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Expansion of China's Outbound Investment Rules Regulating the Qualified Domestic Institutional Investor (QDII) Program

On July 5, 2007, a new set of rules came into effect which, for the first time, allow PRC brokerage houses and fund management companies to use their client's funds to invest in overseas fixed income, stocks, and other financial derivative products. It is estimated that a good number of PRC securities and fund management firms will immediately meet the government-established eligibility requirements, and they will join already qualified PRC banks and insurers in offering these overseas financial investment products.

To tap overseas investment expertise, domestic PRC securities and fund management companies will now be allowed to engage the services of qualified overseas investment advisors. Conversely, foreign fund managers can now target and access the Chinese wealth management market without first setting up previously mandated local operations in China. As a result, new foreign funds are being launched to target and will now have access to the highly coveted high net worth customers of the Chinese domestic banks.

In addition, PRC brokerage houses and fund management firms will be permitted to raise funds to invest in overseas fixed-income and equity products along with products involving forwards, swaps, warrants, options and futures, although they remain restricted in investing in overseas property markets, mortgage loans, metals and goods. Furthermore, PRC authorities stated that derivative investments should be for risk-hedging purposes only, and that speculative and leveraged trading would not be permitted.

One of the key programs designed to facilitate the offshore movement of Chinese financial investments is the "Qualified Domestic Institutional Investor" (QDII) program. This program encourages and facilitates the outflow of foreign exchange that can be invested in overseas capital markets by domestic institutional investors, such as PRC banks and insurance companies.

The first QDII product managed by a PRC fund company, according to a June 26 report from the New China News Agency, is being created by China Southern Fund Management Co. Ltd., in cooperation with Mellon Financial Corp., and is expected to raise between US \$800 million to \$1 billion.

As qualified banks and investment firms within China begin to create their own QDII vehicles, additional collaborations can also be expected with foreign financial institutions specializing in managing and moving QDII funds offshore.

Under the QDII program, Chinese domestic banks have been given the go-ahead to invest as much as 50% of their overseas investment quotas in equity funds, subject to the regulations of overseas regulators such as the Hong Kong Securities and Futures Commission. The continuing liberalization in the QDII program is seen as a move to encourage capital outflows from an extremely robust Chinese economy. Deutsche Bank AG estimates that

approximately US \$10 billion will leave China over the next 12 months while Morgan Stanley predicts a US \$23.4 billion medium-term outflow.

It is an understatement to state that the QDII program is evolving rapidly. As of July 1, 2007, 19 banks and three insurers have been granted QDII licenses since the government launched the domestic institutional investor scheme in 2004. A continuous steady stream of announcements of new QDII vehicles can be expected from the widening range of financial-sector actors permitted to engage in QDII fund-raising and placement.

The QDII program in Practice

Since the commencement of the QDII program, domestic Chinese interest has been building slowly, due, in part, to the immediate competitive appeal of the rapidly-appreciating equity prices on China's domestic exchanges and the steady (albeit gradual) appreciation

of the RMB against the U.S. dollar. This new widening of the QDII investor pool could potentially ignite a very large-scale QDII movement. In addition, there is an expectation that this opening of new opportunities for diversification of investments will strike a chord in the professional investment community within China.

Indeed, the continuous liberalization of the QDII rules, in short order, suggests several things: a) the hope that opening new channels to offshore investment will put a dent in China's roaring accumulation of foreign exchange reserves and the economic pressures resulting therefrom; b) the realization that alternative investment opportunities are now a pressing concern to an economy that has always prided itself on a robust, domestic private and corporate savings and less on providing investment choices. In short, new opportunities in China are increasingly available to foreign investment firms.

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