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From QDII to QDLP – Constantly Exploring the Liberalization of China's Capital Markets

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The recently concluded Boao Forum for Asia Annual Conference 2018 conveyed an important signal to expand the opening up of financial markets in China. As part of the implementing efforts, the State Administration of Foreign Exchange ("**SAFE**") has released two news alerts in recent days proposing to promote QDII reforms and to consider increasing QDLP/QDIE quotas in due course.

From QDII to QDLP

The Qualified Domestic Institutional Investors ("**QDII**") program has been the major channel for domestic financial institutions to invest overseas since its launch in 2006. Under China's separate-commission approach to supervising its financial system, the QDII program is not subject to a single uniform set of regulations. Instead, the three former regulatory commissions for banking, securities and insurance each issued respective rules and applied them to financial institutions under their own supervision. As a result, different types of financial institutions are subject to different QDII rules (including commercial banks and trust companies, securities firms and fund management companies, insurance companies), and the scope of and restrictions on overseas investments vary from type to type. In general, except for insurance QDIIs, which have a relatively wider investment scope and are eligible to invest in assets such as qualified offshore equity funds and real estate, the QDII program mainly permits investments in offshore securities, which are subject to strict restrictions. For instance, the QDII rules for banking, securities brokers and mutual funds explicitly prohibit investment in offshore hedge funds.

Another feature of the QDII program is that SAFE oversees the approval of investment quotas

for institutions of all types and uniformly controls the quotas in accordance with the country's balance of payments position. The data published on SAFE's official website as of March shows that SAFE has not issued new QDII quotas since December 2015.

Given that the QDII program only applies to specific financial institutions and sets strict limitations on investment scope, etc., some well-developed regions such as Shanghai have begun to explore new ways to allow for overseas investment on a pilot basis. The Qualified Domestic Limited Partners ("**QDLP**") regime was first implemented in Shanghai as a pilot program. The Shanghai Municipal Financial Service Office ("**SFO**") led the foreign exchange administration, industry and commerce administration and other relevant authorities to form a "joint meeting" to take charge of the implementation and supervision of the pilot program. Same as with the QDII program, SAFE oversees the quotas for the QDLP pilots and may loosen or tighten the quotas in due course. The approval of QDLP quota has also been suspended since the second half of 2015.

The major differences between the QDII and QDLP programs can be seen from the general comparison between the two programs in the chart below:

Main Features	QDII	QDLP
Applicable Institutions	Domestic financial institutions	Offshore asset management institutions
Scope of Overseas Investment	Mainly overseas secondary markets; required to meet the limitations imposed in QDII rules	Various types of offshore funds; no clear limitations on other investments
Regulatory Authorities	Financial regulators and SAFE	SFO taking the lead
Approval Requirements	Application with financial regulator for license and then separately with SAFE for quota	Application made with SFO who will coordinate with SAFE on quota approval matters
Domestic Structure	Offshore asset management institutions selling their products to QDIIs are not required to establish any onshore presence	Participating offshore asset management institutions are required to establish onshore entities

Due to its clear positioning, the QDLP program has effectively broken through some of the limitations of the QDII program. The domestic investors of the QDLP pilot funds can be qualified institutional or individual investors. The pilot funds may invest in various types of offshore funds, including secondary market funds, PE funds, real estate or infrastructure funds, etc. More importantly, unlike the QDII program which only provides distribution channels for purchasing the products of offshore asset managers, the QDLP program allows and attracts a number of world-class asset managers to establish subsidiaries in Shanghai. Although there are few to date, the participants have been very high-profile and diversified, ranging from the

initial hedge fund managers (Citadel, Man, Oaktree, etc.) to subsequently, large-scale asset management institutions (such as BlackRock). Meanwhile, the QDLP rules require that funds established within China must entrust both a safekeeping bank and a fund administrator, which will also promote the development of the fund services industry in China. According to statistics from the Shanghai Lujiazui Financial City Development Bureau, more than half of the overseas institutions ranked among the global top 50 largest asset managers have established asset management subsidiaries in Shanghai, for which the QDLP program deserves much of the credit by serving as the first footprint for many offshore asset management institutions.

Replication and Expansion of the QDLP Model

SAFE's press release on the QDLP program also mentions the Qualified Domestic Investment Enterprises ("**QDIE**") program in Shenzhen. While following the model of Shanghai's QDLP pilot, Shenzhen's QDIE program has some new features, and the qualifications and entry requirements to participate also differ from those in Shanghai. The current status of QDIE shows that few offshore asset management institutions have directly established subsidiaries in Shenzhen but rather co-operated with local QDIE quota holders, thus QDIE appears closer to the QDII program in this respect.

It remains to be seen whether similar pilot programs will be expanded to Beijing or other areas. In addition, SAFE's statement that "the QDLP and QDIE pilot programs could be more suitable for overseas investments targeting high-tech enterprises, especially those in their start-up period" may also foretell further expansion of these pilot programs by indicating that they might be used for investing in offshore projects rather than merely in offshore funds.

The major differences between Shanghai QDLP program and Shenzhen QDIE program can be seen from the general comparison between the two programs as in the chart below:

Main Features	QDLP	QDIE
Major Participants	Offshore asset management institutions	Mainly domestic entities
Requirements for Fund Managers	Registered capital of no less than USD 2 million	Registered capital of no less than USD 2 million for foreign-invested subsidiaries; registered capital of no less than RMB 10 million for Chinese-funded entities
Minimum Size of Fund	RMB 30 million for contractual funds; RMB 100 million for partnership funds	RMB 30 million
Domestic Structure	Setting up a foreign-invested enterprise ("**FIE**") to serve as the QDLP fund manager, or adopting a holding structure	No holding structure provided

	under which a subsidiary of the FIE serves as the QDLP fund manager	
Fund Investors	Qualified institutional and individual investors	Qualified institutional and individual investors
Scope of Investment	Offshore markets	Offshore markets

Whether it is the issuance of new QDII quotas or further increasing the total quotas for QDLP or QDIE, both reflect China's continued efforts to further fulfill its two-way market opening commitments. Faced with emerging opportunities in China, overseas institutions need to be observant and have a longer-term perspective in order to structure their business in China more effectively and enjoy first-mover advantages on the market.

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