, insurance companies and fund managers.

**QDII for commercial banks**

In May 2007, the China Banking Regulatory Commission (CBRC) issued a Circular on Adjusting the Scope of Overseas Investment by Commercial Banks for Overseas Wealth Management Business for Clients, allowing onshore commercial banks to invest in offshore equity within certain limits. This significantly expanded the scope of investment authorized for commercial bank QDIIs.

**QDII for fund managers and securities firms**

In June 2007, the China Securities Regulatory Commission (CSRC) issued the Interim Measures for Overseas Securities Investment by Qualified Domestic Institutional Investors and its implementation notice, allowing qualified Chinese fund management companies and securities firms to invest in offshore financial markets.

The funds created by fund managers and securities may invest in a wide range of financial products. In contrast to the QDII regime for commercial banks, CSRC’s rules provide more flexibility in terms of product structuring.
Access to Luxembourg regulated products

The signing of the MoU between regulators in Luxembourg and China took the process one step further, allowing Chinese institutional investors to invest in Luxembourg regulated investment fund products. In 2008, the MoU was signed between Luxembourg’s Commission for the Supervision of the Financial Sector (CSSF) and the CBRC. It allows QDIIs to invest on behalf of their clients in financial products regulated by the CSSF. The MoU makes Luxembourg one of the few financial centers to have such an agreement1 in place. This agreement also makes it possible to distribute Undertaking for Collective Investment in Transferable Securities (UCITS) in mainland China through the QDII scheme.

QDII products issued by Chinese fund managers show that they tend to allocate investment to the Hong Kong market, to Chinese related securities or to top performing foreign funds. Most banks’ QDII products tend to replicate an index and invest in a single asset class, or replicate an international investment fund, generally a UCITS. As a leading jurisdiction for UCITS, Luxembourg is the natural home for QDII products investing in funds.

Going forward, Luxembourg is expected to evolve into the domicile of choice for an internationally recognized brand of alternative investment fund products meeting the requirements of the Alternative Investment Fund Managers (AIFM) Directive, including real estate, private equity, venture capital and hedge funds.

B. QFII and RQFII

The Qualified Foreign Institutional Investor (QFII) scheme allows foreign investors access to securities markets in China since they can invest in the country’s restricted Renminbi (RMB). The QFII scheme allows foreign institutions to trade Chinese A-shares and other financial instruments via special accounts opened at designated custodian banks.

In July 2012, CSRC broadened the QFII investment scope to include stock futures and warrants and increased the shareholding limit in a single listed company by all overseas investors to 30%.

The RMB Qualified Foreign Institutional Investor (RQFII) pilot scheme was launched in December 2011. Under the RQFII program, offshore investors in Hong Kong will be allowed to invest offshore RMB in the Chinese mainland securities markets via the Hong Kong subsidiaries of mainland securities companies and fund management companies. It is expected that the investment scope of RQFII may be further extended in the future. The program highlights the gradual opening of China’s securities markets and provides a channel for offshore RMB to flow back into mainland China. It is possible to connect a UCITS structure to RQFII funds. The program also opens a door for local asset managers to further explore their international business by providing a new playing field.

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1 At 31 December 2011, the CSRC (www.csrc.gov.cn) listed 51 overseas authorities, and the CBRC listed 48 (www.cbrc.gov.cn), which had signed an MOU; Luxembourg is listed on both websites. As a consequence, Luxembourg- domiciled UCITS funds are eligible for QDII portfolios promoted by banks, fund managers and securities firms in China.
III. Your bridge between the European and Chinese markets: why Luxembourg?

- Luxembourg is a natural gateway for investment flows in and out of China.

- Luxembourg is recognized as the global hub for cross-border investment funds offering Chinese asset managers a platform to launch an investment fund product and to distribute this on a cross-border basis – i.e., not only in Europe but back to Asia and across the globe.

- The MoU signed between Luxembourg’s and China’s regulators makes Luxembourg one of the few financial centers to have such an agreement, enabling QDIIIs to invest directly in Luxembourg regulated financial products, including investment funds domiciled in Luxembourg.

- Luxembourg is actively building relationships with China and other Asian countries and has concluded 11 treaties to avoid double taxation with various Asian countries or regions (including the People’s Republic of China, Japan, Indonesia, Malaysia, South Korea, Mongolia, Thailand, Singapore, Vietnam, India and the Hong Kong Special Administrative Region).

Luxembourg offers Investors:

- A strong tradition of investor protection
- A stable democracy and strong economy: Luxembourg is a founding member of the European Union
- A knowledgeable and responsive regulator
- Proactive legislation: a close working relationship between the business community, the government and legislators which underpins Luxembourg’s innovative legal framework
- A tradition of financial expertise
- A unique concentration of investment fund industry experts in all aspects of product development, administration and distribution
- Extensive experience in technical investment fund solutions, including multiple share classes and pooling
- Service providers such as depositories, custodians, fund administrators, fund lawyers, audit firms and tax advisors experienced in cross-border registrations of both UCITS and alternative funds

A. UCITS: the global distribution product for Chinese asset managers

Undertaking for Collective Investment in Transferable Securities (UCITS) and other regulated investment vehicles play a significant role in the development of QDIIIs, this is due to Chinese banks and fund managers that are very reluctant to invest directly in foreign markets.
The reason is simple: investment funds are an easy way to invest in the global market, tapping into experienced asset management specialists in worldwide markets without having to set up a complex back office to handle administrative tasks. UCITS are open-ended funds investing in transferable securities such as shares and bonds which are subject to a harmonized EU regulatory regime. The regime is designed to offer high levels of investor protection appropriate for retail investors. This UCITS regime regulates the organization, management and oversight of such funds, and lays down rules on diversification, liquidity and use of leverage.

UCITS may be set up in an “umbrella” structure with various sub-funds created to pursue different strategies and to operate as distinct entities. Accordingly, a UCITS may have several sub-funds, each of which may pursue different investment policies and attract different investors.

UCITS are flexible and may take a contractual (FCP) or a corporate (SICAV) form. Investment funds that fulfill the requirements of the UCITS Directive benefit from a “passport” permitting them to be freely marketed throughout the European Union.

UCITS have evolved from a European investment fund product to a truly international product; today, the “UCITS brand” is renowned globally. As a result, an increasing number of asset managers are establishing UCITS funds with a clearly defined global distribution strategy in mind.

Luxembourg has successfully positioned itself as the global leader for cross-border distribution of investment funds, with the result that today almost 75% of UCITS funds distributed internationally are based in Luxembourg.

A growing number of countries in Asia recognize the UCITS as a high quality, well regulated and stable investment product with significant levels of investor protection, and permit the distribution of UCITS products.

The main UCITS exporting countries in Europe

Figures as at 31 December 2011; Source: Lipper

73% of all UCITS registered in at least 3 countries (including home state) are Luxembourg Funds
B. Alternative funds: a complete range of products and solutions

While UCITS are savings vehicles targeting retail investors and designed to offer the highest possible protection of investors, other asset classes such as real estate, private equity, venture capital and hedge funds fall outside the scope of UCITS.

Currently, the distribution of non-UCITS funds very much depends on each local country's distribution regulations. However, it is expected that this will soon change.

The European Union is implementing a harmonized regime regulating the managers of those non-UCITS investment funds, with a view of increasing levels of investor protection. All such funds will be classified as “alternative investment funds”. Authorized managers of such products will benefit from a passport to market to professional investors throughout the European Union, similar to the existing passport for the marketing of UCITS to investors. This new regime will replace local private placement regimes which vary from one European country to another.

The “Alternative Investment Fund Managers” regime is expected to create a global alternative investment fund brand for non-UCITS funds comparable to that currently existing for UCITS. Luxembourg is well positioned to replicate the Luxembourg UCITS success story for the distribution of alternative funds, benefiting from its reputation and expertise as a hub for UCITS products.

The vehicles used in Luxembourg are the following:

- Specialized Investment Fund (SIF)
- Investment company in risk capital (SICAR)
- Financial holding companies (SOPARFI). These unregulated entities are usually used for the efficient structuring of investments in combination with SIFs or SICARs

SIFs and SICARs can take various forms (e.g., common fund, investment company, limited liability or public limited company, partnership) and can be set-up to be transparent or opaque structures from a tax perspective. For further information, see EY's “Investment Funds in Luxembourg - A Technical Guide”
C. A hub for expansion into Europe and beyond

Luxembourg has a long-standing reputation of being the global center of cross-border investment fund management. Therefore, if a Chinese asset manager plans to launch an investment fund product and to distribute this on a cross-border basis, i.e., not only in Europe but back to Asia, to Latin America and to the Middle East, Luxembourg offers the ideal platform for their distribution ambitions.

A number of well established factors make Luxembourg the leading jurisdiction. These include Luxembourg’s “brand recognition” and “track record” in the cross-border space with a market share of almost 75%, the existence of a center of excellence for its fund infrastructure and expertise to create products covering all asset classes and for any investor type, deep servicing and product structuring know-how in the cross-border space, multi-language capabilities and, most importantly, a very stable economic, political and regulatory environment.

An example, of how asset managers using Luxembourg UCITS may expand their investor base:

![Diagram showing how asset managers using Luxembourg UCITS can expand their investor base.](image)
D. A pragmatic tax regime

A pragmatic tax regime

A number of key features make Luxembourg a tax efficient place to conduct business:

- Stable and consistent tax legislation
- Planned activities may be discussed in advance with the Luxembourg tax authorities leading to a certainty of outcomes
- Tax authorities apply a pragmatic approach
- Access to a wide variety of over 60 double taxation treaties; these types of agreements between countries tend to eliminate the taxation of the same income in two countries (i.e., elimination of double taxation)
- Access to all advantages resulting from EU Directives
- Flexible use of tax efficient structures for repatriation of profits
- Dividends and capital gains are tax exempt according to the participation exemption regime
- No withholding tax on interest, license fees and dividends (if certain conditions are met)
- No capital duty/stamp duty
- Management services and administration services provided by a Luxembourg service provider to a Luxembourg fund are VAT exempt or outside the scope of VAT
- Special tax regime for expatriate highly skilled employees (if certain conditions are met)
Examples of efficient tax structures

1. **Inbound: investing efficiently in China**

   - **Principally no, or very limited, dividend withholding taxation between EU states. No capital gains taxation in Luxembourg upon disposal of shares in the fund (with restrictions).**
   - **Possibility for fund-up structuring (e.g., via a feeder vehicle).**
   - **Specific repatriation instrument/entity allow bringing proceeds back to the fund without withholding taxes. No withholding tax on liquidation proceeds.**

   ![Diagram of Inbound tax structure]

2. **Outbound: Chinese investors investing in European companies using alternative fund structures.**

   - **No withholding tax on dividends paid to investors. No capital gains taxation in Luxembourg upon disposal of shares in the fund (with restrictions).**
   - **Possibility for fund-up structuring (e.g., via a feeder vehicle).**
   - **Specific repatriation instruments allow bringing proceeds back to the fund without withholding taxes. No withholding tax on liquidation proceeds.**

   ![Diagram of Outbound tax structure]
A broad double taxation treaty network

For many managers and investors, a wide-reaching double taxation treaty (DTT) network is important when selecting an overseas jurisdiction to perform foreign investments. The aim of DTTs is to avoid double taxation and to encourage international trade, as well as flows of capital and labor between the contracting jurisdictions and also to provide certainty in taxation, to combat tax avoidance, tax fraud and tax evasion, and to eliminate possible discriminatory taxation.

Managers can therefore benefit from DTTs to minimize tax costs on the returns on their investments in Asia, e.g., withholding tax on dividends, interest and, possibly, capital gains. A DTT does not create any additional taxation in comparison with domestic tax law. Thus, even if the DTT sets a withholding tax of 10% maximum on interest payments to a Chinese resident investor, no withholding tax applies in Luxembourg on interest payments made to Chinese resident investors under Luxembourg domestic tax law. DTT benefits are not exclusively reserved to fully taxable companies in Luxembourg.

Luxembourg is actively building relationships with China and other Asian countries and has concluded DTTs with various Asian countries or regions.

Luxembourg has an extensive DTT network spanning the world’s major economies, including the United States, Canada, Brazil, most European countries, South Africa, the United Arab Emirates and Russia.

China can also act as a “door opener” for Luxembourg structures to other countries which have a DTT with mainland China but not with Luxembourg (e.g., Philippines, Macao, Brunei, Laos).
E. Luxembourg – Hong Kong, a natural gateway for Chinese investors

In practice, Chinese asset managers generally do not come directly from China to invest in Europe. Instead, they usually adopt a “stepping-stone approach”: Chinese asset managers usually set up their own subsidiaries in Hong Kong to familiarize themselves with the international regulatory and operational standards and build up their know-how from there. They then use Hong Kong and their locally regulated entities to look outwards for further distribution in Asia and Europe.

The Luxembourg-Hong Kong DTT negotiated and concluded by both jurisdictions highlights the bridge between Hong Kong and Luxembourg as a preferred channel for Chinese investments in Europe, combining two favorable tax regimes. Hong Kong has always played a predominant role as a window to the Chinese market. It has substantially increased the number of DTTs since 2010, when 5 DTTs were in place. This number went up to 25 signed agreements, of which 21 were in force at the end of December 2012.

If Hong Kong companies do business or make investments overseas, they are thus potentially subject to significant tax costs. Such costs would typically take the form of, inter alia, withholding tax on interest, dividends, royalties, or capital gains. Since Hong Kong has adopted a favorable territorial tax system, such taxes can generally not be recovered in Hong Kong, which may lead to final tax costs for investors.

It is possible to reduce such costs by using Luxembourg investment vehicles, provided certain conditions are met. The DTT between Luxembourg and Hong Kong allows flexible and tax-efficient returns on profits and cash to Hong Kong investors and remains one of the most attractive DTTs in place.
### Glossary

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<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>A shares</td>
<td>Companies incorporated in mainland China and traded on the mainland A-share markets. A shares are quoted in Renminbi, and currently only mainlanders and selected foreign institutional investors are allowed to trade them.</td>
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<td>AIFM</td>
<td>Alternative Investment Fund Managers</td>
</tr>
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<td>AuM</td>
<td>Assets under Management</td>
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<tr>
<td>B shares</td>
<td>Companies incorporated in mainland China and traded in the mainland B-share markets (Shanghai and Shenzhen). B shares are quoted in foreign currencies. Initially, only foreigners were allowed to trade in them, but since March 2001, mainlanders have been authorized to trade B shares as well. However, they must use legal foreign-currency accounts to do this.</td>
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<td>CBRC</td>
<td>China Banking Regulatory Commission</td>
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<td>CSRC</td>
<td>China Securities Regulatory Commission</td>
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<td>CSSF</td>
<td>Commission for the supervision of the financial sector, the Luxembourg supervisory authority for the financial sector.</td>
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<td>FCP</td>
<td>Common fund, an unincorporated and tax-transparent co-ownership of assets</td>
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<td>DTT</td>
<td>A Double Taxation Treaty (DTT) eliminates double taxation of income earned in one Contracting State by a resident of the other.</td>
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<td>Institutional investor</td>
<td>Undertakings and organizations that manage a sizeable number of funds and assets. The term covers credit institutions and other financial sector professionals, insurance and re-insurance undertakings, welfare institutions and pension funds, industrial and financial groups, and structures put in place by these entities to manage substantial funds and assets.</td>
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<tr>
<td>H-shares</td>
<td>Companies incorporated in mainland China and listed on the Hong Kong Stock Exchange and other foreign stock exchanges.</td>
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<td>Professional investor</td>
<td>A professional investor as defined within the meaning of the Markets in Financial Instruments Directive (MiFID).</td>
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<td>Acronym</td>
<td>Description</td>
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<tr>
<td>QDII</td>
<td>Qualified Domestic Institutional Investor</td>
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<td>QFII</td>
<td>Qualified Foreign Institutional Investor</td>
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<td>RMB</td>
<td>Renminbi</td>
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<td>RQFII</td>
<td>RMB Qualified Foreign Institutional Investor</td>
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<td>SICAR</td>
<td>Investment company in risk capital</td>
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<td>SICAV</td>
<td>Investment company with variable capital</td>
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<tr>
<td>SIF</td>
<td>A specialised investment fund</td>
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<tr>
<td>SOPARFI</td>
<td>Financial holding companies - Companies which have, as their main corporate purpose, the holding of participations in other companies</td>
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<tr>
<td>UCI</td>
<td>Undertaking for collective investment</td>
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<tr>
<td>UCITS</td>
<td>Undertaking for collective investment in transferable securities</td>
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Appendix – selected publications

Investment Funds in Luxembourg
A technical guide – September 2014
For further information, see:
www.ey.com/lu/investment-funds-in-luxembourg

The Luxembourg Specialized Investment Fund
March 2012

CSRC announces provision for domestic securities investments by QFIs

A new dawn for alternative investments
Navigating the challenges and opportunities of the AIFM Directive

Cross-border management of UCITS
The Luxembourg Specialized Investment Fund - March 2012

The Luxembourg Financial Connection, Issue 21

Financial Services Alerts:
- Luxembourg proposes one-stop shop for alternatives – Draft law transposing AIFM Directive
- SIF risk management and conflicts of interest requirements clarified
- European Commission consults on UCITS VI, money market funds and long-term retail UCIs
- New guidelines from ESMA: significant impacts for many UCITS
- Commission issues UCITS V proposal
- Commission proposes key information document for investment products proposal
- Investment funds: French reclaim opportunity
- Securitization – CSSF publishes revised best practices document

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The Association of the Luxembourg Fund Industry (ALFI)

The Association of the Luxembourg Fund Industry (ALFI), the representative body for the Luxembourg investment fund community, was founded in 1988. Today it represents over a thousand Luxembourg-domiciled investment funds, asset management companies and a wide variety of service providers including depositary banks, fund administrators, transfer agents, distributors, law firms, consultants, tax advisers, auditors and accountants, specialist IT providers and communications agencies.

ALFI defines its mission as to lead industry efforts to make Luxembourg the most attractive international centre.

EY Luxembourg is a member of ALFI.

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