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China's Qualified Domestic Institutional Investor Program: Opening the Door to Chinese Overseas Investment

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The People's Republic of China formally launched the Qualified Domestic Institutional Investor (QDII) program in 2006 as a means by which 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. The QDII program is designed to help address China's growing foreign exchange surplus, excessive liquidity in the Mainland domestic securities markets, and upward pressure on asset prices generally. The QDII program also provides these Chinese institutions with the opportunity to gain greater experience with overseas investment, while at the same time providing new investment options for the emerging investor class of China, where household savings are estimated at approximately US$2.4 trillion as of a recent date.

Recent expansions of the QDII program represent the acceleration of China's liberalization of

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foreign exchange restrictions and offer increased opportunities for Chinese investors to diversify their investments outside of the Mainland. On April 7, 2008, the China Banking Regulatory Commission (CBRC) announced that it had entered into a memorandum of understanding with the US 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. The SEC memorandum of understanding is the latest in a string of memoranda that the CBRC has entered into with securities regulators in major global markets. In a similar effort to provide Chinese investors with increased access to world equity markets, the China Securities Regulatory Commission (CSRC) last summer released guidance designed to facilitate the development of products focused on non-Chinese markets and offered through Chinese securities-related institutions to Mainland investors.

From a US perspective, these expansions of the QDII program represent an encouraging sign that US asset managers, investment companies, and other service providers may obtain increased access to Chinese investors without having to navigate the challenges of entering China's domestic market. However, US asset managers and other service providers should bear in mind that, despite the recent liberalization of the QDII program, significant challenges remain, and a number of issues await clarification.

Background of the QDII Program

China's long-sustained economic growth has resulted in massive foreign exchange reserves due to recurring trade surpluses and continued significant capital inflows. Consequently, the Chinese government has been under mounting international pressure to address its trade imbalance and re-value its currency. On the domestic front, China's economic boom has fostered excessive liquidity and a precipitous rise in its stock markets (at least until recently), leading to domestic appeals for a means to ease inflation and upward pressure on asset prices. In order to encourage capital outflows and ease upward pressure on the yuan and domestic stock markets, in April 2006, the People's Bank of China (the PBOC) issued an announcement setting forth broad policies authorizing limited offshore investments by commercial banks, investment managers, brokers, and insurance companies.[1] Shortly thereafter, the PBOC, the CBRC, and the State Administration of Foreign Exchange (SAFE) jointly issued regulations that provide commercial banks with procedures relating to the QDII application process and the structure and management of offshore investments.[2] Comparable regulations were not adopted with respect to investment managers, securities companies and insurance companies until over a year later.

Although the advent of the QDII program was greeted with initial fanfare, the reception from Chinese investors has been tepid to date. Chinese investors have preferred to keep their money at home with its formerly thriving stock markets and the steady appreciation of the yuan against the US dollar. Additionally, the current volatility in the world's stock markets and US subprime concerns also may explain why Chinese investors have not rushed overseas. Further, the regulations governing the operations of QDII vehicles (including their permissible investments) initially were quite restrictive and, in the case of QDII products sponsored by securities-related institutions, not well developed. For instance, the regulations initially placed significant restrictions on the types of products that bank QDIIs could invest in, prohibiting investment in equities and structured products.

Perhaps in response to the muted reaction to the QDII program, in mid-2007 Chinese regulators began to significantly expand the QDII program, further demonstrating China's desire to address foreign exchange reserve pressures and related concerns. In May 2007, the CBRC issued a circular expanding the permitted scope of investment of QDII products sponsored by commercial banks (the CBRC Circular).[3] Similarly, in June 2007, the CSRC released provisional regulations[4] and a circular[5] (together, the CSRC Regulations) that provided reasonably detailed requirements regarding the establishment and operations of QDII products sponsored by securities-related institutions, such as fund management companies and securities companies.

Types of QDII Products

The Chinese QDII program is divided into three broad categories of products, each of which is primarily regulated by a different regulator: (1) bank products, which are primarily regulated by the CBRC; (2) products sponsored by securities-related institutions, which are primarily regulated by the CSRC; and (3) insurance company products, which are primarily regulated by the China

Insurance Regulatory Commission (CIRC). In addition, SAFE and the PBOC also regulate QDII products. This multi-faceted regulation has occasioned periodic turf battles among regulators and resulted in somewhat schizophrenic implementation of the QDII program.[6]

The following discussion focuses on bank QDII products and the products of securities-related institutions. With respect to insurance company QDII products, although the CIRC released guidance last summer that filled in some outstanding regulatory gaps, these products still lack detailed implementation guidelines.[7] However, it is important to note that a spokesperson for the CIRC recently noted that the CIRC has basically completed comprehensive rules and is waiting for the right time to release them.

Bank Sponsored QDII Products and CBRC Regulations

Under the QDII program, Chinese commercial banks are permitted to raise assets for the program by packaging investment products to which investors subscribe and over which the banks have discretionary management authority. Prior to the publication of the CBRC Circular, bank QDII products were only permitted to invest in overseas fixed income instruments (including bonds and notes).[8] The CBRC Circular significantly expanded the permitted scope of investments by commercial banks under the QDII program by removing the prohibition on investments in equities and structured products. The CBRC Circular allows approved Chinese commercial banks to invest QDII program assets in equities and funds authorized by a supervisory authority with which the CBRC has a memorandum of understanding. Currently, the CBRC has entered into memoranda of understanding with regulators in Hong Kong, Singapore, the United Kingdom, Japan, and, most recently, the United States. The CBRC has announced that it intends to further expand the program by entering into memoranda of understanding with Germany and other countries.

Pursuant to the CBRC Circular, if banks invest QDII assets in equity securities, funds or structured products, they must adhere to the following investment restrictions:

- QDII assets may only be invested in equities that are listed on an overseas stock exchange, and the exchange must be regulated by a regulatory authority that has entered into a memorandum of understanding with the CBRC (Relevant Regulatory Authority);
- No more than 50 percent of the QDII product's net assets may be invested in equities, and any investment in a single issue should not exceed 5 percent of the QDII product's net assets;
- QDII assets may only be invested in "public" funds approved, registered or recognized by a Relevant Regulatory Authority; and
- QDII assets may only be invested in structured products issued by a financial institution rated A or above by an internationally recognized rating agency.

In addition to these investment restrictions, the CBRC Circular also sets forth the following investor protection restrictions:

- The minimum amount that any client can invest in a QDII product is 300,000 yuan (approximately $42,000);[9]
- Each client must have experience with investing in equities, and banks must formulate specific evaluation procedures to confirm suitability; and
- Any offshore investment manager retained to assist a Chinese bank with investing its clients' assets must be registered or approved by a Relevant Regulatory Authority.

In essence, these restrictions establish a "sophisticated investor" standard for bank QDII products.

QDII Products Sponsored by Securities-Related Institutions and CSRC Regulations

With the promulgation of the CSRC Regulations in June 2007, securities-related institutions have a firm regulatory basis upon which to develop QDII products. Securities-related institutions may raise funds (in yuan, US dollars or any other major currency) for overseas investment from a broad spectrum of investors. Unlike the CBRC Circular, the CSRC Regulations do not impose a minimum investment or "sophisticated" investor standard and, therefore, QDII products sponsored by securities-related institutions may have access to a potentially larger number of domestic

Chinese investors. In addition, under the CSRC Regulations, these QDIIs are permitted to invest in a wide range of investment products and significantly more overseas markets than are QDII products sponsored by banks. However, unlike the bank QDII program overseen by the CBRC, each of these QDII products must be separately approved by the CSRC.

The CSRC Regulations primarily focus on: (i) qualifications for domestic securities-related institutions; (ii) use of non-Chinese investment advisers; (iii) appointment of a custodian; (iv) fund raising; and (v) permitted types of investments.

Qualifications

In order to sponsor a QDII product, securities-related institutions must have the following qualifications:

- Fund management companies must have: (i) minimum net assets of 200 million yuan; (ii) at least two years' experience in the fund management business; and (iii) minimum assets under management of 20 billion yuan (or equivalent in foreign currency).

- Securities companies must have: (i) minimum net assets of 800 million yuan; (ii) at least one year of experience in operating collective asset management plans; (iii) a minimum net capital/net asset ratio of 70 percent; and (iv) minimum assets under management of 2 billion yuan (or equivalent in foreign currency).

These qualifications are in addition to the qualifications generally expected of securities-related institutions, such as good corporate governance, financial soundness and appropriate risk controls.

Use of Non-Chinese Investment Advisers

QDII products sponsored by securities-related institutions can use a non-Chinese investment adviser to manage assets, provided that the investment adviser meets the following requirements: (i) over five years of investment management experience; (ii) securities assets under management of not less than US$10 billion; and (iii) organized and regulated in a jurisdiction in which the regulatory authority has entered into a memorandum of understanding with the CSRC.[10] With respect to items (i) and (ii), these requirements are relaxed if the adviser is an overseas branch of the appointing securities-related institution.

Appointment of Custodian

When carrying out overseas investment activity, a QDII that is a securities-related institution must hire a qualified Chinese bank as the custodian of its assets. However, the domestic custodian may appoint a qualified non-Chinese custodian to hold custody of overseas assets provided that the non-Chinese custodian's paid-up capital is no less than US$1 billion, or it has assets under custody of at least US$100 billion. The Chinese custodian must remain liable for any losses resulting from the non-Chinese custodian's negligence.

Fund Raising

Under the CSRC Regulations, a QDII product sponsored by a securities-related institution may offer its investment products through public offerings pursuant to existing regulations. There are size requirements associated with QDII offerings (in terms of the amount of funds raised and number of shareholders) that differ depending on whether the QDII product is sponsored by a fund management company or securities company. However, as noted above, the CSRC Regulations do not impose additional requirements (such as investment minimums or sophistication standards) at the investor level. In connection with investor protection, the CSRC Regulations instead require that QDIIs clearly communicate relevant risks to investors.

Permissible Investments

In terms of investment options, the CSRC Regulations provide a detailed list of permissible investments. For example, in addition to listing various fixed income and equity investments, the CSRC Regulations address a QDII's ability to invest in funds of funds, derivatives and illiquid assets, as well as utilize such investment techniques as securities lending and reverse repurchase agreements. Furthermore, the CSRC Regulations provide investment allocation restrictions. For instance, any investment in a single issuer (either a direct investment or via an investment in an overseas fund) is limited to 10 percent of the QDII product's net assets.

Obstacles, Opportunities and Other Issues

Obstacles and Opportunities

Following the liberalization of the QDII program last year, equity-oriented QDII funds sponsored by large securities-related institutions were the first to launch. This first batch of QDII funds was well received and most funds were initially oversubscribed. Since then, these equity-oriented QDII funds have all reported sizeable losses. As of the end of last year, these funds reportedly lost an average of 12 percent. In fact, one QDII fund liquidated five months after starting. The poor performance of these QDII funds has been attributed to the current global market turmoil and the appreciation of the yuan against the US dollar. Given the continued volatility of major stock markets around the world and the yuan currency hurdle, Chinese investors understandably have been reluctant to invest overseas. Consequently, securities-related QDII funds subsequently launched have been undersubscribed. Similarly, bank-sponsored QDII products likely will have trouble attracting investors in the current market. For these reasons, analysts predict that the QDII program will not have a significant near-term impact on US markets.

Even if the QDII program gains momentum, the amount of assets currently authorized for overseas investment is relatively small. Chinese regulators have approved QDII products (both bank and securities-related institution sponsored) valued at approximately US$50 billion. Although this number is expected to increase, competition for QDII assets likely will be fierce. Asset managers will need to work closely with Chinese banks and securities-related institutions and, where possible, take advantage of pre-existing relationships to promote their funds and services. At present, US asset managers and other service providers have already established a presence in the QDII program. For instance, several of the QDII products launched under these new regulations are subadvised by US asset managers. In addition, US asset managers have entered into joint ventures with, or have minority stakes in, Chinese financial institutions that have launched QDII products. Also, as permitted under the expanded QDII regulations, US financial services firms presently offer administrative, distribution and custodian services to QDII products.

Despite initial setbacks, many industry observers remain confident that the QDII program eventually will lead to significant outflows of Chinese capital into US and other markets.[11] Until recently, the booming Chinese domestic stock markets have provided a more attractive investment option for Chinese investors. However, the sharp decline in Chinese stocks may give Chinese investors an incentive to diversify and invest overseas. In fact, the Shanghai Composite Index has fallen by nearly half since its peak last fall. Chinese regulators also have shown a commitment to the program, including recent efforts to remedy the disincentives described above. In December, the CSRC provided QDII fund managers with the flexibility to invest in yuan-denominated A shares listed in Shanghai and Shenzhen, as well as overseas markets. This development, which permits QDII funds to offset some of the foreign currency risk associated with the yuan's continued appreciation, is presumably intended to increase interest in the QDII program (as well as, potentially, help support the domestic A share market).

Operational Issues

As more QDII program assets enter world markets and competition for these assets heats up, investment managers and investment companies providing services to QDIIs must also take note of certain operational issues. The new QDII regulations are "trial" or "provisional" regulations and, as such, there are a number of interpretative issues with respect to their application. For example, in connection with investments in funds, both the CBRC Circular and the CSRC Regulations contain a "public" fund qualification that is understood to prohibit investment of QDII assets in hedge funds. However, it is worthy of note that certain foreign regulatory authorities, including the Hong Kong Securities and Futures Commission and the Monetary Authority of Singapore, authorize hedge funds for retail (that is, public) sale. The status of these hedge funds for QDII investment is unclear, although the wiser course of action is to avoid investment in hedge funds, even publicly-offered hedge funds, until and unless the CBRC or CSRC explicitly permits such investments.

There also are noticeable differences between bank-sponsored QDII products and QDII products sponsored by securities-related institutions, both in terms of investor qualifications and permissible investments. For example, QDII products sponsored by securities-related institutions do not have a minimum investment requirement. As a result, these QDII products may attract more assets than bank-sponsored QDII products, but also may entail higher operational costs on a per-unit basis. With respect to permissible investments, QDII products sponsored by securities-related institutions are permitted to invest in significantly more jurisdictions and are therefore able to better diversify. Also, issues arise regarding a QDII bank's ability to invest in structured products. Specifically, the rating requirement for structured products applies to issuers, not the issue, which appears to limit investments in structured products issued through special purpose vehicles. There does not appear to be a comparable restriction with respect to QDII products sponsored by securities-related institutions. Furthermore, while the CBRC Circular's language is ambiguous, there does not appear to be a percentile limitation on a bank sponsored QDII's investment in equity funds or investments in a single equity fund, as there is with respect to direct investments in equities.[12] On the other hand, QDII products sponsored by securities-related institutions are limited in their investment in "overseas funds" to 10 percent of their assets. Certain industry observers have questioned the logic behind these differences and have called for the two programs to be harmonized.

US Legal Compliance Issues

In addition to operational issues, US asset managers and fund compliance personnel should carefully consider the application of their compliance programs to doing business in the QDII arena. When promoting funds and services and establishing other business relationships with QDIIs, US asset managers and compliance personnel should take into account the potential application of the US Foreign Corrupt Practices Act (FCPA). As several QDIIs are state-owned, a point of contact may be a "foreign official" under the FCPA, and any benefit conveyed to such person may be viewed as a prohibited payment under the FCPA. Moreover, if such payments are perceived to have been made for the purpose of influencing any act by such a foreign official in order to assist the company in obtaining or retaining business, the conduct may be deemed to be a violation of the criminal provisions of the FCPA. Accordingly, prior to entering into the QDII market, compliance personnel should carefully review the adviser's code of ethics (specifically the gift and entertainment policies typically found therein) to ensure that FCPA and other concerns are reasonably addressed.

Compliance personnel also should be aware of other issues that may arise in the context of doing business with QDIIs, such as compliance with the US Investment Company Act of 1940 (the 1940 Act) and US anti-money laundering laws. For instance, investments in US registered funds by QDII products may raise issues under the percentage restrictions of Section 12(d)(1) of the 1940 Act.[13] Furthermore, although China is a member of the Financial Action Task Force and has made significant progress in developing its anti-money laundering regulations, investment advisers and registered investment companies should conduct their proper due diligence before accepting QDII assets. Naturally, there may be other compliance challenges associated with any specific QDII product, and asset managers, funds and their compliance personnel should work closely with counsel to ensure that compliance matters are appropriately identified and addressed.

Conclusion

While the short-term impact of the recent expansion of China's QDII program likely will be modest, the move opens the door to US asset managers, investment companies, and other financial service providers to gain access to Chinese investors and their assets. As pressure continues to mount on China to liberalize its foreign exchange controls and address other concerns, Chinese regulators appear committed to the growth of the QDII regime and the amount of assets authorized for overseas investments is expected to increase. The QDII program also should witness an increase in its popularity as Chinese investors gain greater experience with overseas investments and seek further diversification. In addition, as the Chinese middle-class grows and China's population ages, expanded investment options and opportunities to pursue higher returns will be crucial to meet significant long-term retirement funding obligations. Accordingly, the long-term prospects for the QDII program and its impact on US markets and the financial service industry should be quite optimistic.

NOTES

1. *See* "Announcement Regarding the Adjustment of Certain Foreign Exchange Administration Policies" (April 13, 2006).

2. *See* "Provisional Administrative Rules on the Overseas Wealth Management Business of Commercial Banks on Behalf of Their Clients"(April 17, 2006).

3. "Notice of the Adjustments to the Offshore Investment Scope of Overseas Wealth Management Business of Commercial Banks on behalf of Their Clients"(May 10, 2007).

4. "Trial Measures for the Administration of Overseas Securities Investments by Qualified Domestic Institutional Investors" (June 18, 2007).

5. "Circular on Issues Concerning the Implementation of Trial Measures for the Administration of Overseas Securities Investment of Qualified Domestic Institutional Investors"(June 18, 2007).

6. For example, SAFE initially resisted implementation of the QDII program, but determined to back its implementation much more enthusiastically as inflationary pressures from China's foreign exchange reserves became more acute. In addition, the CSRC recently issued a gauge document to securities-related institutions sponsoring QDII products that makes clear that QDII program assets may be invested in the domestic Chinese A share market, a move broadly seen as an attempt to increase the popularity of the QDII program and prop up recently sagging domestic equity prices at the expense of the broader purposes of the QDII program.

7. *See* "Tentative Measures for the Overseas Investment with Insurance Funds" (July 26, 2007).

8. Pursuant to the "Notice of China Banking Regulatory Commission on Commercial Banks Overseas Financial Management Services" issued on June 21, 2006, acceptable fixed income instruments included bonds, notes and other structured products with at least a "BBB" credit rating. Prior to May 2007, equities, equity structured products, commodities and derivatives were not permissible investments.

9. While this amount likely would not qualify for even an initial breakpoint on an investment in a US-registered mutual fund's Class A shares, it represents a considerable investment in a country where the per capita GDP approximates $2,000 per annum. Some industry observers have speculated that this requirement will be relaxed, or outright abolished, in the future.

10. As of a recent date, the CSRC has entered into more than 30 such memoranda with foreign regulatory authorities, including regulators from the US, Canada, Japan, and most Western European nations.

11. *E.g.,* Juan Chen and Ellen Sheng, "US Stocks Open More to China," *Wall St. J.,* April 8, 2008, *available at http://online.wsj.com/article/SB12075694651.html*.

12. Anecdotal evidence suggests that QDII banks invest more than 50 percent of program assets in equity funds, which may present a competitive advantage for US equity fund managers in terms of attracting such assets.

13. *See, e.g., Fund of Funds Investments,* Rel. No. IC-27399 (June 20, 2006). Unregistered investment companies (such as most foreign funds) are prohibited from acquiring more than three percent of the outstanding voting securities of a US open-end registered investment company. By limiting the *sale* of registered open-end fund shares to unregistered foreign funds, such as QDII products that meet the definition of "investment company" set forth in Section 3 of the 1940 Act, the 1940 Act limits the potential for abuse of US funds at the hands of offshore funds notwithstanding the limited capacity of US law to regulate the activities of foreign funds.

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