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A legal update from Dechert's Financial Services Group

China Is Opening the Door to Investment in U.S. Stocks and Funds

The China Banking Regulatory Commission ("CBRC") is expected to soon enter into a memorandum of understanding with the U.S. Securities and Exchange Commission ("SEC") that will allow Chinese commercial banks that offer wealth management services to invest in equity securities (including investment funds) in the United States under China's Qualified Domestic Institutional Investor ("QDII") program. If finalized, the move would further expand the CBRC's recent liberalization of the QDII program through entry into comparable memoranda of understanding with the UK's Financial Services Authority in December 2007 and the Monetary Authority of Singapore in January 2008. The United Kingdom and Singapore are only the second and third markets, respectively, to sign a memorandum of understanding with the CBRC. Prior to December 2007, Hong Kong was the sole market which was covered by the QDII program. The CBRC also has announced that it intends to enter into memoranda of understanding with Germany and Japan to widen the QDII program further.

While the immediate impact of entry into a memorandum of understanding with the SEC likely will be modest, the move provides U.S. funds and managers with an opportunity to access Chinese investors without having to utilize local intermediaries or partners, or otherwise offer services and investment products into the Chinese markets. In addition, it offers the potential for significantly increased access to Chinese investors and their assets in the event of a future expansion of the QDII program as China liberalizes foreign exchange controls, gains greater experience with overseas investment, and seeks greater diversification and returns to meet significant long-term retirement funding obligations.

The QDII Program

The QDII program was formally launched by China in 2006 as a means of easing upward pressure on asset prices and giving Chinese investors and intermediaries greater experience with, and access to, overseas investment. Under the program, selected Chinese commercial banks, investment managers, brokers and insurance companies that have been approved as QDIIs may invest client assets in overseas markets notwithstanding China's otherwise stringent foreign exchange regulations.

When first authorised, the QDII program only allowed QDIIs to invest overseas in fixed income products (including bonds and notes). The initial reception was tepid, as Chinese investors preferred to keep their money at home in China with its booming stock market and the steady appreciation of the yuan against the U.S. dollar. In May 2007, the CBRC issued a notice that significantly expanded the permitted scope of investment by commercial banks under the QDII program to allow Chinese commercial banks to invest in equities and funds authorised by a supervisory authority with whom the CBRC has a memorandum of understanding. It is worthy of note that the May 2007 notice does not apply to other types of QDIIs. As of a recent date, 21 commercial banks had been authorised to invest approximately US$15.1 billion under the QDII program.

Permitted Investments for QDIIs

Chinese commercial banks raise assets for the QDII program by packaging investment products to which investors subscribe and over

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which the banks have discretionary management authority. If a bank invests QDII assets in overseas equity securities, the investments must satisfy the following requirements:

- the equities must be listed on an overseas stock exchange;
- no more than 50% of the total net assets may be invested in equities, and any investment in a single issue should not exceed 5% of total net assets;
- the minimum amount which any client of the relevant bank can invest is 300,000 yuan (approximately US$42,000) - a very large sum for the majority of Chinese, as the per capita GDP of China approximates US$2,000;[1]
- each client must have experience with investing in equities, and banks must formulate specific evaluation procedures to confirm suitability;
- any offshore investment managers retained to assist a Chinese bank with investing its clients' assets must be registered or approved by a regulatory authority which has entered into a memorandum of understanding with the CBRC ("Relevant Regulatory Authority"); and
- the exchanges on which the equities are listed should be regulated by a Relevant Regulatory Authority.

In addition to direct investment in stocks, the May 2007 notice also contemplates that QDII assets may be invested in overseas funds, and specifically in "public" funds that have been approved, registered or ratified by a Relevant Regulatory Authority. At least two significant interpretive issues exist with respect to the ability to invest QDII assets in funds. First, the "public" qualification is understood to prohibit investment of QDII assets in hedge funds. However, it is worthy of note that as of a recent date, the Hong Kong Securities and Futures Commission ("SFC") (the original Relevant Regulatory Authority) has authorised 14 hedge funds for retail sale in Hong Kong. The status of these hedge funds for QDII investment is unclear. Second, while the notice's language is ambiguous, there does not appear to be a percentile limitation on investment in equity funds or investment in any single equity fund, as there is with respect to direct investment in equities.[2] Anecdotal evidence suggests that a QDII bank is not limited to investing only 50% of QDII assets in equity funds.

QDII banks also may invest client assets in investment grade fixed income securities, structured products issued by financial institutions that are rated A or above by an internationally recognised rating agency,[3] and derivative instruments (but only for hedging purposes).

Opportunities and Obstacles

The expansion of the QDII program represents an encouraging sign that U.S., UK and other asset managers and investment companies may obtain increased access to Chinese investors. However, tapping into this market via the QDII program will likely be a long-term project. Despite the recent liberalization of the QDII program, there has not been any sudden rush by the Chinese to invest overseas, particularly as major stock markets around the world have experienced increased volatility. Nearly all QDII products which have been made available to investors to date have been undersubscribed. As the *Wall Street Journal Asia* commented on January 30, 2008, "quite simply, investors in China don't think the rest of the world looks very attractive right now".

Furthermore, there currently are only 21 Chinese commercial banks formally licensed to develop QDII wealth management products. In light of the increasing number of jurisdictions whose regulatory authorities are negotiating memoranda of understanding with the CBRC, the relatively small number of Chinese banks authorised under the QDII program, and the relatively small amount of assets authorised for over-

[1] *See* World Economic Outlook Database, October 2007 Edition, International Monetary Fund, http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/index.aspx (based on 2006 figures). Some industry observers have speculated that this requirement will be relaxed, or outright abolished, in the future.

[2] Investments in a U.S. registered fund by a QDII investment product may raise issues under the percentage restrictions of Section 12(d)(1) of the Investment Company Act of 1940.

[3] The rating requirement applies to the issuer, not the issue, which limits investment in structured products issued through special purpose vehicles.

seas investment, competition for access to QDII assets likely will be fierce. Asset managers will need to work closely with Chinese banks and, where possible, take advantage of pre-existing relationships to promote their funds and services.

Finally, it is unclear what effect, in the short term at least, the U.S. subprime crisis will have on Chinese investment in the United States when the QDII program finally opens to U.S. markets.

Despite the obstacles noted above, it is widely believed that the expansion of the QDII program will have a significant long-term impact on the approved foreign markets, as well as on China. Expansion of the markets in which QDII assets may be invested will give Chinese investors increased access to a more diversified array of investments and investment advisers, and likely will encourage further liberalization of China's foreign exchange controls and restrictions on foreign investment. This, in turn, may help relieve inflationary pressures and the potential for asset or stock market "bubbles" in China. Eventually, expansion of the QDII program should help non-Chinese asset managers gain greater access to the estimated US$2.4 trillion of savings in China as these assets are put to use in addressing the retirement fund needs of an aging Chinese populace.

This update was authored by Keith Robinson (+1 852 3518 4705; keith.robinson@dechert.com), Basil Hwang (+1 852 3518 4788; basil.hwang@dechert.com), and James Stonehill (+1 852 3518 4708; james.stonehill@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financialservices.

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Allison R. Beakley
Boston
+1 617 728 7124
allison.beakley@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Daphne T. Chisolm
Charlotte
+1 704 339 3153
daphne.chisolm@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Steven S. Drachman
New York
+1 212 698 5627
steven.drachman@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Susan C. Ervin
Washington, D.C.
+1 202 261 3325
susan.ervin@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Wendy Robbins Fox
Washington, D.C.
+1 202 261 3390
wendy.fox@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Basil Hwang
Hong Kong
+1 852 3518 4788
basil.hwang@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Stuart J. Kaswell
Washington, D.C.
+1 202 261 3314
stuart.kaswell@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Fran Pollack-Matz
Washington, D.C.
+1 202 261 3442
fran.pollack-matz@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Newport Beach
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Hong Kong
+1 852 3518 4705
keith.robinson@dechert.com

Alan Rosenblat
Washington, D.C.
+1 202 261 3332
alan.rosenblat@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

David A. Vaughan
Washington, D.C.
+1 202 261 3355
david.vaughan@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Dechert LLP

www.dechert.com

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