

CHINA'S CAPITAL FLOW REGULATIONS:
THE QUALIFIED FOREIGN INSTITUTIONAL INVESTOR
AND THE QUALIFIED DOMESTIC INSTITUTIONAL
INVESTOR PROGRAMS

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I. Introduction

China's rapid economic growth over the past three decades has improved living standards and strengthened the country's participation in the global economy. Because of such rapid development, however, the Chinese government faced growing tensions between the needs of China's domestic economy and the foreign pressures on its trade position and currency, the Renminbi ("RMB"). China's rapid accumulation of excess foreign exchange ("forex") in recent years has been a particularly visible sign of increasing economic imbalances. Foreign pressure for the RMB to appreciate² and domestic pressure within China to ease inflation and curb government debt contributed to rapid amassing of excess forex reserves. The government became concerned that a significant portion of China's recent forex accumulations originated from foreign speculative capital inflow and that China's investment of its forex holdings in low-return securities carried large opportunity costs and posed potential liquidity problems. Forex accumulations from speculative capital inflows were considered low quality because they represented a liability on the Chinese government in favor of foreign speculators, who could withdraw their capital (i.e., "capital flight") and consequently destabilize China's economy. At the same time, China was earning low returns by holding forex in relatively safe, long-term assets. Thus, the Chinese government sought to improve the quality of its forex accumulations and to allocate more efficiently its forex holdings by gradually liberalizing capital flow.

Chinese regulatory agencies introduced the qualified foreign institutional investor ("QFII") and the qualified domestic institutional

¹ Student, Boston University School of Law (J.D. 2009).

² See OLIVIER BLANCHARD, MACROECONOMICS 381 (5th ed. 2008) (defining "appreciation" as the increase in price of one currency relative to another).

investor (“QDII”) programs in 2002 and 2006 to expand market-based channels for capital inflow and outflow, respectively. The QFII program sought to improve the quality of China’s forex holdings by attracting valuable medium- and long-term foreign capital while deterring short-term speculative inflows (“hot money”). With a complementary objective, the QDII program sought to improve the returns on and diversity of China’s forex holdings by permitting broader channels for capital outflow into offshore markets.

The QFII program has allowed more foreign investors to invest in China. However, the regulations create an unclear and unpredictable legal environment, which may discourage otherwise valuable foreign investment by increasing the actual and perceived costs of investing in China. Thus, regulators need to create a more transparent and predictable legal environment by communicating frequently with the investing public about existing enforcement, pending regulatory decisions, the underlying decision-making process, and policy positions. Regulatory predictability guides investors’ expectations and increases their confidence, which in turn encourages market participation.

On the other hand, the QDII program has opened more foreign markets to Chinese investors, but numerous detailed restrictions and the current stormy financial climate reduce the attractiveness of overseas investments. Thus, regulators should gradually relax or phase out certain overly conservative restrictions, encourage QDIIs to hire competent foreign investment experts, require effective risk management procedures and training, and offer positive incentives for QDIIs to establish and maintain disciplined risk management programs.

Finally, in both programs, regulators should emphasize robust monitoring. Issuing overly protective restrictions is insufficient to ensure market integrity. The regulatory agencies must jointly engage in continuous, consistent, and careful monitoring of institutional investors.

China’s QFII and QDII programs are significant transitional mechanisms toward open capital markets. Chinese regulators should steadily encourage freer markets and financial innovation. The recent crises in the U.S. financial system should not deter China from moving in the direction of a market economy. The 2008 financial market crash demonstrates that liquidity and investor confidence are crucial to a country’s production, consumption, and savings. Fear of market failure should not turn China away from the immense cumulative benefits of free markets. Instead, China should focus on

developing a robust market system that can both deter and weather future financial panics. Trustworthy capital markets are essential to maintaining the political stability of a country, encouraging innovation, and improving the living standards of ordinary citizens. Thus, the Chinese government should continue to guide the development of open capital markets. In administering the QFII and QDII programs, regulators must focus on gaining and securing investors' confidence and the public's trust by (1) providing more legal predictability, (2) exercising robust monitoring, (3) requiring high standards of risk management, and (4) encouraging the import of foreign expertise to train domestic financial advisers.

II. Macroeconomic Context: Growth, Reform, and Capital Controls via Forex Management

The Chinese government introduced the QFII and QDII programs in response to capital imbalances resulting from growing tensions between China's trade and exchange rate positions and its domestic economic policies. Thus, it is necessary to provide an overview of China's modern economic development to help the reader understand why the government introduced the QFII and QDII regulations.

Since 1979, the Chinese government has sought to encourage rapid economic development by increasing exports and foreign direct investment ("FDI") in China.³ Until 1994, the Chinese government adopted patchwork policies that encouraged economic growth without threatening its general ability to steer the economy.⁴ After 1994, the government implemented more systematic, market-based reforms.⁵ In particular, reform of China's forex system has been essential to economic growth by furthering exports and FDI.⁶

³ Thomas Hall, *Controlling for Risk: An Analysis of China's System of Foreign Exchange and Exchange Rate Movement*, 17 COLUM. J. ASIAN L. 433, 438-39 (2004); see DAVID A. MOSS, A CONCISE GUIDE TO MACROECONOMICS: WHAT MANAGERS, EXECUTIVES, AND STUDENTS NEED TO KNOW 149 (2007) (defining foreign direct investment ("FDI") as the cross-border purchase of equity in a company such that the purchase is large enough to give the foreign owner managerial influence in the company).

⁴ BARRY NAUGHTON, THE CHINESE ECONOMY: TRANSITIONS AND GROWTH 85 (2007).

⁵ *Id.* at 88.

⁶ Hall, *supra* note 3, at 434-35 (stating that China's forex regime is "a critical part of China's economic policy and law").

Trade and cross-border investments require a mechanism for exchanging currencies. The forex market is where the trading of different currencies occurs.⁷ Consisting of an international network of traders connected by telephone and the Internet, the forex market has four types of participants: banks and other financial institutions, brokers, customers, and central banks.⁸ Governments, companies, and individuals trade currencies for several reasons: (1) to acquire the foreign currency needed to buy goods and services from or to invest in another country; (2) to hedge against losses due to exchange rate movements; (3) to earn short-term profits from exchange rate fluctuations; and in the case of a central bank, (4) to influence the value of its own country's currency.⁹

A country, through its central bank, may hold forex reserves for economic and political reasons, such as to (1) gain economic credibility; (2) pay import bills and foreign debts; (3) facilitate trade; (4) enforce its exchange rate policy; (5) insure itself from potential currency crises; and (6) earn investment returns.¹⁰ To achieve those goals, the country will hold only foreign currency as strong as or stronger than the country's own currency.¹¹

For the past half century, the Chinese government has controlled capital flow into and out of China via forex management.¹² The dominant goal of capital controls has been to achieve financial stability "by restricting destabilising movements of foreign capital."¹³ From the 1950s through the 1970s, China maintained a strict forex

⁷ The Basics of Foreign Trade and Exchange, Fed. Res. Bank of N.Y., <http://www.ny.frb.org/education/fx/foreign.html> (last visited Nov. 13, 2008).

⁸ *Id.*

⁹ *Id.* (defining "exchange rate" as "the price of one currency in terms of another").

¹⁰ Yongnian Zheng & Jingtao Yi, *China's Rapid Accumulation of Foreign Exchange Reserves and Its Policy Implications*, 15 CHINA & WORLD ECONOMY 14, 19 (2007).

¹¹ Alan Greenspan, Chairman, Fed. Res. Bd., Currency Reserves and Debt, Remarks Before the World Bank Conference on Recent Trends in Reserve Management (Apr. 29, 1999), available at <http://www.federalreserve.gov/BoardDocs/Speeches/1999/19990429.htm>.

¹² Zhichao Zhang, *Capital Controls in China: Recent Development and Reform Prospects* 6 (Durham University Business School, Working Paper, 2006), available at http://icf.som.yale.edu/research/china/newpage/en/essay_en/market/capital%20controls%20in%20china.pdf

¹³ *Id.* at 5.

system, which limited both the quantity and the price of forex.¹⁴ From 1979 until 1994, the government operated a dual forex system.¹⁵ At that time, the government required domestic enterprises and Foreign Invested Enterprises (“FIEs”)¹⁶ to surrender their forex earnings (from conducting business with other countries) to it in return for RMBs and a forex quota, determined for each enterprise as a percentage of its forex earnings.¹⁷ From 1980 to 1988, the government allowed two separate forex “swap” markets: one where FIEs could trade their forex quotas at a free-market price and another where domestic enterprises could trade their forex quotas at a restricted price.¹⁸ In 1988 and 1989, the government allowed both types of enterprises to swap forex quotas at the free-market rates in localized, provincial swap centers and also gradually allowed private citizens to sell forex at those centers.¹⁹ This policy allowed swap exchange rates to coexist with the government’s official exchange rate.²⁰ Although the swap markets provided exporters and importers with more flexible and efficient access to forex, the multiple-rate, multiple-swap-center system created problems of arbitrage and corruption.²¹

In response to these problems, China consolidated its forex system into a handful of government-designated forex banks trading in an interbank forex market under a unified exchange rate in 1994.²² The interbank forex market established a single national exchange rate and connected all Chinese financial institutions authorized to trade forex to the international forex market.²³ In 1996, the Chinese government adopted “full current account convertibility” to further

¹⁴ *Id.* at 7.

¹⁵ *Id.*

¹⁶ See Foreign Invested Enterprises FAQ’s, LEHMANBROWN, <http://www.lehmanbrown.com/FAQ-FIE.htm>. “Foreign invested enterprise” is any foreign company doing business in the country of reference. For example, a U.S. company doing business in China is an FIE in China.

¹⁷ Zhang, *supra* note 12, at 9-10.

¹⁸ *Id.* at 10-11 (describing calculation of forex quota as percentage of enterprise’s forex earnings, which it was required to surrender to Chinese government in exchange for RMBs plus forex quota).

¹⁹ *Id.* at 11.

²⁰ *Id.* at 13.

²¹ *Id.*

²² Hall, *supra* note 3, at 445-46.

²³ *Id.*

relax controls on forex activity.²⁴ The current account includes all of a country's transactions in goods and services with other countries (excluding financial investment transactions).²⁵ In contrast, a country's capital account includes transfers of investment money to or from other countries.²⁶ Under "full current account convertibility," the Chinese government no longer restricted the transfer of forex in trade transactions.²⁷ The next, logical step was to progress towards full capital account convertibility by 2000.²⁸ However, the Asian financial crisis of 1997, which many economists attributed to volatile capital movements, prompted the Chinese government to take a cautious approach to liberalizing capital flow.²⁹ China weathered the financial crisis better than other Asian countries because its capital controls protected the RMB's value from speculative attacks.³⁰ From 1997 to 2001, China reinstated tighter capital controls in the aftermath of the financial crisis.³¹ Nevertheless, since its 2001 entry into the World Trade Organization ("WTO"), China has emphasized that it will progressively pursue capital account convertibility (i.e., liberalization of capital flow).³²

Despite restrictions on capital flow, China's liberalization of its forex system for trade purposes substantially increased companies' and individuals' access to the global forex market.³³ Easier access to forex encouraged exports and FDI, which generated large amounts of forex income for China.³⁴ In February 2006, China became the largest holder of forex reserves, valued at US \$853.7

²⁴ *Id.* at 461.

²⁵ See OECD Glossary of Statistical Terms, Balance of Payments, Current Account Definition, <http://stats.oecd.org/glossary/detail.asp?ID=154> (last visited Nov. 13, 2008) (defining "current account" to include "all the transactions (other than those in financial items) that involve economic values and occur between resident and non-residents entities").

²⁶ See OECD Glossary of Statistical Terms, Balance of Payments, Capital Account Definition, <http://stats.oecd.org/glossary/detail.asp?ID=151> (last visited Nov. 13, 2008) (defining "capital account" to include "capital transfers" and "acquisition/disposal of non-produced, non-financial assets").

²⁷ Hall, *supra* note 3, at 461.

²⁸ Zhang, *supra* note 12, at 14, 18.

²⁹ *Id.* at 3, 14.

³⁰ *Id.* at 18-19.

³¹ *Id.* at 19.

³² *Id.*

³³ Hall, *supra* note 3, at 445.

³⁴ Zheng & Yi, *supra* note 10, at 15-18.

billion.³⁵ In October 2006, its holdings exceeded US \$1 trillion for the first time, and by the end of March 2008, China held nearly US \$1.7 trillion in forex reserves.³⁶ Economists traditionally recommend that a country maintain sufficient forex reserves to pay for at least three months of imports.³⁷ China only needed less than US \$350 billion to pay for one quarter of its imports in 2005, but it held US \$818.9 billion in forex reserves.³⁸ Based on the three-months-imports rule, China's forex reserves were wildly excessive. Economists have increasingly favored an alternative standard of measurement: a country should maintain sufficient forex reserves to pay for its stock of short-term foreign debt ("Greenspan-Guidotti rule").³⁹ Under the Greenspan-Guidotti rule, China's excess forex reserves were not quite as large but still substantial.⁴⁰

A. Sources of Forex Accumulation: Problems with Recent Speculative Capital Inflows

From 1978 through 2003, China accumulated forex reserves from two primary sources: recurring trade surpluses and accelerating FDI.⁴¹ After 2003, however, hot money inflow became an additional source, leading to rapid, unprecedented, and problematic forex accumulation.⁴² China's accumulation of forex from hot money resulted from a combination of foreign pressure on the Chinese

³⁵ *Id.* at 15.

³⁶ China's Foreign Exchange Reserves, 1977-2008, <http://www.chinability.com/Reserves.htm> (last visited Aug. 16, 2008).

³⁷ Zheng & Yi, *supra* note 10, at 19.

³⁸ *Id.* at 19-20.

³⁹ Charles Wyplosz, *The Fuss about Foreign Exchange Reserves Accumulation*, VOX, May 28, 2007, available at <http://www.voxeu.org/index.php?q=node/182> (explaining that if size of China's forex reserves is viewed relative to size of its foreign debts over time, then increase in forex accumulation, while still large, is not as disproportionate as suggested by absolute numbers). For a graphical representation of this idea, see *id.* (showing graphs of China's reserves over time (1) in absolute terms; (2) compared with GDP; and (3) compared with its foreign liabilities).

⁴⁰ *Id.*

⁴¹ Zheng & Yi, *supra* note 10, at 16-18.

⁴² *See id.* at 18-19.

government to allow the RMB to appreciate and the Chinese government's determination to control the exchange rate.⁴³

From 1994 to 2005, China maintained "a de facto fixed exchange rate vis-à-vis the U.S. dollar."⁴⁴ After 2002, Chinese exports grew rapidly, prompting other countries to call for the RMB's appreciation with the intention of making their exports more attractive to Chinese consumers.⁴⁵ At the same time, China's successful economic reforms prompted foreigners to invest more in Chinese companies as they viewed the RMB to be more valuable.⁴⁶ Thus, the growing foreign investment exerted additional pressure on the RMB to appreciate.⁴⁷

Concerned that an abrupt and unrestrained appreciation of the RMB would destabilize the domestic economy, China's policymakers opted for a gradual appreciation of the RMB to protect China's trade surplus and to maintain financial stability.⁴⁸ In July 2005, the government adopted a managed floating exchange rate based on a basket of foreign currencies and allowed the daily trading price of the U.S. dollar against the RMB to float within a specified percentage ("currency band") around a value published by China's central bank.⁴⁹ At the same time, international pressure on the RMB led to expectations that the RMB's value eventually would rise. Thus, speculators sought to trade their foreign currencies for relatively cheap RMBs, bringing hot money into China.⁵⁰ At the

⁴³ See *id.* at 19 ("The remaining approximately US \$45 bn [forex reserves] was estimated by government officials as mostly speculative capital inflows ("hot money") and some snuck in under the guise of current accounts."); see also *id.* at 21 ("The recent widespread expectation of an RMB appreciation has induced continuous short-term capital inflows and the central bank has to buy excessive foreign exchange to maintain the [currency] bands.").

⁴⁴ NAUGHTON, *supra* note 4, at 389.

⁴⁵ *Id.*

⁴⁶ See Zheng & Yi, *supra* note 10, at 17-18; see also *The Basics of Foreign Trade and Exchange*, *supra* note 7.

⁴⁷ See *The Basics of Foreign Trade and Exchange*, *supra* note 7.

⁴⁸ See Zheng & Yi, *supra* note 10, at 15, 18 (explaining that RMB's sudden and substantial appreciation could destabilize China's economy in two ways: (1) rendering Chinese exports substantially more expensive, which would deteriorate the trade surplus and slow economic growth and (2) attracting large inflows of speculative capital, which would increase the risk of a financial crisis).

⁴⁹ *Id.* at 20-21 (noting that currency band was specifically $\pm 0.3\%$).

⁵⁰ *Id.* at 15-18.

artificially undervalued exchange rate, speculative demand for RMBs exceeded supply, resulting in an excess of foreign currencies and a shortage of RMBs in the market.⁵¹ To maintain its managed exchange rate, China's central bank printed new RMBs, traded them for the excess foreign currencies at the managed rate, and held the hot money as additional forex reserves.⁵²

However, printing new RMBs increased China's money supply, contributing to domestic inflationary pressures.⁵³ To counteract risks of inflation, China's central bank conducted monetary operations ("sterilizations") to bring the domestic money supply back to a target level.⁵⁴ The central bank sterilized the excess capital inflow by selling Chinese government bonds to remove excess RMBs from the money supply.⁵⁵ However, government bonds are a form of government debt, and repeated sterilizations of capital inflows would thus be unsustainable in the long run if government debt becomes excessively large compared with domestic income.⁵⁶

China's recent accumulation of excess forex from hot money inflows created the additional problem of self-perpetuation.⁵⁷ The more forex China accumulated, the more other countries (particularly the U.S. and Japan) regarded China as having a larger wallet, and the more they pressured for the RMB to appreciate so that China would import more of their goods and services.⁵⁸ Foreign pressure on the

⁵¹ *Id.* at 21.

⁵² *Id.*

⁵³ *Id.* (explaining that expansion of money supply increases risk of inflation because increase in volume of RMBs reduces purchasing power of each RMB).

⁵⁴ MAURICE OBSTFELD & KENNETH ROGOFF, FOUNDATIONS OF INTERNATIONAL MACROECONOMICS 558 (1996) (defining sterilization as the financial policy of "influencing the exchange rate without changing the money supply"; "the net effect is a change in the relative supply of domestic-currency and foreign-currency bonds held by the public").

⁵⁵ Zheng & Yi, *supra* note 10, at 21. For more detailed reading on sterilization and monetary policy, see OBSTFELD & ROGOFF, *supra* note 54, at 558, 598.

⁵⁶ Zheng & Yi, *supra* note 10, at 21.

⁵⁷ *Id.* at 15, 18.

⁵⁸ See *RMB Revaluation is Not a Panacea for External Imbalances*, HONG KONG TRADE DEV. COUNCIL ECON. FORUM, Oct. 1, 2006, available at <http://info.hktdc.com/econforum/bea/bea061001.htm> ("American critics have been claiming that an artificially undervalued Rmb has reduced their

appreciation of the RMB triggered successive waves of speculation and hot money inflow, which in turn forced China's central bank to accumulate even more forex under China's managed exchange rate system.⁵⁹ In sum, China's rapid accumulation of forex in recent years is both a cause and result of tensions between maintaining stable domestic economic growth and responding to foreign pressure to moderate trade imbalances.

B. Uses of Forex Reserves and the Financial Risks of Suboptimal Returns

China uses its forex reserves to (1) gain economic credibility; (2) pay import bills and foreign debts; (3) facilitate trade; (4) enforce a managed floating exchange rate regime; (5) insure itself from potential currency crises; and (6) earn investment returns.⁶⁰

The usefulness of China's forex reserves depends not only on the magnitude of accumulation but also on its quality. Specifically, forex proceeds accumulated from trade surpluses are beneficial as they represent disposable wealth. However, forex "earnings" accumulated from FDI and hot money may be detrimental as they are implied debts.⁶¹ FDI and hot money are effectively long-term and short-term loans, which China must pay back eventually.⁶² In addition, forex "earnings" due to hot money are offset by the liabilities that the Chinese government incurs when it issues bonds as part of its sterilization operations in response to the hot-money inflows. Thus, China may comfortably spend only the portion of its forex reserves due to trade surpluses and should carefully invest the portions of its forex reserves due to FDI and hot money.

China holds most of its forex reserves in the form of U.S. Treasury bills and bonds and other U.S. dollar-denominated securities.⁶³ As of May 2006, China held an estimated two-thirds of

competitiveness, which in turn resulted in the mounting US trade deficit with China of an all-time record of US\$202 billion in 2005.").

⁵⁹ Zheng & Yi, *supra* note 10, at 18.

⁶⁰ *Id.* at 19; *see also* Wyplosz, *supra* note 39 (arguing that China's large forex accumulation understandable as form of self-insurance against potential currency crises, such as East Asian financial crisis of 1997-1998).

⁶¹ Zheng & Yi, *supra* note 10, at 19.

⁶² *Id.*

⁶³ *Id.* at 21.

its forex reserves in U.S. dollar-denominated assets.⁶⁴ Thus, China's forex holdings typically have earned safe but low returns around 4%.⁶⁵ Furthermore, expected long-term depreciation⁶⁶ of the U.S. dollar reduces returns on dollar-denominated securities over time.⁶⁷ On the other hand, China must pay out higher rates of return to foreign investors to compensate them for the higher risks of investing in a developing country.⁶⁸ In 2006, for example, the expected rate of return of foreign investment in China was roughly 15%.⁶⁹ The substantial imbalance between low rates of return on Chinese holdings of foreign assets and high rates of return on foreign holdings of Chinese assets reflects a huge opportunity cost to China and exposes China to risks of asset-duration/interest-rate mismatch.⁷⁰ That is, holding forex reserves in long-term, low-return securities creates potential liquidity problems if foreign investors demand payment on their short-term, high-return securities.

To summarize, China's large and rapid forex accumulation in recent years is both a cause and a symptom of economic imbalances, and relatively low returns on China's forex holdings and substantially higher returns on foreign investors' RMB holdings expose the country to large opportunity costs and liquidity risks.

C. Policy Response to Problematic Forex Accumulation and Suboptimal Investment

To address the problems of rapid speculative forex accumulation and sub-optimal returns on forex holdings, economists and policy experts have recommended that China (1) gradually liberalize capital inflows and outflows but carefully control hot money inflows; (2) allow private companies and individuals to hold

⁶⁴ *Id.* (citing U.S. DEP'T OF TREASURY, REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES (2006), available at http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/international_econ_exchange_rate.pdf).

⁶⁵ *Id. supra* note 10, at 22-23 (explaining that 4% was fixed return on long-term U.S. government securities).

⁶⁶ BLANCHARD, *supra* note 2, at 381 (defining "depreciation" as decrease in price of one currency relative to price of another currency).

⁶⁷ Zheng & Yi, *supra* note 10, at 22.

⁶⁸ *See id.*

⁶⁹ *Id.* (commenting that "[s]uch an institutional arrangement makes China lose money in the aggregate").

⁷⁰ *Id.* at 23.

more forex; (3) invest in key sectors abroad; and (4) gradually and marginally diversify its forex holdings out of U.S. dollar-denominated securities.⁷¹ To attract long-term foreign capital and to obtain higher returns on and more diversity of forex holdings, the Chinese government introduced the QFII and QDII programs in 2002 and 2006, respectively.

III. QFII Regulations

The QFII program permits qualified foreign institutional investors to make limited investments in China's capital markets and restricts capital flight (i.e., short-run capital outflow due to investors' panic).⁷² Since China's regulatory agencies exercise broad discretion on the program's implementation, foreign investors face additional transaction costs arising from an unpredictable regulatory environment.

A. Regulatory Structure and Mechanics: To Encourage Non-Speculative Capital Inflows

In November 2002, the China Securities Regulatory Commission ("CSRC") and the People's Bank of China ("PBC"), China's central bank, introduced the QFII program to allow foreign investment in China.⁷³ Keenly aware of the lessons from the Asian financial crisis of 1997, the government sought to encourage medium- and long-term investments and to deter short-term capital inflows.⁷⁴ The *Interim Measures on the Administration of Domestic*

⁷¹ *Id.* at 22-24.

⁷² See *SAFE Issues Supplementary Regulations on Foreign Exchange Aspects of China's QFII Program* (Paul Weiss, New York, N.Y.), Dec. 2002, at 2, available at <http://www.paulweiss.com/files/Publication/60a14d76-3531-4f9b-8e4287acedf063f/Presentation/PublicationAttachment/c02471fe-7b17-4314-9573-8984dd871e66/120202.pdf>.

⁷³ *China Releases Temporary Measures for Investment in Domestic Securities by Qualified Foreign Institutional Investors*, LEGAL UPDATES & NEWS (Morrison & Foerster, San Francisco, Cal.), Nov. 2000, available at <http://www.mofo.com/news/updates/files/update856.html>.

⁷⁴ *Interim Measures on the Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* (promulgated by the China Sec. Reg. Comm'n and the People's Bank of China, Nov. 5, 2002, effective Dec. 1, 2002), 12 ST. COUNCIL GAZ. art. 11 [hereinafter QFII Interim Measures of 2002], translated in <http://www.fdi.gov.cn/>

Securities Investment by Qualified Foreign Institutional Investors (“QFII Interim Measures of 2002”) allowed qualified foreign investors, up to approved quotas, to invest directly in securities listed and traded on China’s stock exchanges.⁷⁵ The CSRC and the State Administration of Foreign Exchange (“SAFE”) share regulatory authority over the QFII program.⁷⁶ In September 2006, the government adopted the current set of QFII regulations and abolished the QFII Interim Measures of 2002. However, the basic framework and concepts remain, so exploring the 2002 regulations is fruitful to understanding the current version. This paper will discuss the abolished version and then the current version.

The QFII Interim Measures of 2002 define a QFII as a foreign⁷⁷ fund management institution, insurance company, securities company, or other asset management institution, which (1) meets certain eligibility conditions; (2) has approval from the CSRC to invest in securities in China; and (3) has an investment quota from the SAFE.⁷⁸ The QFII Interim Measures of 2002 define a QFII as a foreign⁷⁹ fund management institution, insurance company, securities company, or other asset management institution, which (1) meets certain eligibility conditions; (2) has approval from the CSRC to invest in securities in China; and (3) has an investment quota from the SAFE.⁸⁰ To be eligible, an applicant must have financial stability and good credit, satisfy certain asset size and other requirements of the CSRC, and satisfy additional good standing requirements.⁸¹ Furthermore, the securities regulator of the applicant’s home jurisdiction must have signed a Memorandum of Understanding (“MOU”) and must maintain a cooperative regulatory relationship with the CSRC.⁸² Under the 2002 regulations, the CSRC required

pub/FDI_EN/Laws/Securities/P020060620358981569357.pdf; *see also* *SAFE Issues Supplementary Regulations*, *supra* note 72, at 2.

⁷⁵ *China Releases*, *supra* note 73.

⁷⁶ QFII Interim Measures of 2002, *supra* note 74, at art. 5.

⁷⁷ *Id.* at art. 38. (applying QFII Interim Measures of 2002 to institutional investors from the Hong Kong and Macao special administrative regions and Taiwan).

⁷⁸ *Id.* at art. 2.

⁷⁹ The QFII Interim Measures of 2002 also applied to institutional investors from the Hong Kong and Macao special administrative regions and Taiwan. *Id.* at art. 38.

⁸⁰ *Id.* at art. 2.

⁸¹ *Id.* at art. 6.

⁸² *Id.*

applicants to have a minimum number of years of experience in their business sector and a minimum amount of assets under management in the latest fiscal year, based on whether the applicant was a fund management institution (five years and US \$10 billion), an insurance company (30 years, US \$10 billion, and US \$1 billion of paid-up capital⁸³), a securities company (30 years, US \$10 billion, and US \$1 billion of paid-up capital⁸⁴), or a commercial bank (ranking globally among the top 100 commercial banks in total assets and US \$10 billion).⁸⁵ The CSRC could require additional eligibility conditions.⁸⁶ Thus, the regulations precluded overly risky (e.g., thinly capitalized) foreign institutional investors with bad track records or burdensome liabilities from investing in China and also precluded investors from jurisdictions that had not agreed to co-supervise QFII investment activities with the CSRC. In this way, the QFII qualification standards function to block low quality capital inflows.

To apply for QFII status, a prospective investor must submit a written application and supporting documentation.⁸⁷ If the CSRC approves, it issues a securities investment license to the applicant.⁸⁸ The applicant, through its Chinese custodian bank (see below), must request an investment quota from the SAFE within one year of receiving a QFII license.⁸⁹ If the SAFE approves the quota, it issues a forex registration certificate to the applicant.⁹⁰ The CSRC and the SAFE annually review securities investment licenses and forex registration certificates, and if a QFII fails an annual review, its securities investment license and forex registration certificate automatically expire.⁹¹

⁸³ “Paid-up capital” is the total amount of capital that has been paid in full by shareholders. *Paid-Up Capital*, INVESTOR’S BUSINESS DAILY FINANCIAL DICTIONARY, http://www.investors.com/FinancialDictionary/Term/Paid_Up_Capital.asp.

⁸⁴ *Id.*

⁸⁵ QFII Interim Measures of 2002, *supra* note 74, at art. 7.

⁸⁶ *Id.* at art. 6.

⁸⁷ *Id.* at art. 8.

⁸⁸ *Id.* at art. 9.

⁸⁹ *Id.* at art. 10 (“[T]he applicant shall apply through its custodian to the SAFE for the investment quota. . . . The securities investment license shall automatically become invalid if the applicant fails to obtain the foreign exchange registration certificate within one year. . .”).

⁹⁰ *Id.*

⁹¹ *Id.* at art. 31 and 36.

Under the 2002 regulations, a QFII must retain exactly one commercial bank in China as a custodian (subject to approval by the CSRC, the PBC, and the SAFE) to manage its assets.⁹² A QFII had to open exactly one special RMB account at its custodian for the exclusive purposes of conducting securities transactions and related forex transactions.⁹³ The custodian was responsible for holding the QFII's assets, completing its forex and RMB transactions, monitoring its investment activities, timely reporting of violations, timely reporting of changes in its investment account, preparing its annual financial reports to the CSRC and the SAFE, and maintaining records of its investment activities for at least the past fifteen years.⁹⁴ The CSRC, the PBC, and the SAFE could also impose additional responsibilities on the custodian.⁹⁵ A QFII also must entrust exactly one securities company for trading purposes, and such entity must maintain records of the QFII's securities transactions in China for at least the past fifteen years.⁹⁶ Thus, a QFII's custodian bank and securities company operate as gatekeepers by monitoring and documenting the QFII's financial activities in China. Such gatekeeping requirements increase the accountability of foreign investors.

Alongside the QFII Interim Measures of 2002, the SAFE promulgated the *Interim Provisions on Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* ("QFII Interim Forex Provisions of 2002") to provide details about the administration of the custodian, the investment quota, and the special RMB account.⁹⁷ Under the QFII Interim Forex Provisions of 2002, a single applicant's requested investment quota must be between US \$50 million and US \$800

⁹² *Id.* at art. 3, 13, 16, and 19.

⁹³ *Id.* at art. 23 and 24; *see also SAFE Issues Supplementary Regulations*, *supra* note 72 ("As implied in the QFII Measures, the QFII Regulations make clear that only one (1) special RMB settlement account can be established per QFII, no doubt to better regulate QFII activity.").

⁹⁴ QFII Interim Measures of 2002, *supra* note 74, at art. 15.

⁹⁵ *Id.* at art. 15.

⁹⁶ *Id.* at art. 3, 19, and 22.

⁹⁷ *Interim Provisions on Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors* (promulgated by the State Admin. of Foreign Exch., Nov. 28, 2002, effective Dec. 1, 2002) [hereinafter QFII Interim Forex Provisions of 2002], *translated in* http://www.fdi.gov.cn/pub/FDI_EN/Laws/Securities/P020060620358376876600.pdf (P.R.C.).

million, inclusive.⁹⁸ The SAFE could adjust the minimum and maximum limits “in accordance with the capital market conditions and balance of payments.”⁹⁹ Regulatory limits on the amount of capital inflow operated to limit the influence that foreign investors could exert in China’s markets.

The 2002 regulations allowed a QFII, within its approved quota, to invest in several types of RMB-denominated securities in China’s capital markets: (1) publicly listed and traded stocks except for foreign currency-denominated shares (“B-shares”); (2) publicly listed and traded government bonds; (3) publicly listed and traded convertible and corporate bonds; and (4) other securities approved by the CSRC.¹⁰⁰ A single QFII and QFIIs in aggregate were subject to limits (“shareholding caps”) on the amount they could invest in any single listed company.¹⁰¹ The CSRC could adjust shareholding caps according to market developments.¹⁰² Limiting foreign investments to only publicly listed and traded Chinese securities or approved securities maintained the transparency of foreign investment activities in China, thereby reducing opportunity for underhanded conduct.

A QFII was also subject to capital flow restrictions, specifically when and how much investment principal it must place into its special RMB account to invest in Chinese securities (“inward remittance”) and when and how much of the original investment principal and after-tax returns it may remove from the account to convert into foreign currency to send back to its foreign jurisdiction (“outward remittance” or “repatriation”).¹⁰³ Within three months after obtaining a license, a QFII must make an inward remittance, which must be in any SAFE-approved freely convertible currency and no more than the QFII’s approved quota.¹⁰⁴ The inward remittance is immediately converted into RMB and directly deposited into the QFII’s special RMB account.¹⁰⁵ If a QFII wanted

⁹⁸ *Id.* at art. 8.

⁹⁹ *Id.*

¹⁰⁰ QFII Interim Measures of 2002, *supra* note 74, at art. 18.

¹⁰¹ *Id.* at art. 20.

¹⁰² *Id.*

¹⁰³ *Id.* at art. 23-30. The QFII Interim Measures use the terms “inward remittance” and “outward remittance” to mean payment of money into and out of China, respectively.

¹⁰⁴ *Id.* at art. 25.

¹⁰⁵ *Id.*

to fully use its approved quota, it must remit that amount within three months after obtaining a forex registration certificate; otherwise, its quota was automatically reduced to the amount it actually remitted.¹⁰⁶ A QFII, except a Chinese closed-end fund management institution, must wait one year (“capital lock-up period”) after its initial inward remittance before it can request the SAFE’s permission to repatriate its funds.¹⁰⁷ A Chinese closed-end fund management institution must wait three years.¹⁰⁸ A QFII must make its repatriation in installments, each capped at 20% of the QFII’s total investment principal.¹⁰⁹ Successive installments for QFIIs that are Chinese closed-end fund management institutions must occur at least one month apart.¹¹⁰ Successive installments for all other QFIIs must occur at least three months apart.¹¹¹ The SAFE could adjust the inward and outward remittance conditions as necessary.¹¹² Furthermore, the regulations imposed a harsher penalty for violating outward remittance (i.e., capital outflow) rules than for violating inward remittance (i.e., capital inflow) rules.¹¹³ For violating quota rules, a QFII is subject to a maximum fine of RMB 30,000, but for unauthorized outward remittance, a QFII must effectively undo the conduct and pay a maximum fine of five times the “evaded amount.”¹¹⁴ Lawmakers intended the inward and outward remittance requirements to reduce the frequency and magnitude of speculative capital flows.¹¹⁵ At the same time, the regulations also sought to facilitate foreign capital transferability *within* China by allowing QFIIs to transfer investment quotas to each other and to eligible

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at art. 26.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.* at art. 30.

¹¹³ See QFII Interim Forex Provisions of 2002, *supra* note 97, at art. 26-27 (setting forth disparate penalties for inward versus outward capital flow violations by QFIIs).

¹¹⁴ *Id.*

¹¹⁵ See Yongding Yu, *Managing Capital Flows: The Case of China* 4 (Research Ctr. for Int’l Fin., Working Paper No. 0816, 2008), available at <http://ie.cass.cn/download.asp?id=313&tn=science> (“[B]y means of capital controls, the government wished that [the] wrong type of capital can be prevented from being introduced.”).

applicants, subject to approval from the CSRC and the SAFE.¹¹⁶ Thus, the timing and quantity restrictions on inward and outward remittances operated to preclude short-term speculative capital inflow and subsequent capital flight.

The early QFII program lagged due to its tough qualification standards and a slow approval process.¹¹⁷ Thus, the government sought to revise the rules to make the QFII program more accessible.¹¹⁸ The revised rules make it easier for more foreign institutional investors to join but also introduce more regulatory uncertainty by giving the CSRC and SAFE blanket discretion on implementation details.¹¹⁹ In September 2006, the CSRC, the PBC, and the SAFE jointly promulgated the *Measures for the Administration on Securities Investment within the Territory of China by Qualified Foreign Institutional Investors (2006)* (“QFII Measures of 2006”) to supersede the original QFII Interim Measures of 2002.¹²⁰ The new regulations focus on attracting medium- and long-term investments from abroad while restricting disproportionately risky, short-term, speculative capital inflows.¹²¹ The CSRC and the SAFE emphasized their cooperation in administering and supervising QFIIs’ investment activities and

¹¹⁶ QFII Interim Measures of 2002, *supra* note 74, at art. 11.

¹¹⁷ See *New QFII Regulations Mark Further Liberalisation of China’s Capital Markets*, OVERSIGHT, (Simmons & Simmons), April 2007, <http://www.elexica.com/download.aspx?area=crms&resource=HKOversight042007.pdf>.

¹¹⁸ See *id.*

¹¹⁹ See Taylor Hui, *China QFII Rules Revised—Significant Developments for Foreign Fund Managers*, DEACONS KNOWLEDGE, Oct. 2006, http://www.deacons.com.hk/eng/knowledge/knowledge_268.htm (“The New QFII Rules do not set out the specific requirements with respect to remittance and repatriation, but instead provide that remittance, repatriation and any lock-up period shall be as adjusted by SAFE. . . .”).

¹²⁰ *Id.*

¹²¹ See Yang Lei, *China Relaxes QFII Rules to Attract More Overseas Investment*, XINHUA NEWS, Aug. 25, 2006, available at http://www.gov.cn/english/2006-08/25/content_370283.htm (reporting that China intended the revised QFII rules “to attract more non-speculative overseas investment for its stock markets . . . [making] it possible for more overseas foreign institutional investors to qualify as investors in the Chinese A-share markets”).

related forex issues.¹²² The 2006 regulations explicitly state that the CSRC's approval of a QFII application depends on the SAFE's opinion and that the SAFE's approval of an investment quota depends on the CSRC's opinion.¹²³ This clarification of the importance of cooperation between China's securities regulator and forex regulator highlights policymakers' increasing sensitivity, at the threshold, to the potential impact of foreign investment on China's exchange rate position.

1. Qualification for QFII status: Preference for Certain Types of Entities

The QFII Measures of 2006 define a QFII as a foreign¹²⁴ fund management institution, insurance company, securities company, or other asset management institution, which (1) has approval of the CSRC to invest in securities in China and (2) has a grant of an investment quota from the SAFE.¹²⁵ The 2006 regulations favor pension funds, insurance funds, mutual funds, charitable funds, and other long-term asset management institutions in order to encourage medium- and long-term investments.¹²⁶

To be eligible for QFII status, an applicant must have sound financial and credit positions and satisfy the CSRC's asset size and other eligibility requirements.¹²⁷ The CSRC revised the minimum business experience and asset-under-management requirements, based on whether the applicant is a fund management institution (5 years and US \$5 billion), insurance company (5 years and US \$5 billion), securities company (30 years, US \$10 billion, and US \$1 billion of paid-up capital), commercial bank (ranking globally among

¹²² Measures for the Administration on Securities Investment within the Territory of China by Qualified Foreign Institutional Investors (2006) (promulgated by the China Sec. Regulatory Comm'n, the People's Bank of China and the State Admin. of Foreign Exch., Aug. 24, 2006, effective Sept. 1, 2006), art. 5 [hereinafter QFII Measures of 2006], *translated in* http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/MinisterialRulings/P020061026642537340942.pdf (P.R.C.).

¹²³ *Id.* at art. 8-9.

¹²⁴ The QFII Measures of 2006 also apply to institutional investors from the Hong Kong and Macao special administrative regions and Taiwan. *Id.* at art. 36.

¹²⁵ *Id.* at art. 2.

¹²⁶ *Id.* at art. 10; *see also* Hui, *supra* note 119.

¹²⁷ QFII Measures of 2006, *supra* note 122, at art. 6.

the top 100 commercial banks in total assets and US \$10 billion), or other institutional investor such as a pension fund, charitable fund, endowment fund, trust company, government investment management company, or other similar fund (5 years and US \$5 billion).¹²⁸ Fund management institutions, insurance companies, and pension, charitable, and government funds need only half the amount of minimum assets to qualify under the 2006 regulations than was necessary under the 2002 regulations. In contrast, the revised regulations do not change the minimum asset requirement for securities companies and commercial banks. The explicit regulatory bias in favor of pension, insurance, mutual, and charitable funds promotes relatively high-quality capital inflows since those types of institutional investors typically seek stable investments and do not engage in speculative behavior.

Furthermore, insurance companies have to satisfy a much lower business experience requirement of five years, as compared with the previous requirement of thirty years. The favorable treatment of financial institutions with long-term investment horizons promotes stable, long-term investments. That is, the more lenient qualification requirement for foreign insurance companies allows a greater number of such companies to invest in China, and since they tend to make relatively long-term investments, these insurance companies bring more long-term capital into China. Additionally, the revised regulations continue to require the securities regulator of an applicant's home jurisdiction to have signed an MOU and to maintain a cooperative regulatory relationship with the CSRC.¹²⁹ Regulatory cooperation between China and a foreign investor's home jurisdiction imposes more accountability on the foreign investor.

¹²⁸ Circular of China Securities Regulatory Commission on the Relevant Issues Concerning the Implementation of the Measures for the Administration on Securities Investment within the Territory of China by Qualified Foreign Institutional Investors (promulgated by the China Sec. Regulatory Comm'n, Aug. 24, 2006, effective Sept. 1, 2006), item 1 [hereinafter QFII Implementation Circular of 2006], *translated in* http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/MinisterialRulings/P020061120606022181707.pdf (P.R.C.).

¹²⁹ QFII Measures of 2006, *supra* note 122, at art. 6.

2. Use of Trustee Banks and Securities Companies: Their roles as Gatekeepers

The 2006 regulations require a QFII to retain exactly one Chinese commercial bank as trustee¹³⁰ to manage its assets, which must be strictly separate from those of the trustee.¹³¹ Segregation of assets promotes transparency of a QFII's investment activities in China. Domestic branches of foreign-funded commercial banks may apply to qualify as a trustee only if they have operated in China for three consecutive years.¹³² As previously described, the trustee's responsibilities under the 2006 regulations are roughly the same as under the old regulations with two changes. First, the current law requires the trustee to keep records of its QFII's investment activities in China for at least the past twenty years, five more than previously required.¹³³ Second, the trustee must prepare reports on its QFII's international balance of payments as specified by the SAFE.¹³⁴ A QFII must retain at least one and may retain up to three securities companies or investment management companies in China to undertake its transactions on the Shanghai or Shenzhen stock exchanges.¹³⁵ The institution(s) must keep records of the QFII's transactions for at least the past 20 years.¹³⁶ The lengthier paper trail requirement further extends the role of a QFII's trustee bank and securities companies as gatekeepers.

3. Permitted Investments and Account Requirements: A Focus on Transparency

Under the 2006 regulations, QFIIs may, within their quotas, invest in the following RMB-denominated financial instruments: (1) publicly listed and traded stocks; (2) publicly listed and traded bonds; (3) securities investment funds; (4) publicly listed and traded

¹³⁰ The 2006 regulations use "trustee" in place of "custodian," which was used in the 2002 regulations.

¹³¹ QFII Measures of 2006, *supra* note 122, at art. 3, 14 & 15.

¹³² *Id.* at art. 11.

¹³³ *Id.* at art. 13; *contra* QFII Interim Measures of 2002, *supra* note 74, at art. 6.

¹³⁴ QFII Measures of 2006, *supra* note 122, at art. 13.

¹³⁵ *Id.* at art. 3 and 19; QFII Implementation Circular of 2006, *supra* note 128, at item 15.

¹³⁶ QFII Measures of 2006, *supra* note 122, at art. 22.

warrants;¹³⁷ and (5) other CSRC-approved financial instruments.¹³⁸ Thus, the regulations expand the categories of securities in which foreign institutions may invest; e.g., QFIIs are no longer excluded from participating in China's B-share market. Nonetheless, QFIIs still must invest within the shareholding caps set by the CSRC.¹³⁹ A single foreign investor investing through a QFII and foreign investors in the aggregate must not hold more than 10% or 20% of the total outstanding shares of any single listed company, respectively.¹⁴⁰ However, a "QFII may participate in the issuance of new shares, issuance of convertible bonds, additional insurance of shares and purchase of rationed shares."¹⁴¹ Thus, the regulations still limit the amount of foreign capital invested in any single company but now allow foreign investors to participate in the primary markets (i.e., initial public offerings) as well as the secondary markets.

To conduct its investment operations, a QFII must open a forex account and a special RMB account with its trustee bank.¹⁴² In contrast to the old law, the 2006 measures do not specify a timeframe for a QFII's initial inward remittance to its special RMB account. Instead, a QFII must contribute its investment principal within the timing and quantity requirements set by the SAFE, but its total inward remittance must not exceed its approved quota.¹⁴³ Similarly, a QFII must repatriate its investment principal and/or proceeds according to the timing and quantity requirements set by the SAFE.¹⁴⁴ The SAFE may coordinate with the PBC to adjust the inward and outward remittance requirements depending on China's forex position and its international balance of payments.¹⁴⁵ However, so far, the SAFE has not issued any new guidelines on inward and outward remittances. Thus, until the SAFE issues new detailed rules, many legal practitioners continue to assume that the specific limits under the 2002 regulations, though nominally abolished, still

¹³⁷ A "warrant" is a "[a]n instrument granting the holder a long-term . . . option to buy shares at a fixed price [from the issuer]." BLACK'S LAW DICTIONARY 1617 (8th ed. 2004).

¹³⁸ QFII Measures of 2006, *supra* note 122, at art. 18; QFII Implementation Circular of 2006, *supra* note 128, at item 9.

¹³⁹ QFII Measures of 2006, *supra* note 122, at art. 20.

¹⁴⁰ QFII Implementation Circular of 2006, *supra* note 128, at item 10.

¹⁴¹ *Id.* at item 9.

¹⁴² QFII Measures of 2006, *supra* note 122, at art. 24.

¹⁴³ *Id.* at art. 26.

¹⁴⁴ *Id.* at art. 27.

¹⁴⁵ *Id.* at art. 28.

effectively apply.¹⁴⁶ The CSRC is also expected to reduce the capital lock-up period to three months for open-end retail funds,¹⁴⁷ and the SAFE most likely will not require prior approval of small amounts of repatriation.¹⁴⁸ Thus, regulators seem to be easing some restrictions at the margin, e.g., loosening repatriation requirements where strict compliance would be overly burdensome and marginal violations would pose little risk to the markets.

Previously, a QFII could open only one securities account, one securities settlement account, and one special RMB account.¹⁴⁹ The 2006 revisions recognize the need for proper asset segregation and allow a QFII to open three types of securities accounts: (1) direct accounts to hold its own assets; (2) nominal accounts to hold its customers' assets; and (3) special direct accounts to hold assets on behalf of long-term funds, such as public, insurance, pension, and charitable funds.¹⁵⁰ Each QFII may hold multiple securities accounts at the China Securities Depository and Clearing Corporation Limited ("China Clearing Corp.") in one-to-one correspondence with respective special RMB accounts approved by the SAFE.¹⁵¹ Thus, by permitting multiple accounts and requiring corresponding segregation of assets, regulators recognize the practical needs of QFIIs' multi-faceted business structures and accordingly promote transparency across the multiple types of investment activities.

In sum, the QFII regulations of 2006 lowered the qualification thresholds on certain types of foreign investors and gave regulators more discretion to implement the QFII program.

B. Discussion of the QFII Program in Practice and Recommendations

The original QFII program of 2002 was so exclusive that only the largest and most well known international financial

¹⁴⁶ *New QFII Regulations Mark Further Liberalisation*, *supra* note 117.

¹⁴⁷ An "open-end fund" is a "mutual fund that continually offers new shares and buys back existing shares on demand." BLACK'S LAW DICTIONARY 1045 (8th ed. 2004)

¹⁴⁸ *New QFII Regulations Mark Further Liberalisation*, *supra* note 117.

¹⁴⁹ *Id.* 7

¹⁵⁰ QFII Implementation Circular of 2006, *supra* note 128, at items 6, 7 & 8; see *New QFII Regulations Mark Further Liberalisation*, *supra* note 117.

¹⁵¹ QFII Implementation Circular of 2006, *supra* note 128, at item 6; Hui, *supra* note 119.

institutions could afford to participate, in terms of both actual costs and opportunity costs. In mid-2003, Switzerland-based investment bank UBS became China's first QFII with a SAFE-approved investment quota of US \$300 million.¹⁵² By August 2006, the SAFE had approved a total of US \$7.495 billion of QFII investment quotas, filling about three-fourths of its aggregate ceiling of US \$10 billion at that time.¹⁵³ However, due to tough qualifying requirements and liquidity restrictions under the 2002 regulations, only 52 QFIIs existed under the early rules.¹⁵⁴ A combination of high qualification standards, liquidity controls on inward and outward remittances, shareholding caps, and burdensome approval procedures made investing in China less appealing than elsewhere.¹⁵⁵ Thus, China's policymakers intended the 2006 regulations to broaden the QFII program's appeal and, in particular, to encourage more institutions with long-term investment horizons to participate.

The 2006 measures opened up China's capital markets to smaller fund management institutions, insurance companies, pension funds, charitable funds, and government funds. Towards the end of 2007, the Chinese government expanded the total QFII investment quota from US \$10 billion to US \$30 billion.¹⁵⁶ In March 2008, Columbia University became the first foreign investor to receive a QFII license after the quota expansion.¹⁵⁷ The QFII program has grown substantially in quantity and breadth since the 2006 regulations. However, the recent global economic downturn led wary investors to withdraw substantially from QFII funds. According to the Lipper Fund Market Insight Report, the aggregate value of QFII funds fell 12.93% in January 2008, slightly more than the average

¹⁵² *First Foreign Institutional Investor Buys into Chinese Stock Market*, CHINA DAILY, July 10, 2003, http://www.chinadaily.com.cn/en/doc/2003-07/10/content_244242.htm

¹⁵³ Lei, *supra* note 121.

¹⁵⁴ *New QFII Regulations Mark Further Liberalisation*, *supra* note 117.

¹⁵⁵ *See China Releases*, *supra* note 73.

¹⁵⁶ *China Approves Columbia University as QFII*, XINHUA NEWS, Mar. 14, 2008, http://news.xinhuanet.com/english/2008-03/14/content_7791582.htm; *China to Relax Regulation on Foreign Investment in Chinese Securities Market*, XINHUA NEWS, Apr. 8, 2008, http://news.xinhuanet.com/english/2008-04/08/content_7941219.htm.

¹⁵⁷ *China Approves Columbia University as QFII*, *supra* note 156.

11.62% drop in China's A-share mutual funds.¹⁵⁸ The six-month return of QFII funds was 3.68%, about the same as the average return on China's stock markets as represented by the Shanghai-Shenzhen 300 index.¹⁵⁹ Due to recent shocks in global markets, QFII funds on average lost 50.27% of their value in the first eight months of 2008.¹⁶⁰ To counteract investors' risk aversion to investing in China's markets given heightened global financial uncertainties, the SAFE announced in April 2008 that it was drafting new forex management rules that would further relax restrictions on QFIIs' investment funds, but the agency did not indicate when it would release the new rules.¹⁶¹

While the 2006 regulations allowed more foreign investors to invest in China, they also gave regulators broader and less transparent discretion to oversee such investment activities. The language of the QFII Measures of 2006 gives the SAFE and the CSRC expansive authority to fine-tune the QFII framework. The SAFE and the CSRC must weigh each other's opinions in deciding whether to grant an investment license or to approve a requested investment quota, but neither the regulations nor their implementing rules provide any specific standards by which the agencies are to make such determinations.¹⁶² Articles 26 through 28 of the

¹⁵⁸ *Drop in Value of QFII Funds Reflects Market*, SHANGHAI DAILY, Feb. 14, 2008, http://news.xinhuanet.com/english/2008-02/14/content_7602936.htm.

¹⁵⁹ *Id.*; see also *First Unified Index of Shanghai, Shenzhen Bourses Released*, BUSINESS BEIJING, Apr. 15, 2005, <http://www.btmbeijing.com/contents/en/business/2005-04/newsbrief4/shenzhen> ("The Shanghai & Shenzhen 300 index is a constituent index compiled by selecting 300 A-shares from the Shanghai and Shenzhen stock markets as samples. Its samples cover about 60 percent of the market value in the Shanghai and Shenzhen markets, which makes the index a good representative of the market.").

¹⁶⁰ Rita Raagas De Ramos, *Huge Losses for Chinese Equity Funds*, BUSINESS WEEK ONLINE, Sept. 24, 2008, http://www.businessweek.com/globalbiz/content/sep2008/gb20080924_654440.htm?campaign_id=rss_topStories.

¹⁶¹ *China to Relax Regulation*, *supra* note 156.

¹⁶² See QFII Measures of 2006, *supra* note 122, at art. 8-9 (stating only that the CSRC and SAFE mutually consider each other's opinions); see also QFII Implementation Circular of 2006, *supra* note 128 (mentioning nothing about the procedures and/or standards by which the CSRC and the SAFE

regulations require QFIIs to comply with any remittance and repatriation rules as prescribed by the SAFE.¹⁶³ Article 28 states that the SAFE may, in accordance with the PBC, adjust the amount and timeline of the remittance of principal by a QFII “in light of the economic and financial status of China, the supply and demand situation of foreign exchange market and the international balance of payments. . . .”¹⁶⁴ Bound only by their own judgment of China’s economic needs, the CSRC, the SAFE, and the PBC may exercise unrestrained rulemaking in the QFII program. Finally, Article 35 requires that “[w]here a QFII, trustee, or securities company violates the present Measures, the CSRC and the SAFE shall impose corresponding administrative penalties upon it according to law.”¹⁶⁵ However, the QFII Implementation Circular of 2006 does not contain any specific guidelines on the range of administrative penalties that the CSRC and the SAFE may use. In contrast, the old 2002 implementing rules had set forth penalties that included a range of monetary fines and possible disqualification from the program.¹⁶⁶ Thus, from the perspective of a potential QFII, significant regulatory uncertainty exists with respect to when and how much capital it can transfer into or out of China and with respect to the range of consequences it would face if it were to violate the regulations.

The government may have underestimated the costs of such a highly uncertain regulatory environment. A prospective QFII must determine whether investing in China under the current legal environment confers a net benefit or whether it should postpone investing until regulatory conditions become more favorable. A relatively transparent and predictable legal environment may be beneficial to the QFII program in at least two ways: (1) lowering both the actual and *perceived* costs of prospective investors; and (2) influencing market behavior by aligning investors’ expectations with government policy. Investors perceive greater risk when they do not know what to expect, even if in hindsight the actual risk was minimal. The current QFII regulations create a highly unpredictable

determine whether to grant an investment license and to approve an investment quota, respectively).

¹⁶³ QFII Measures of 2006, *supra* note 122, at art. 26-28.

¹⁶⁴ *Id.* at art. 28.

¹⁶⁵ *Id.* at art. 35.

¹⁶⁶ See QFII Interim Forex Provisions of 2002, *supra* note 97, at art. 26-31 (specifying monetary fines and threat of disqualification for different violations).

legal environment by broadly requiring QFIIs to abide by regulators' requirements and allowing regulators broad discretion to change the direction of the program at any time. The CSRC, the PBC, and the SAFE need to give market participants frequent and concrete cues on when and how the agencies will proceed with implementing various details of the QFII program. Communicating more clearly with the investing public can reduce speculation and hence market volatility. Although the Chinese government adopts a preventative stance against market failure, it simultaneously can harness market forces to help further its policies. Regulators need to create a more predictable legal environment by communicating frequently with the investing public about existing enforcement, pending regulatory decisions, the underlying decision-making process, and policy positions. Although the CSRC and the SAFE publish their rules, regulations, decisions, and other announcements, they need to do so on a more frequent basis and with more clarity. For example, when the SAFE announced in April 2008 that it was considering relaxing some restrictions on QFIIs, it could have given the public a more concrete timetable and could have provided insight into which aspects of the program it was seeking to change. A more transparent and predictable legal environment guides investors' expectations and promotes investors' confidence, which make markets more robust, efficient, and stable. Chinese lawmakers might also consider soliciting industry-wide comments and responding with clarifications of various aspects of the QFII program. The U.S. Federal Reserve's requesting of public comments on proposed changes to regulations and the U.S. Securities and Exchange Commission's ("SEC") issuing of no-action, interpretive, and exemptive letters are good examples of government agencies engaging in continuing dialogue with the investing public.¹⁶⁷ In sum, China can better promote its capital inflow policies by creating a more transparent, predictable, and interactive regulatory environment.

¹⁶⁷ See, e.g., Reserve Requirements of Depository Institutions; Issue and Cancellation of Federal Reserve Bank Capital Stock, 73 Fed. Reg. 8009 (proposed Feb. 12, 2008) (to be codified at 12 C.F.R. pts. 204, 209); Investment Management No-Action and Interpretive Letters, SEC, <http://www.sec.gov/divisions/investment/im-noaction.shtml> (listing in detail the SEC's numerous no-action letters by subject categories).

IV. *QDII Program*

In light of China's growing trade imbalances, rapid accumulation of excess forex reserves, and pressure to allow the RMB to appreciate, policymakers were compelled to facilitate more capital outflow in order to diffuse internal macroeconomic tensions. To achieve higher and more diversified returns on China's excess forex reserves and sizeable household savings (aggregate RMB 16 trillion as of 2006), the government opened a new channel for capital outflow via the QDII program in 2006.¹⁶⁸ As the QFII program's counterpart, the QDII program permits qualified domestic institutional investors to make limited investments in foreign capital markets.¹⁶⁹ This expansion in capital outflow enables private investors to spend some of China's excess forex reserves on a range of investments in various offshore securities markets, thereby creating more profitable opportunities for and diversification of China's forex holdings, as suggested by policy experts.

A. **Regulatory Structure and Mechanics: Emphasizing Risk Management**

In the past few years, China has gradually implemented the QDII program in a piecemeal manner, allowing certain types of institutions to invest in specific types of foreign financial products. In 2004, China permitted insurance companies to invest in banking deposits, bonds, and commercial paper.¹⁷⁰ In April 2006, the China Banking Regulatory Commission ("CBRC"), the PBC, and the SAFE

¹⁶⁸ *QDII: Liberalizing China's Foreign Exchange and Securities Market*, SONNENSCHN E-ALERT (Sonnenschein Nath & Rosenthal LLP), Aug. 11, 2006, http://www.sonnenschein.com/docs_e-alert/China_Market.pdf (citing People's Bank of China Decree No. 5 (promulgated by the PBC on April 13, 2006)); see also Victor Ho et al., *QDII—China Banking Regulator Opens the Door to Equity Investment*, (Allen & Overy LLP), May 15, 2007.

¹⁶⁹ *QDII: Liberalizing China's Foreign Exchange and Securities Market*, *supra* note 168.

¹⁷⁰ *PRC's CSRC Officially Permits Overseas Securities Investment by Qualified Domestic Institutional Investors ("QDIIs")*, CADWALADER CLIENTS & FRIENDS MEMO (Cadwalader, Wickersham & Taft LLP), July 3, 2007, at 1-2, http://www.cadwalader.com/assets/client_friend/070307_PRCQDIIEnglish.pdf [hereinafter *Cadwalader Memo*].

jointly allowed qualified commercial banks to invest abroad.¹⁷¹ The 2006 decree represented a major policy shift, since China had previously tightly restricted capital outflows.¹⁷² A year later, the CBRC allowed qualified banks to make equity investments but capped investment at a percentage of net asset value.¹⁷³ Around the same time, the China Insurance Regulatory Commission (“CIRC”) also relaxed restrictions on domestic insurance institutions and expanded their overseas investment options.¹⁷⁴

Finally, in June 2007, the CSRC promulgated the *Trial Measures for the Administration of Securities Investment Outside the Territory of China by Qualified Domestic Institutional Investors* (“QDII Trial Measures”) and issued the Circular of China Securities Regulatory Commission (CSRC) Concerning the Issues about the Implementation of the Pilot Rules Concerning Adminstrating Overseas Securities Investment by Qualified Domestic Institutional Investors (“QDII Circular”).¹⁷⁵ These regulations officially permitted Chinese fund management companies and securities companies to invest in foreign financial products.¹⁷⁶ Industry commentators expect that, for the near future, the greatest quantity of outward investment by individuals in China would flow through securities institutions,¹⁷⁷

¹⁷¹ *Id.* at 2 (citing the Tentative Measures for the Administration of Overseas Investment on Behalf of Their Clients by Commercial Banks).

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ Neal A. Stender et al., *China Outbound Portfolio Investment: Fleshing Out Regulations for QDII Securities Institutions & Insurers*, CHINA LAW & PRACTICE 26-29, Sept. 2007, available at <http://www.orrick.com/fileupload/1255.pdf>.

¹⁷⁵ See Trial Measures for the Administration of Securities Investment Outside the Territory of China by Qualified Domestic Institutional Investors (promulgated by the China Sec. Regulatory Comm’n, June 18, 2007, effective July 5, 2007) [hereinafter QDII Trial Measures], translated in http://www.fdi.gov.cn/pub/FDI_EN/Laws/Securities/P020070705504688903072.pdf (P.R.C.); Circular of China Securities Regulatory Commission (CSRC) Concerning the Issues about the Implementation of the Pilot Rules Concerning Adminstrating Overseas Securities Investment by Qualified Domestic Institutional Investors (promulgated by the China Sec. Regulatory Comm’n, June 18, 2007, effective July 5, 2007) [hereinafter QDII Implementation Circular], translated in http://www.fdi.gov.cn/pub/FDI_EN/Laws/Securities/P020070727602011712707.pdf (P.R.C.).

¹⁷⁶ Cadwalader Memo, *supra* note 170.

¹⁷⁷ Stender et al., *supra* note 174, at 26 (citing the Tentative Measures for the Administration of Overseas Investment with Insurance Funds

and thus, the 2007 regulations substantially expanded the potential for capital outflow. However, the regulations, particularly the QDII Circular, provide very detailed requirements and restrictions, reflecting the government's wariness of foreign markets and its desire to limit the exposure of domestic investors to disproportionate risks. The following discussion of QDIIs focuses primarily on the 2007 regulations governing fund management companies and securities companies.

1. Qualification for QDII Status: Investor Protection

The QDII Trial Measures define a QDII as a domestic fund management company, securities company, or other securities institution, which (1) satisfies the requirements in the QDII Trial Measures; (2) has the CSRC's approval to raise capital in China; and (3) uses such capital to invest in foreign securities markets.¹⁷⁸ An applicant must have stable financial and credit positions. Specifically, a QDII must meet certain minimum net asset requirements, business experience, and asset management size requirements. A fund management company must have minimum net assets worth RMB 200 million, two years of industry experience, and by the end of the latest quarter, assets under management of RMB 20 billion.¹⁷⁹ A securities company must have minimum registered capital of RMB 800 million, net-capital-net-assets ratio of 70%, one year of industry experience, and by the end of the latest quarter, assets under management of RMB 2 billion.¹⁸⁰ A QDII also must have staff experienced in overseas investment management.¹⁸¹ It must employ at least one mid-level manager with minimum five years of investment management experience in a foreign securities market and at least three staff members with minimum three years of such experience.¹⁸² A QDII must also satisfy additional corporate

(promulgated by the China Ins. Regulatory Comm'n, effective June 28, 2007)).

¹⁷⁸ QDII Trial Measures, *supra* note 175, at art. 2. The QDII program also governs Chinese investment in the financial markets of the Hong Kong and Macao special administrative regions. *Id.* at art. 44.

¹⁷⁹ *Id.* at art. 6.

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at art. 5.

¹⁸² *Id.* at art. 7.

governance and good standing requirements.¹⁸³ Thus, the qualification standards function to ensure that Chinese investors entrust only well-capitalized and experienced institutions with their money.

To apply for QDII status, an applicant must submit a written application and supporting documentation to the CSRC.¹⁸⁴ If the CSRC approves the application, it will issue a securities investment license.¹⁸⁵ The QDII may then request the CSRC's permission to raise capital in China.¹⁸⁶ Finally, it must also obtain the SAFE's approval to conduct forex business.¹⁸⁷

2. Use of Custodian Bank to Hold Assets: Role of Gatekeeper

A QDII must retain a qualified commercial bank in China as custodian to hold its assets.¹⁸⁸ The domestic custodian bank may in turn retain a qualified foreign custodian to hold overseas assets.¹⁸⁹ The foreign custodian must also have, in the latest fiscal year, minimum paid-in capital worth US \$1 billion or hold in custody minimum assets worth US \$100 billion.¹⁹⁰ A domestic custodian is responsible for safeguarding the QDII's assets, opening a capital account and a securities account on the QDII's behalf, handling its RMB and forex transactions, and keeping records of its capital flow for at least the past twenty years.¹⁹¹ A domestic custodian must strictly separate its own assets from the QDII's assets.¹⁹² Finally, the domestic custodian is liable for asset losses resulting from its foreign custodian's fault or negligence.¹⁹³ Thus, the regulations encourage domestic custodian banks to be gatekeepers of QDII activity in foreign markets.

¹⁸³ *Id.* at art. 5.

¹⁸⁴ *Id.* at art. 8.

¹⁸⁵ *Id.* at art. 9.

¹⁸⁶ *Id.* at art. 10.

¹⁸⁷ *Id.* at art. 12.

¹⁸⁸ *Id.* at art. 3 & 18.

¹⁸⁹ *Id.* at art. 19.

¹⁹⁰ *Id.* at art. 21.

¹⁹¹ *Id.* at art. 22.

¹⁹² *Id.* at art. 23.

¹⁹³ *Id.* at art. 21.

3. Use of Overseas Investment Consultant: Risk Management, Fiduciary duties, and Liability

A QDII may also hire a qualified foreign investment consultant.¹⁹⁴ The investment consultant must be established outside of China, have engaged in the investment management business for at least five years, and have, for the latest fiscal year, assets under management of at least US \$10 billion.¹⁹⁵ The investment consultant must also satisfy corporate governance and good standing requirements.¹⁹⁶ The QDII Trial Measures hold investment consultants to a stringent standard of fiduciary duty.¹⁹⁷ Furthermore, if an investment consultant is authorized to make investment decisions on behalf of a QDII, the investment consultant is liable for losses resulting from its own omission or negligence.¹⁹⁸ Finally, the securities regulator of the investment consultant's home jurisdiction must have signed an MOU and must maintain a cooperative regulatory relationship with the CSRC.¹⁹⁹ Thus, the regulations encourage disciplined risk management by imposing additional accountability on qualified foreign investment consultants via high standards of fiduciary duty and co-supervision by regulators in their respective home jurisdictions and the CSRC.

4. Raising Capital in China: A Focus on Information Disclosure and Investor Education

A QDII fund management company “may raise capital by publicly selling fund units,” whereas a QDII securities company “may raise capital by establishing a pool[ed] plan.”²⁰⁰ To apply for a capital-raising permit, a QDII must submit a risk disclosure letter and educational materials for investors, such as basic information about the fund or pooled plan, explanation of the investment's material risks, basic information about the target foreign market, and procedures for selecting a benchmark to measure investment

¹⁹⁴ *Id.* at art. 14.

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at art. 16.

¹⁹⁸ *Id.* at art. 17.

¹⁹⁹ *Id.* at art. 14.

²⁰⁰ *Id.* at art. 24-25

performance.²⁰¹ All materials presented to investors must be written in “plain and easily understandable” Chinese.²⁰² A QDII may raise capital in RMB, US dollar, or any other major foreign currency.²⁰³ For each fund, a fund management company must raise more than RMB 200 million; for each pooled plan, a securities company must raise more than RMB 100 million.²⁰⁴ An open-end fund must have more than 200 shareholders; a closed-end fund must have more than 1000 shareholders; and a pooled plan must have more than two shareholders.²⁰⁵ Finally, a QDII, based on its specific needs and SAFE's regulations, must set a reasonable cap on the amount of RMB that it can convert to foreign currencies; it must file this forex quota with the SAFE and regularly report to the SAFE on use of the quota and capital outflow/inflow activity.²⁰⁶ Thus, the public filing and risk disclosure requirements function to educate Chinese investors and assist them in making informed, risk-calculated decisions. These requirements implement the government's policy of risk management at the outset; i.e., providing investors with public access to information about the material risks involved in QDIIs' financial products.

5. Permitted Investments and Prohibited Activities: An External Approach to Risk Management

A QDII fund or pooled plan may invest in (1) bank deposits, transferable deposit receipts, bank's acceptance bill, commercial paper, repurchase agreements, short-term treasury bonds, and other currency market instruments; (2) treasury, corporate, and convertible bonds, mortgage-backed securities (“MBS”), asset-backed securities (“ABS”), and securities issued by CSRC-accredited international financial organizations; (3) publicly listed and traded common and preferred stocks in a foreign jurisdiction that has signed an MOU with the CSRC; (4) registered public funds in a foreign jurisdiction that has signed an MOU with the CSRC; (5) certain structured investment products; and (6) financial derivatives, including

²⁰¹ QDII Implementation Circular, *supra* note 175, at item 4.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ QDII Trial Measures, *supra* note 175, at art. 33 & 37.

forwards, swaps, warrants, options, and futures, publicly listed and traded on a CSRC-approved overseas exchange.²⁰⁷

The QDII regulations impose investment caps on excessively risky investment activities. A fund/pooled plan and a QDII's funds/pooled plans in aggregate may not invest more than specified percentages of their net values in a single entity, in illiquid assets, and in foreign jurisdictions that have not signed MOUs with the CSRC.²⁰⁸ Furthermore, a fund or pooled plan may not be a controlling shareholder in an overseas entity (e.g., a single fund or pooled plan may not hold more than ten percent of the total outstanding voting shares of any single company).²⁰⁹

The CSRC entirely prohibits some investment activities due to their high-risk profiles. A QDII fund or pooled plan may not purchase (1) real estate; (2) real estate mortgages; (3) precious metals or certificates representing precious metals; or (4) commercial products.²¹⁰ A QDII fund or pooled plan also may not (1) borrow money except to pay transaction costs and other temporary expenses; (2) use borrowed money to buy securities except for investment in financial derivatives; (3) engage in short-selling without holding underlying assets; or (4) participate in underwriting securities.²¹¹

By limiting QDII investments to securities that are relatively transparent, more easily valued, and more liquid, such as those listed and traded on stock exchanges, the regulations again reflect the Chinese government's concerns about the excessive risks of investing in foreign markets. Regulators adopt an external approach to risk management by explicitly capping investment amounts and entirely banning some types of investments. However, regulators should also emphasize internal risk management procedures within QDIIs and their qualified investment consultants. For example, rules should require QDIIs to use only sound methods of investment and to document the reasonable bases of their investment decisions in light of each QDII's particular financial fitness, investor composition, and relevant market conditions.

²⁰⁷ QDII Implementation Circular, *supra* note 175, at item 5.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*; see also Cadwalader Memo, *supra* note 170, at 6.

²¹¹ QDII Implementation Circular, *supra* note 175, at item 5.

B. Discussion of the QDII Program in Practice and Recommendations

Since China's macroeconomic situation has produced a more pressing need for capital outflow than for capital inflow in recent years, regulators expanded the QDII program substantially faster than the QFII program. By September 2006, regulators approved only forty-five QFIIs over four years with an aggregate quota of US \$7.5 billion.²¹² In contrast, in only a few months, regulators approved fifteen QDIIs (all but one were commercial banks) with an aggregate quota of US \$10.8 billion, which was much larger than expected.²¹³ By that time, the SAFE allowed Chinese individuals to buy up to US \$20,000 of forex per year, more than double the previous limit of US \$8,000.²¹⁴ However, Chinese investors did not express much demand for the earliest QDII products; for example, four early QDIIs sold only 3.2 percent of their forex conversion quotas after two months of promotion.²¹⁵ Even though the government opened a new channel for capital outflow, domestic investors were not that interested. One reason for the lukewarm response was the unattractiveness of investing overseas in light of an increasingly stronger RMB. Chinese investors viewed overseas investments as depreciating over time in light of their expectations that the RMB would steadily appreciate.²¹⁶ Thus, investors demanded sufficiently high yields from QDII products to compensate for losses due to anticipated changes in the exchange rate.²¹⁷

Two other reasons for the lack of interest in the early QDII offerings were their high entrance fees and their focus on short-term fixed-income products, which generated comparably lower returns than the Chinese stock market.²¹⁸ However, in September 2007, investors expressed high demand for China's first offering of a

²¹² Hang Seng Bank *QDII—A Catalyst for China's New Financial Landscape*, HANG SENG ECON. MONTHLY, Sept. 2006, available at <http://info.hktdc.com/econforum/hsb/hsb060901.htm>.

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ Murray Coleman, *Chinese Leap at Chance to Invest Outside—Global Stock Fund Attracts \$8 Billion on Its First Day; Five More Firms Lining Up*, WALL ST. J., Sept. 28, 2007, at C13.

mutual fund composed of an *all-stock* portfolio of companies from around the world.²¹⁹ BNY Mellon Asset Management's Southern Global Enhanced Balanced Fund subscribed to its full capacity of \$4 billion and had to turn away an additional \$4 billion that investors wanted to contribute.²²⁰ Thus, the demand for QDII financial products depended largely on the types of overseas financial instruments offered as Chinese investors weighed their opportunity costs.²²¹

Investors are gradually becoming more familiar with the QDII program, and regulators have already relaxed certain forex restrictions. For example, by January 2008, the SAFE was allowing individual investors to buy up to US \$50,000 of forex per year.²²² The Chinese government has cumulatively approved more than US \$50 billion of QDII products, approaching the US \$66 billion of overseas investment capital held by the China Investment Corporation ("CIC"), China's sovereign wealth fund.²²³ Also, the CSRC and the SEC signed an MOU in early 2008, which allowed Chinese banks to invest their clients' money in U.S. stocks.²²⁴ China had signed similar agreements with Hong Kong, the United Kingdom, and Singapore.²²⁵ However, Chinese investors have continued to express less enthusiasm than expected. Most of the QDII products have been undersubscribed, and many of them have lost value.²²⁶ While earlier lack of demand for QDII products had been due to comparably insufficient returns on overseas investments, recent avoidance of QDII products has been due to investors' heightened uncertainties about international financial markets in light of the global credit crisis and the distressed U.S. economy.²²⁷

Investors are right to be cautious about QDII products given the current turbulent financial climate. The recent bankruptcy of

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ See Andrew Browne, *Chinese Investors Respond Unevenly to Foreign Funds*, WALL ST. J., Oct. 16, 2006, at C7.

²²² James T. Areddy, *Chinese Investors Get to Bet on U.S. Stocks—SEC Pact Will Open the Door Wider, but a Cautious Approach is Likely to Prevail for Now*, WALL ST. J., Jan. 30, 2008, at C6.

²²³ *Id.*

²²⁴ Juan Chen & Ellen Sheng, *International Finance: U.S. Stocks Open More to China*, WALL ST. J., Apr. 8, 2008, at C2.

²²⁵ *Id.*

²²⁶ Areddy, *supra* note 222.

²²⁷ *Id.*

Lehman Brothers will heavily impact China's oldest QDII fund, the Hua An International Balanced Fund.²²⁸ Lehman Brothers was the fund's investment adviser, and a unit of Lehman guaranteed certain structured notes held by the fund and also issued some of the notes' underlying assets.²²⁹ The fund stated that its "continued existence . . . will be hugely impacted if Lehman is unable to exercise its obligations toward the guaranteed structured notes."²³⁰ Although analysts expect that Lehman's collapse will not have a huge impact on the overall QDII program, the recent financial meltdowns have QDIIs worrying about the reliability of foreign business partners.²³¹ Accordingly, demand for QDII products seems uncertain for the near future. Simon Gleave, a partner at KPMG, one of the largest financial services firm in the world, observed:

How great the demand for QDII will be is a big question. Certainly in the longer-term, following the development of pension funds and insurance funds, such institutional investors will look to diversify their portfolios internationally, but Chinese retail investors will not look to do so.²³²

Thus, both foreign market conditions and domestic development of China's financial institutions will shape the future of the QDII program.

Although the QDII program may not have an immediate impact on China's forex position, it produces at least three major long-term benefits: (1) facilitating the flow of forex from the

²²⁸ Samuel Shen, *China's Hua An Says Lehman Woes to Affect QDII Fund*, REUTERS UK, Sept. 16, 2008, <http://uk.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUKSHA1732320080916?sp=true>.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.* (quoting Zhang Haochuan, an analyst at Shanghai-based fund consulting firm Z-Ben Advisors: "This should not have a huge impact on China's overall QDII business, but concerns will grow regarding the reliability of foreign partners.").

²³² Amy Cho, *Tapping New Wealth*, FINANCIAL TIMES MANDATE, May 2008, http://www.ftmandate.com/news/fullstory.php/aid/1750/tapping_new_wealth.html.

government to private sectors;²³³ (2) diversifying China's forex holdings in various overseas markets;²³⁴ and (3) helping domestic institutional investors gain sophisticated risk management skills through collaboration with foreign investment experts. First, as exchange rate expectations change in the future, private investors would be readily equipped with forex to invest overseas.²³⁵ Transferring forex from the government to the private sector relieves the government of the costly inefficiencies of holding forex in excess of the amount it needs for maintaining a stable and sound economy. Second, global market forces can eventually determine where investors allocate their forex holdings. Third and of particular importance, the QDII program allows domestic institutional investors to form substantive working relationships with foreign investment experts. Li Zhengqiang, vice director of the CSRC's fund department, stated that QDIIs were allowed to hire overseas investment advisors so they could "grow rapidly in the short term."²³⁶ However, the long-term benefits of employing overseas investment advisers may be even more important. Through these relationships, domestic institutional investors can become sophisticated risk managers, strengthening China's own capital markets.²³⁷ Thus, regulators should continue to emphasize the importance of disciplined risk management and the duties of care and loyalty in making investment decisions, while relaxing other rigid restrictions,

²³³ Hang Seng Bank, *supra* note 212; *see also* Zheng & Yi, *supra* note 10, at 24 ("If companies and individuals are allowed to hold more foreign exchange, the pressure the government faces could be reduced. However, this option implies that companies and individuals will have to shoulder risks of foreign exchange fluctuation that the government currently bears.").

²³⁴ *See* Zheng & Yi, *supra* note 10, at 23-24 (discussing diversification of forex reserves).

²³⁵ *See id.*

²³⁶ Press Release, Ministry of Commerce, The People's Republic of China, China Allows QDII to Invest in Overseas Securities Business (June 21, 2007),

<http://english.mofcom.gov.cn/article/newsrelease/commonnews/200706/20070604808526.html>.

²³⁷ *See* Yujing Shu et al., *Expansion of China's Outbound Investment Rules Regulating the Qualified Domestic Institutional Investor (QDII) Program*, K&L GATES NEWSSTAND, July 2007, <http://www.klgates.com/newsstand/Detail.aspx?publication=3950> (summarizing that QDIIs are allowed to hire qualified overseas investment advisors in order "[t]o tap overseas investment expertise").

such as explicit caps on investment. Regulators might also consider introducing positive incentives for QDIIs to establish and maintain robust risk management procedures that go beyond the minimum requirements.

As the QDII program develops, policymakers have shifted their focus from being concerned about domestic investors engaging in massive capital flight to being concerned about unsophisticated domestic investors incurring disproportionate risks in foreign investments.²³⁸ The primary goal of QDII regulations should be to insist on effective risk management by domestic institutional investors. The QDII program offers a valuable opportunity to both for China's regulators and investors to learn more about managing financial risks and other skills necessary to develop robust domestic capital markets.

V. *Conclusion*

China's policymakers designed both the QFII and QDII programs as transitional measures in response to China's growing macroeconomic imbalances, particularly reflected in its rapid accumulation of excess forex reserves. These intermediary programs are the initial steps in a challenging process of capital liberalization. On the one hand, supervision needs to be continuous, and regulation needs to be transparent in order to build structural integrity of China's capital markets. On the other hand, Chinese investors need to gain more experience and become more sophisticated in risk management by working with and learning from the most competent foreign financial experts. The QFII and QDII regulations reflect a responsible approach of gradual reform and also illuminate essential prerequisites to unrestrained capital mobility. That is, before China adopts full capital account convertibility, the Chinese government must first cultivate a predictable regulatory environment, exercise strong supervision, insist on sound risk management by market participants, and endorse the import of valuable financial expertise from other countries.

²³⁸ See Stender et al., *supra* note 174.