

## DISCOVERING PROFITABLE FINANCIAL OPPORTUNITIES IN THE OUTFLOW OF CAPITAL FROM CHINA

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### ABSTRACT

The aim of this study is to understand how the capital is being moved offshore, what are the capital controls in place and how can we help move the money offshore. The research question therefore is to find the most profitable method of moving money offshore from China which heavily takes into considerations the risks involved too. The study has come to an understanding of 5 different effective ways to move the money of Chinese clients offshore without the approval of the government. The five different ways can be categorized into three different categories that include Illegal, Grey and Legal. From the advantages and disadvantages in the conclusion and the research findings, we come to an understanding that illegal methods are far too risky in comparison to the return not only for the service provider but also for the client. The grey methods include some unethical aspects to it and also contain risks that include imprisonment due to fraud. The return through the method of friends and family are far too low and the negotiation room for low commission are far too great on both grey channels. It seems that the legal method of moving money is the best option as the risks involved are much lower than both illegal and grey methods at the same time profitability from these methods are much higher than that grey methods if not in comparison to illegal channels. In between the legal methods, pension funds seem to be the best way to move money.

**KEYWORDS:** Capital outflow, china, illicit capital flows, trade misinvoicing, legal methods of capital outflow, offshore financing.

## 1. INTRODUCTION

Over the last few years China despite its robust growth experienced an extremely drastic outflow of capital that did not only threaten the foreign reserves of China but also threatened the economy itself which could have led to yet another global economic crisis. In December 2015, it was estimated that the total capital outflows since 2006 till 2015 reached a staggering \$1 Trillion USD (Bloomberg News, 2016). The outflows are speculated to be caused due to stock market panics, insufficient consumer confidence in the Chinese market and also due to the lack of confidence in the yuan as a currency to hold. The government of China is also known to be one that utilizes strict capital controls which further threatens the fortunes made by those in China which may have also led to this financial epidemic of fear and panic backed by speculation and market

corrections. It is also stated that there was an increase of \$50 Billion USD in outflows a month after the central bank stated that it would refocus the yuan's moves against a wider basket of currencies in comparison to the dollar. Apart from just capital outflows highlighted by the media is the exporter's trends in holding USD rather than converting them to the yuan which thus leads to lower foreign reserves (Bloomberg News, 2016).

Apart from negative speculations leading to the crisis of China, another viewpoint in this topic suggests that the outflows are not really a red flag as investigations by the Bank for International Settlements (BIS) which is also known as the bank for central banks which suggests that a major amount of the outflows have flown towards those who had made a faddish-investment. The faddish investments are such that of the buying of yuan (RMB) when the Chinese currency was expected to appreciate especially when the interest rates in the economy were higher than those in other economies. Now that the RMB is expected to depreciate, this makes the entire investment unattractive and thus leading to the outflow (Shaffer, 2016). It is also stated by the BIS that approximately 50% of the entire \$175 Billion USD in outflows in the third quarter of 2015 happened due to offshore depositors backing out of the RMB. This information was cited by the BIS from information collected from banks that report to it. Therefore from the BIS perspective the reduction in firms and household deposits in RMB in foreign banks led to banks to reduce their RMB deposits with mainland banks which therefore led to capital outflows.

Other perspectives in the matter state that this outflow is an indicator for the end of the charmed era for emerging markets (Donnan, 2016). It is stated that over-invoicing for exports, cash transactions and other errors and omissions accounted for \$216 billion USD out of the \$676 billion USD in net capital outflows, according to the Institute of International Finance (IIF) (Donnan, 2016). Articles also state the panic shown by economists such as Charles Collins, managing director & chief economist at the IIF stating "This is a really unprecedented event that we are seeing outflows for emerging markets on this scale" (Donnan, 2016).

The concerns of many however lead to one particular theory of outflow that repeats itself in almost all articles and interviews of economists, financial institutions and speculators – Chinese companies had been paying off their offshore dollar denominated debt and also other overseas debts in expectations of a weakening RMB thus leading to a large outflow in capital and eventually truly leading to a weaker RMB which thus led to the beginnings of widespread panic. At present, this widespread panic however in April 2016 has come to a halt as the central banks foreign reserves finally grew for the first time in 5 months. The confidence level of those worrying about the potential RMB crash has been taken by surprise by the current circumstances. The total foreign reserves grew by \$10 billion USD in March 2016 which leaves the nation with a total of \$3.21 Trillion USD in reserves. Despite this great news on the Chinese side, the reserves were expected to grow by \$47 billion USD however this was not achieved as the central bank had in fact been selling a lot of dollars to keep the RMB value under control (Gendrowski, 2016).

We can see that from the state of large outflows since 2006 until the year 2016, the problem of capital outflows has been affecting one of the fastest and strongest economies currently in the world. Widespread panic and speculation have long been drivers of profits especially in the financial markets and therefore where capital moves there is money to be made and the purpose of this study is to find a method of making a profit from capital outflows in China. The goal is to understand how the capital is being moved offshore, what are the capital controls in place and how can we help move the money offshore. The research question therefore is to find the most profitable method of moving money offshore from China which heavily takes into consideration the risks involved too.

## **2. BACKGROUND LITERATURE**

### **2.1 Illicit Capital Flows from China**

Illicit capital flows which is also known as illegal capital flight involves money that is earned illegally and then transferred, or used. The funds could have been earned in many different ways illegally by means such as bribery or kickbacks or they could also be earned legally however not paying taxes makes those funds illegal (Kar & Freitas, 2012). There is no method of calculating illicit flows and most data collected by economists and researchers are based on surveys that rely on opinion of government bodies, private companies & other such entities. These survey results indicate the tax-evasion by high-net-worth-individuals (HNWIs) & companies account for 65% of all cross-border illicit flows especially in emerging markets which are also known as developing countries. 30% is accounted for by crime and 5% by corruption (Raymond, 2005). Data in relation to 2009 suggests that developing countries lost between \$775 billion USD & \$903 billion

USD. The previous year 2008 however was said to have larger illicit outflows between \$1.26 trillion USD and \$1.44 trillion USD (Dev & Freitas, 2011).

The drivers of illicit outflow are divided into three types:

1. Macroeconomic
2. Governance Related
3. Structural

In the case of China, capital outflows were due to growing and high amount of current account surpluses. Inflation that is rising and high also contributes to illicit capital flight. Also the factor of RMB being speculated to be under-valued is a major driver as revaluation of currencies could lead to high losses for firms and that is a risk they are not willing to take. Non-inclusive growth which is part of the structural realm of drivers of illicit outflows is a result of HNWIs who shelter their money abroad. Trade openness (exports and imports) allows a larger opportunity to misinvoice trade especially when customs cannot keep pace with the growing trade (Kar & Freitas, 2012). Illicit outflows have their consequences that mainly effect the middle & low income people as governments cannot collect taxes. The developments of total illicit outflows from China are very much related to the relation of mainland and Hong Kong, for example Hong Kong-China trade leads to extreme problems in detecting the origin of an export and also the destination of imports. Minimal taxes in Hong Kong also add to the attractiveness in the opportunities of illicit capital flight between Hong Kong and mainland. Over-invoicing of imports and under-invoicing of exports is a very interesting and common method of moving money. Figure 1 presents estimates of trade misinvoicing calculations in China from 2000 to 2011.

## 2.2 Trade Misinvoicing: Concept and Opportunities

Trade misinvoicing is defined as a method of transferring money across economies illicitly which involves knowingly misreporting the value of a trade transaction on an invoice that is to be given to customs authorities (GFI Integrity, 2016). It is also known as a form of laundering money and trade misinvoicing is known to be the largest factor accounting for most of the illicit financial outflows as statically reported by Global Financial Integrity.

The reasons to misinvoice include the following but are not limited to:

Year	Trade Misinvoicing				CED	Nominal IFFs "Net"	Nominal IFFs Outflow	Real IFFs Outflow	Gross Domestic Product	Real GDP Growth	Total Trade Misinvoicing as % GDP	Total IFFs as % GDP	Trade Openness
	Export Under-invoicing	Import Over-invoicing	World	Share of World TM									
	USD Billions	USD Billions	USD Billions	%	USD Billions	USD Billions	USD Billions	2005 USD Billions	USD Billions	%	%	%	%
2000	73.9	54.3	128.2	74.3	44.4	172.6	172.6	204.7	1,198.5	8.4	10.7	14.4	39.6
2001	74.8	62.7	137.5	75.0	45.7	183.2	183.2	214.9	1,324.8	8.3	10.4	13.8	38.5
2002	86.9	66.9	153.8	95.0	8.1	161.9	161.9	194.4	1,453.8	9.1	10.6	11.1	42.7
2003	98.9	84.6	183.5	95.8	8.1	191.6	191.6	218.4	1,641.0	10.0	11.2	11.7	51.9
2004	129.3	121.7	251.1	100.0	0.0	229.7	251.1	269.4	1,931.6	10.1	13.0	13.0	59.8
2005	153.4	130.1	283.5	96.9	9.2	292.7	292.7	292.7	2,256.9	11.3	12.6	13.0	63.0
2006	149.9	146.2	296.1	77.3	87.0	383.1	383.1	366.0	2,712.9	12.7	10.9	14.1	64.9
2007	154.9	171.8	326.7	80.0	81.9	408.6	408.6	372.5	3,494.2	14.2	9.3	11.7	62.2
2008	138.6	209.9	348.4	84.8	62.5	411.0	411.0	341.2	4,520.0	9.6	7.7	9.1	56.6
2009	132.1	162.6	294.7	100.0	0.0	277.2	294.7	268.3	4,990.5	9.2	5.9	5.9	44.2
2010	129.8	237.6	367.4	84.3	68.2	435.6	435.6	371.1	5,930.4	10.4	6.2	7.3	50.2
2011	119.2	310.8	430.0	71.3	172.9	602.9	602.9	472.0	7,298.1	9.2	5.9	8.3	49.9
<b>Average</b>	<b>120.1</b>	<b>146.6</b>	<b>266.7</b>	<b>86.2</b>	<b>49.0</b>	<b>312.5</b>	<b>315.7</b>	<b>298.8</b>	<b>3,229.4</b>	<b>10.2</b>	<b>9.5</b>	<b>11.1</b>	<b>52.0</b>
<b>Cumulative</b>	<b>1,441.7</b>	<b>1,759.1</b>	<b>3,200.8</b>	.	<b>588.1</b>	<b>3,750.0</b>	<b>3,788.9</b>	<b>3,585.5</b>	.	.	.	.	.
<b>Logarithmic Growth 2000-2011</b>	<b>5.5</b>	<b>16.3</b>	<b>11.4</b>	.	.	<b>11.5</b>	<b>11.6</b>	<b>7.2</b>	.	.	.	.	.

1/ Adjustment for Hong Kong and Macao included.

2/ GDP figures from IMF World Economic Outlook; Trade Openness defined as (Imports+Exports)/GDP, where trade data is from the IMF International Financial Statistics database. All other figures are GFI

**Figure 01. China: Illicit Financial Flows and Trade Openness, 2000-2011**

1. Money Laundering: Used if officials and criminals need to wash their money from proceeds of crime and corruption.

2. Evading Taxes or Customs Duties: Used in order to pay less or no tax by under-reporting the value of goods
3. Claiming Tax Incentives: Some countries tend to offer tax incentives to those who are exporters of the domestic goods. Over-reporting allows people to abuse these incentives.
4. Dodging Capital Controls: Developing countries generally have restrictions on the total amount of capital one can bring or take from the country. Misinvoicing acts as an alternative to get money out despite the capital controls. (GFI Integrity, 2016)

According to the UBS China economics team which consists of Ning Zhang, Jennifer Zhong & Tao Wang, they suspect in their analysis that misinvoicing has returned to China in the early 2016. They state that “Some capital outflows may have been disguised under over-invoicing of imports from Hong Kong. In the previous three months (December to February), China imports from Hong Kong jumped by 71% y/y on average, in sharp contrast with Hong Kong’s statistics of its exports to China.” (Scutt, 2016).

### 2.3 Legal Methods of Capital Outflow

The normal method of legally flowing money out of China is simple, there is a quota of \$50,000 USD which can be taken out by an individual annually however the citizens must have a valid reason and documentation to validate their foreign investment or capital outflow (Harris, Getting Money out of China: The reality has changed, 2016). Should a company wish to invest a larger amount outside of China, the company must first seek approval by the government of China, which is officially said to take 3 days however in reality it is stated to take much longer. Once the approval is given, it is legally accepted for the company to send money out of China (Harris, Getting money out of China: An Update, 2015).

There are other methods of flowing larger sums of money out of China however the road is grey in nature. Companies in China are known to lose a law suits in a foreign country in order to get large sums of money out of the country (Yap, 2016). Losing a law suit provides companies with a fine that they have to pay thus giving companies valid reasons to pay companies abroad in foreign denominated currency. The contrary company in foreign lands has negotiated terms with the Chinese company which thus allows the Chinese company to have off shore dollars and successfully they are able to take money out of the country legally. This however can be seen as an unethical and grey method of capital outflow.

The other way which is very similar to faking a law suit is to utilize arbitrage to settle a dispute between a foreign company and a Chinese company and thus finally coming into a final decision for the Chinese company to pay the foreign firm (Yap, 2016). Arbitrage is a legal method of settling disputes and thus this method also falls into a grey area for capital outflow (HG Legal , 2016).

### 2.4 Overview of Current Chinese Investment Regulations

The currency utilized in China is the RMB and the government is known to have strict capital controls in terms of money leaving the country. Capital Controls are different means that a government, central bank or other regulatory bodies utilize in order to limit the inflow or outflow of foreign capital within a domestic economy. The measures include taxes, tariffs, legislations and volume restrictions. Sometimes controls are even made through market-based forces and capital controls affect many asset classes such as equities, bonds & foreign exchange trades (Investopedia, 2016). The central bank of China which has played a major role in protecting the depreciation of the RMB by purchasing RMB through state-owned banks in Hong Kong has now begun to implement a required reserve ratio (RRR) of offshore RMB (CNH) on all their state-owned offshore banks in order to protect the depreciation of the RMB in the present and future (Hsu, 2016). The require reserve ratio (RRR) is also known as the Cash Reserve Ratio (CRR) and it is the total percentage of deposits a bank needs to keep in cash in relation to the instructions of the central bank (The Economic Times, 2016).

The increase in required reserve ratio (RRR) on offshore state-owned banks also increase the interest rate on CNH due to banks having to have a reserve of RMB which will not be available for lending therefore the lack of supply leads to an increase in the cost of borrowing (Fast-FT, 2016). The regulators of China have also required their banks to thoroughly check the transactions between corporations (Hsu, 2016). The foreign exchange regulator had also instructed verbally to banks in Shenzhen to limit the amount of dollars bought by individuals and corporate clients (Wildau, China steps up capital controls to stem outflows, 2016). According to managers of banks in Shenzhen which include managers of Industrial &

Commercial Bank of China (ICBC) and Bank of China (BOC), Chinese residents in the year 2016 are only allowed to purchase up to \$50,000 USD worth of foreign currency annually and the quota was set at the beginning of the 2016 calendar year (Wildau, China steps up capital controls to stem outflows, 2016). Apart from the quota on how much currency can be converted, corporations and individuals who wish to convert their RMB to foreign currencies must provide official documents stating that the conversion is in relation to Foreign Direct Investment (FDI), Trade or other approved purposes for buying and selling of foreign currency (Wildau, China steps up capital controls to stem outflows, 2016). Despite the allowance of \$50,000 USD to flow out from China annually per person, and despite the fact that documentations might be provided, the regulators' approval are in addition based on other factors which are listed below:

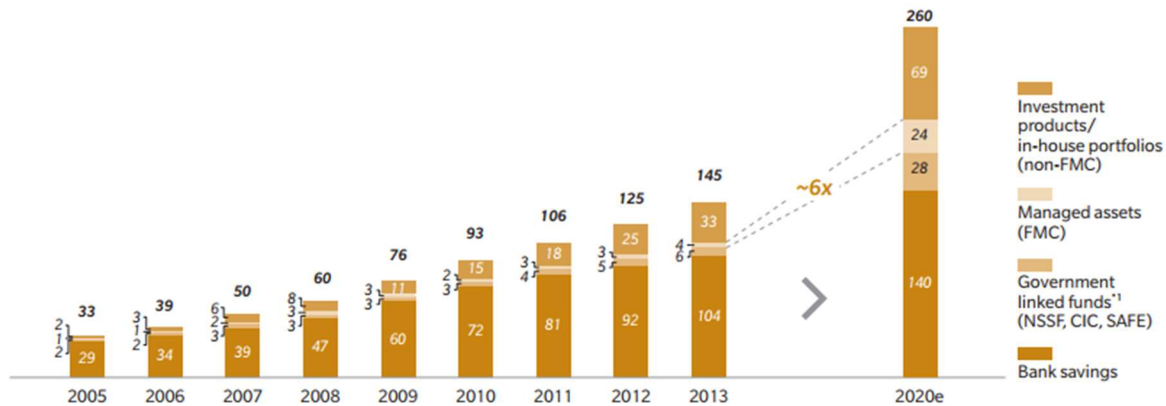
1. The risk of transaction (high-risk or fake transactions) – If a transaction to the regulators seem fake, the citizen must provide conclusive proof that the transaction is real (Harris, Getting Money out of China: The reality has changed, 2016).
2. The type of transaction – if the transaction is related to industries such as services, the approval rate is very low due to this industry being used as a disguise to transport money. The approval rate could improve if the citizen can prove that the service company offshore does not have any shareholders that are of Chinese decent or citizen (Harris, Getting Money out of China: The reality has changed, 2016).

Foreign nationals who are working in China and are paying taxes are allowed to send their income back to their home country as long as the foreign national has proof of income taxes paid in China and also required is the details of the bank account where the money will be sent (Briefing, 2011). For foreigners who do not have proof of income tax paid can only send \$500 USD per day to a foreign bank. There is no limitation or ceiling on foreigners in an annual basis unlike Chinese citizens who are allowed to send up to \$2000 USD per day but only \$50,000 per year (Briefing, 2011). It is also worth mentioning that China permits the cash allowance of upto RMB 20,000 to travelers without declaration to customs (Hinsbergh, 2015). Passengers traveling with foreign currency above USD 5000 need to declare their excessive cash to customs (IATA, 2016).

According to Dan Harris, the founder of Harris Moure which is an International law firm that represents American companies overseas, he states that in his opinion, many Chinese regulators look the other way when money is being brought into the Chinese economy. He also states that the Chinese companies and government owned enterprises promote schemes that are very attractive investment opportunities however are illegal in nature. He explicitly states that many of his clients enter the Chinese investment market on illegal schemes which is not a problem for the government however, when it is time to take money out of China, the regulators find the irregularities thus making it impossible for the money to leave the country (harris, 2015). He recommends that if an investment is illegal in China, do not invest in it. He states do not believe those who claim that the government will look the other way because it won't when the time comes to take your money out.

#### **2.4.1 Investment Funds in China**

Investment funds in China are not new and Institutional Investors in China control over RMB 70 TN in assets. The largest assets are under the control of 3 government-linked wealth funds which outsource only very specific parts of their portfolio (Edelmann, Pittaway, & Chua, 2014). It seems that Fund Management Companies (FMC's) only held 3% of the total 145 TN RMB assets in China however the numbers have been growing at a steady yet slow pace. Figure 2 portrays the market history and projected trends of Chinese investible assets including those managed by fund management companies from 2005 – 2020 (estimated). The numbers are in RMB (trillions).



<sup>1</sup> Government linked funds include only estimated outsourced portion of NSSF, CIC and SAFE portfolios.  
 Source: PBOC, CBRC, CIRC, and annual reports of NSSF, SAFE and CIC; Oliver Wyman analysis.

**Figure 02: Historic and projected growth in Chinese investible assets 2005 - 2020**

According to regulations in the Chinese market, Institutional Investors can allocate a maximum of 15% of their investment capital into foreign securities however pension funds have the regulatory ceiling of 20% (Edelmann, Pittaway, & Chua, 2014). Since 2015, when Aberdeen Asset Management which is a private British FMC got its license to set up a wholly foreign owned enterprise which includes investment management in its scope of business, it is possible for almost all citizens to apply and possibly get a license to manage assets in China (Appell, 2015). All the private asset management firms that are foreign owned are established in the free trade zone in Shanghai, China which leads us to believe that it is easier to get a license when located in the free trade zone (Appell, 2015). A good example of a well-known corporation that has received the approval of the government of China to start their Fund Management Subsidiary is JPMorgan Chase & Co. They are one of the few companies that received the approval to open the wholly owned private subsidiary in fund management companies industry (Yue & Yuqian, Foreign Companies Still Trying to Break Into China's Investment Funds Market, 2016).

Asset management companies at the moment in 2016 however are experiencing heavy invigilation and tighter regulations, as Fund Managements were ordered by the China Securities Regulatory Commission (CSRC) to stop creating and selling any new asset management products for 6 months starting from May 2016 (Yue, Asset Management Subsidiaries of Fund Companies are Punished, 2016). In 2015, the total asset amount under the management of foreign fund companies soared by 130% reaching 8.57 trillion yuan (Yue, Asset Management Subsidiaries of Fund Companies are Punished, 2016) which shows that this industry is following a trend of growth in the future as shown in the graph earlier.

Establishing a wholly foreign own enterprise (WFOE) in China requires different documents and requirements in different cities. This study will focus on registering a WFOE in Shanghai due to previous data showing us that applying for a license in the free trade zone is statistically more probable in terms of acceptance in comparison to others. The recommended registered capital which can be injected into the business over the course of 5 to 10 years for service oriented businesses such as financial services is RMB 100,000 to RMB 500,000. The initial paid up capital is however 15% of the total registered capital (Path To China, 2016). The documents required are either certificates of incorporations, articles of formation for corporate investors and personal investors require passport copies which are certified by the embassy. A bank reference letter will also be required. Shanghai Legal Representative (managing director) will be required with 6 photos. An office address in Shanghai with leasing contracts, landlord identifications are some of the prerequisites. 8 proposed Chinese names for the company, business scope and registered capital information will be required during the registration process. Finally 4 letters of authorization will be required thus completing the first document list required to register a financial service company in Shanghai, China (Path To China, 2016). After these processes the company is then allowed to operate. The process mentioned above applies not only to the free trade area but all of Shanghai, the only difference between them is the office address you will give.

Another type of Asset Management Company called Qualified Domestic Limited Partnership (QDLP) allows foreign hedge funds and FMC's to set up subsidiaries in China, sell financial products and requires them to invest these funds abroad. A new program which can be seen to target foreign private fund companies just as the QDLP does was revealed in the month of June in 2016. The program is yet to be named and launched however, its purpose is very similar to that of QDLP but differs in one particular way. It requires the firms to invest the funds money they receive from Chinese investors inside China (Yue & Yuqian, Foreign Companies Still Trying to Break Into China's Investment Funds Market , 2016). Zhang Jinwei of Value Partners Group Ltd., which is the parent company of a QDLP subsidiary states that many view the yet-to-be-named new program as their opportunity to turn things around. He also states that many QDLP WOFE's hoped that the government would allow them easy access to both licenses, focusing on the new yet-to-be-named program so that these companies can invest within China and abroad. Also in the same article Josh Gu, the director of quantitative research at Hedge Fund Research states many foreign portfolio managers look to enter into the A-share market and also to enjoy the dividends provided by the economic growth of China (Yue & Yuqian, Foreign Companies Still Trying to Break Into China's Investment Funds Market , 2016).

#### **2.4.2 Setting up an offshore company**

Many would think setting up an offshore company is a hassle or might be expensive however, with modern laws and regulations countries like Panama have been truly able to tap into global demands. According to Intertrust Corporation, a company that helps people incorporate companies in countries abroad, an incorporation in Panama takes approximately 1 day for a mere fee of \$900 USD. After that you must pay an annual fee of \$800 USD. Panama is a tax free haven and is a sovereign state with one of the fastest growing economies in the world and also has the largest per capita income in Central America (Intertrust Corp., 2016).

### **3. METHODOLOGY**

The study takes into account secondary data in its research due to the vast availability of information regarding the subject matter at hand. Firstly the study began by the formation of the research question which diverted from a wide question regarding capital markets and the implications of capital outflows to a very specific research question focusing on making a profit from the outflow of capital. After the formation of the research question, the reading of different journal articles related to the topic was the second step. With the help of the current situation and the past historic study of the topic, an opinion in terms of where the profits are/were and how they could be made was set.

#### **3.1 Unit of Analysis**

The present study takes into consideration individuals and organizations which includes corporations and government bodies.

#### **3.2 Sample Size**

The sample size utilized in this research takes into account several research papers, study of individual opinions of numerous financial managers, lawyers and economists which include:

1. Josh Gu – Director of quantitative research at Hedge Fund Research
2. Zhang Jinwei – Executive at Value Partners Group Ltd.
3. Wang Qionghui – Executive at JP MORGAN & CHASE Co.
4. Dan Harris – Lawyer & Founder of Harris Moure International Law Firm
5. Ning Zhang – Economist at UBS China
6. Jennifer Zhong – Economist at UBS China
7. Tao Wang – Economist at UBS China

#### **3.3 Type of Study**

The current study is a qualitative research that is not limited to true statistical numbers only but also the opinion of the masses are taken into consideration as the financial market is a market driven not only by logic but is heavily influenced by emotions & speculations too.

4. RESEARCH FINDINGS AND CONCLUSION

From the literature review, we come to realize that there are many different ways to take money out of China which includes Illegal, Grey and Legal methods. The major illegal method of taking money out of China that has led to billions of dollars to flow out is the misinvoicing method. Trade misinvoicing has been defined as a method of transferring money across economies illicitly which involves knowingly misreporting the value of a trade transaction on an invoice that is to be given to customs authorities (GFI Integrity, 2016). This particular method of taking money out could not only help flow money out of the nation but also works as a method to evade taxes or customs which can be done by under-reporting the value of goods.

According to Scutt (2016), “In light of RMB depreciation expectation and rising pressure of capital outflows in late 2015, we think it is possible that speculators have used over-invoicing of China’s import from Hong Kong again as a channel to move money out of China, though the absolute size has been relatively limited (i.e. China’s monthly average imports from Hong Kong was USD1.5 billion from December to February)”. This quote signifies that the competition in the misinvoicing market via Hong Kong at the moment is relatively small thus creating a larger opportunity for service providers. It is also worth noting that USD 1.5 Billion is not a large sum for large institutions such as UBS China especially for a 3 month period. For an individual or small financial firm, the size of imports from Hong Kong and the misinvoicing opportunity is quite large. The USD 1.5 Billion in 3 months also acts as an information of how much and how easy it might be for misinvoicing methods to find clients. If we take an average of 2% off the USD 1.5 Billion as our misinvoicing market, that leads us to \$30 Million USD in three months being transported. For some this may be a large amount and for others too little. This study leaves room for the readers to decide if the opportunity in misinvoicing via Hong Kong is large enough for them or not.

The amount of money that can be taken out through misinvoicing is large as the value of goods can be highly manipulated however it is important to keep the value of goods in a certain range so that the officials do not get alerted. The amount of time taken to divert money is also very little thus trade misinvoicing leads to fast outflow of large capital. We can see from the UBS report that an average of \$1.5 Billion USD has been exchanged over imports just via Hong Kong proving the ease of imports and misinvoicing. Figure 3 shows an example explaining the procedure to misinvoice.



Figure 03: Misinvoicing Procedure

In order to make a profit from such a model, one would need to set up a trading company in a tax free haven. Setting up a trading company in a tax free haven as stated in the literature review is very easy and cheap. As we have seen earlier, setting up a corporation in Panama costs \$900 USD and takes approximately 1 day. Once the trading company has been founded, it is all about finding the customers in China who are looking to take their money out of the nation. The main target market would be those Chinese companies/entities who have been denied the ability to invest abroad or to take money abroad. Any international business done by thereafter will be done by the company via our trading company which will regularly and randomly misinvoice the trades thus successfully diverting cash on a regular basis. Should the company of our client not have much international business, one could indeed trade in artwork or gems which are sold to the Chinese client by us. The trade would be misinvoiced and our company could indeed give them an option to sell the gem/art back to us at the original misinvoiced price – the diverted capital. The business model could be very simple as our company could take a flat subscription to utilize our services or our company could take a commission at a mutually agreed rate. This business model suites best for those who are high risk takers which includes knowing that one could go to prison. This

business also requires the ability to go abroad and set up trade companies in tax havens. The level of investment in this particular model is not very high unless the selected tax haven trading company start-up costs are very high.

#### **4.1 Illegal – Misinvoicing: Advantages and Disadvantages**

Under the illegal method we found that misinvoicing is a method that could be utilized to move money offshore at a fast pace while still moving a large amount of money.

The main advantages of this method of moving money is that it allows large sums of money to be moved. The movement of money can be done at a very fast pace and with clever thinking, taxes/customs can also be evaded. The profitability of utilizing this method would be determined by the type of profit model we utilize however commission based method could serve to be profitable. This method also allows black money to be cleansed thus a larger market can be tapped. The investment size in this business is limited to opening the trading company in a foreign country unless real trading is done.

The disadvantages of such a business is that it is highly risky not only for the client but also the person providing the misinvoicing services due to the whole method being illegal. The risk involves not only large amounts of fines by different governments but also bad press/name and prison sentences. The multiple opening and closing of businesses is also a hassle as that could alert the officials thus leading to the service provider to potential high invigilation. The security of the service provider could also be at stake as moving black money does lead to relations with “bad” people. This type of relations could be injurious to health or even may result in death under circumstances.

Apart from illegal methods there are legal and grey methods of flowing capital out of China. According to the knowledge of the researchers, each person in China has the right to take out \$50,000 USD annually however a valid reason must be presented. A vacation or holiday is one reason that is valid or investments in foreign securities could also be another valid reason. Annually taking \$50,000 USD out of China is not a small amount however when large amount of money is needed to be taken out by an individual, this method does not seem very attractive. This capital control however could be turned into a business by working with friends and a client who wishes to take money out of China. What could be done for example is; a client wants \$500,000 USD out of China thus you get 10 of your Chinese friends together and decide to all help the client move the money abroad. All 10 friends will thus act as partners and thus decide to invest \$500,000 USD together on one of their upcoming weddings abroad for example. Once the transaction is validated, the client will receive the \$500,000 USD he provides in his offshore account or where s/he requires it minus the commission which could be split between the 10 or according to the arrangements made with the friends by the deal making friend.

#### **4.2 Grey – Utilizing Friends & Family: Advantages and Disadvantages**

The \$50,000 USD allowance given by the Chinese government to each individual creates an opportunity to share that ability and make profits. Finding a client and thus utilizing your friends or family members allowance to help the client move money for a commission is the method of moving money. The extremely low amount of investment required for the business model is a major advantage. Also the fact that this form business falls in the grey side of legality, it is quite safe unless the government is truly after you. Since the amount of money that can be moved with this form of business model annually is quite low depending on the amount of people you can find, the officials generally would look away from such small cases thus providing more security in comparison to misinvoicing. The amount of work needed to be done is relatively low being yet another advantage for this model.

The amount of profits to be made from this model could be much lower than that of other channels especially since so many people are involved. Since their involvement is a necessity and they would need to know what is happening, profits might need to be shared most of the time thus reducing the profitability. The organization of so many people could also lead to problematic situations where the stories of all involved may not match. The amount of people involved with the client's money which is spread between all could easily go wrong therefore clients would be very unlikely to trust this business model. High risk for the client is a big disadvantage as it could be utilized as leverage for lower commission rates.

Providing official documents in order to get the approval from the government to invest or take money out of china for example an invoice which is validated by a foreign official the government of China will take into consideration their take on the transaction which according to research in the literature review are:

1. The risk of transaction (high-risk or fake transactions)
2. The type of transaction

If the official feels that the transaction is fake the person wishing to get foreign currency must provide further proof to prove that the transaction is real. Types of transactions also matter as consultation fees have much lower approval rates as these industries have already in the past been used for the purpose of transporting money. The approval rate is improved if the foreign company being dealt with does not have any Chinese partners or shareholders. Considering these circumstances taking money out of the country in this way is difficult unless the plan is concrete and well thought of. A person of experience could truly help in the success of such a transportation of capital for a client without much trouble.

Accordingly if a company wishes to invest large amounts of capital abroad the company must seek approval from the government of China. In times such as when the great outflow of capital from China occurred, the government will most likely make it very difficult to take money out of China which is why the business opportunity exists as large amounts of commissions can be charged to take money out of China. When companies are not given the approval by the government to invest abroad for various reasons, the company could take grey methods of taking money out of China. Being sued by a foreign company and losing the case could lead the Chinese company to pay large sums of fines to foreign entities. This channel could be utilized as a legal (until authorities have proof of purposeful wrongdoing) however unethical channel to take money out of China. How we could make a profit is by setting up a foreign company that finds the fault in our clients company and thus suing them in court where they will purposefully lose the case. Once they lose the case they will pay a fine to our company. This allows the Chinese client to successfully and legally take money out of China. Once the fine has been paid, our company takes a commission and forwards the rest of the money to where ever the Chinese client wishes their money to be sent. This method is highly unethical and very risky for the Chinese client should the foreign suing company decide not to pay back the money, however arrangements can be made with the client such that the majority shareholders in the foreign company are the people known or trusted by our client. This of course will need to be carefully planned so that the officials do not get alarmed and reject the fine.

The investment amount in this type of business is relatively higher than that of utilizing friends and family as previously described, much larger amounts of capital can be moved in this way. The investment is quite low as the set up cost of the foreign company and the law suit which includes hiring a lawyer are the only investments required in the business to make a profit. Also the fact that the Chinese client will be losing on purpose, a cheap lawyer can be utilized. It is also true that the same company would not be able to continuously sue and win fines from Chinese companies therefore this is a one-time investment on the foreign company. Generally every client will require a new foreign company to be started.

#### **4.3 Grey – Losing cases with foreign firms: Advantages and Disadvantages**

Losing cases with a foreign firm to pay a fine which leads to the outflow of capital is another method of moving clients' money from China offshore. The amount of money that could be moved with this method is very advantageous and also the fact that it falls in the grey part of legality. The scenario could be created perfectly to fit the client's requirements which is what makes this method of moving money very attractive. The time taken to move the money varies depending on the service provider's business ownership abroad and the amount of time taken by the jury. Opening a new business solely for the purpose of the law suit could be possible but if done numerous times, officials could be alerted. Relatively lower costs in comparison to legal methods are also advantageous as cheap lawyers could be utilized.

The outcome of the law suit is unpredictable however the chances of success are higher than failure since the client is trying to lose. The risk for the career of lawyers is great thus finding lawyers who are willing to provide such services might be difficult. This scenario if caught by the officials in some way could backfire as fraud not only to the client but also the other party. The risk at which the clients' money may be too high for the client to agree to high commission rates as the other party could indeed not pay the client after the fine has been paid. This process is highly unethical and release of such information could not only hinder the brand name of a business but also the name of the client in society.

The ethical and legal way to move Chinese capital offshore is by starting an investment fund in China itself. Only recently has China legalized and approved foreign private fund management companies (FMC). In 2015, Aberdeen Asset Management which is a private British FMC got its license to set up a wholly foreign owned enterprise which consists of investment management in its scope of business which opened the doors for foreigners to open FMC's in China (Appell, 2015). With investment funds opened in China one could indeed ask clients who wish to move their money offshore to invest their money into our investment fund which would focus on foreign securities or financial products. Once our company has invested abroad and earns in foreign currency, dividends or profits could be paid to our Chinese clients in foreign currency in bank accounts abroad. Despite this ability to legally move money offshore it can be well noted that the

investment in a FMC in China begins with a minimum required capital of RMB 100,000 to be paid up in 5 to 10 years. 15% of the total registered capital needs to be paid up initially to operate the company. The higher the registered capital, the higher the chances of getting approved by the government. Although the advantages of moving money abroad in this sense are many, the biggest amounts of profits to be made are from the clients who want their money moved abroad as soon as possible without much risk. The amount of risk involved in investing money in an FMC is much greater than being able to take the money out within a matter of months with the means of illegal or grey channels. The funds will move offshore at a slow pace with FMC's as profits will only be paid out after a certain period of time. Another method of utilizing a FMC as a channel to move a client's money offshore is to pretend like the company is investing abroad however the FMC is only moving the clients' money out of China. This would solve the problem of slow capital movement for the clients however Chinese laws and regulations of FMC's are quite restrictive. The company can only invest 15% of its total investment capital in foreign nations. It should also be noted that these financial services are heavily under invigilation. The company in this method of moving money abroad will pay taxes and may cost more than the other channels of moving money abroad. This channel however is a legal and ethical channel to move money.

Focusing on the market of FMC's in China, it seems like an industry with low competition as figure 2 shows us in the literature review under investment funds in China that FMC's currently only hold 3% of the total 145 TN RMB assets in China. We can also see from the Figure 2 that not only is this market untapped but it is growing at a slow but noticeable pace over the past decade.

It is forecasted that the amount of assets held by Fund Management Companies (FMC) will grow by 6 times by 2020 from 2013. What we also come to realize from our literature review is that pension funds are given the regulatory ceiling of 20% when it comes to investing abroad in comparison to the 15% ceiling to other institutional investors, which leads us to think if opening a pension fund could also be a good idea for moving money of the Chinese clients abroad. Of course since pensions can only be paid out once the employees are retired, this allows pension funds the ability to invest abroad thus allowing them to transfer large sums of money abroad. An example of how a pension fund could be utilized for money movement business is as such:

A client wishes to move 50 Million RMB abroad but the government decides not to authorize them due to certain issues with their documents. The client can come to the pension fund and ask to transfer 50 Million RMB. The pension fund could therefore if their investment capital is large enough, transfer 50 Million RMB in USD as an investment however, the client would have to pay a large commission that is higher than the return the pension fund would have earned should they have invested abroad. An example could be 15% commission and thus the pension fund makes a large profit without much risk and the client gets his money abroad legally. This way to money movement would not only help the client, the pension fund, future retirees but also the government as the amount of capital moving abroad would be reduced since the client could have utilized other illegal channels as mentioned above. This way 15% of the entire money that could have been moved stays within the economy and pension funds earn an almost risk free earning which protects the future retirees.

#### **4.4 Legal – Fund Management Companies (FMC): Advantages and Disadvantages**

Opening a (FMC) in China to provide money management services and thus moving money offshore either by paying dividends/profits abroad or investing money directly in particular client's bank accounts for commissions are the legal way to transfer money for Chinese clients abroad.

This process of moving money is legal. The investment capital in starting an investment firm is quite low starting from a minimum of RMB 100,000 as registered capital. The amount of money that could be transported depends on the size of the operation and thus the more money invested, the more money that could flow out. The money could be moved very fast and constant approval of the government will not be required. For foreigners the Chinese capital markets also open up thus investments can be made not only offshore but within mainland too. The low competition and slow growing market allows us to be one of the first few foreign companies to enter the market thus giving us a head start. The legitimacy of the business could attract much more clients in comparison to other shady methods mentioned above.

The disadvantages of this particular method is that financial firms in China are heavily invigilated and during times of crisis such as the great outflow, the government imposes regulations on the business which may hamper the entire operation. Accounts are available for the government and taxes will need to be paid. The 15% or 20% allowance of total investment capital abroad truly narrows the scope of transporting money unless the FMC gets a QDLP license. Also the fact that it is

quite tough to get the QDLP license is a disadvantage as setting up the company could actually cost a lot more than RMB 100,000 with other costs involved for a QDLP license.

Additionally, profitability could also be increased by utilizing the current regulations set by the Chinese government on offshore state-owned banks. State-Owned banks in Hong Kong have started implementing a required reserve ratio (RRR) on offshore RMB (CNH) (The Economic Times, 2016). This requirement of RRR on banks will increase the interest rate on CNH especially due to banks having to have the RRR which lowers the availability of CNH to lend. The lack of supply of currency which leads to increased cost of borrowing could be a great option to increase the profitability of moving money offshore. The business model could be such that Chinese clients who wish to move their money offshore be directed through one of the above channels into Hong Kong. They will pay us be it either as a fine or investment capital in RMB which will be deposited in our Hong Kong account where the interest rates in January reached a record high of 13.4% (Wildau, China opens new front in war on speculators, 2016). Interest on CNH have been much higher than that of inflation rates in most developed economies thus holding foreign Chinese CNH in Hong Kong could drastically increase our profits. The profitability could be further heightened if the company moving the money held a lot of foreign currency to buy Chinese offshore yuan however earning an interest rate in the range of 10-13.4% is highly attractive no matter the capital amount invested.

## **5. RECOMMENDATIONS**

### **5.1 Government of China**

The outflow of capital from China has drastically increased the pressure on the government to increase government spending on balancing the exchange rate of the RMB via many different methods. The outflow of capital from China is inevitable thus legalizing methods of moving money offshore that will help China in some way would be the right way to look at this problem. Many Chinese citizens who wish to take their money offshore only want this due to speculation and fear of the future of Chinese currency thus allowing more foreign entities the ability to trade in Chinese markets with Chinese RMB in comparison to B-Shares in USD could increase the demand for RMB at an unprecedented level. It can be understood that the government seeks to protect its Chinese citizens by giving them a chance to learn to trade in the market before experienced foreign entities enter the market and a slow transition is the way to go. All in all this research leads us to believe that the government is doing a great job in retaining capital and also creating creative solutions as found in this research such as money being diverted to move offshore via pension funds which indirectly help future retirees and does so in a risk free manner. These regulations have truly been well thought of and thus the only transition left is for the Chinese to increase the demand of RMB thus infusing market confidence is through allowing foreign entities to slowly enter the Chinese market over the course of 10 to 20 years.

### **5.2 Clients**

For those clients who wish to move their money offshore the first and foremost recommendation the research can provide is to stay away from illegal and grey methods of moving money offshore. The movement of money may be easier and the cost of the transaction may also at times be cheaper than that of legal methods however the risks involved in the movement are far too great. Illegal methods also lead to the degradation of society as taxes will not be paid and an outflow of capital without any taxes being paid will affect middle and lower class citizens at first and overtime affect the rich via the loss of disposable income of the middle and lower classes.

It is also important to understand for clients wishing to move their money abroad due to the fear of the future of the RMB that the Chinese yuan is backed with approximately 3 trillion dollars thus the crash of the RMB can only occur if the outflow of capital from China by Chinese citizens is leached out. At current times the inflow of capital into China is much higher than that of the outflow thus the RMB does not have a great chance of failing. Consumer confidence in the Chinese market should be high as even the stock exchange is heavily regulated by the government. Thus not believing in speculations is the right thing to do and consultation with different money managers and trying to understand the scenario on your own before making any rash decisions is highly advised. Speculations are made in order to make a profit and if you do not know what you are doing and follow the crowd, you might lose a lot more money than you anticipated to save in the first place.

### 5.3 Service Providers

Service providers should regularly on correct intervals speculate on the falling RMB to increase demands to flow capital out of China. This will increase the opportunity to make money and thus help the company grow at a much faster pace. Not utilizing illegal channels is recommended unless the commission rates are as high as 30-40%. Legal methods of moving money are much less of a hassle and also have almost risk free ways to make money. Despite the path or method of choice for the service provider profitability could also be increased by utilizing the current regulations set by the Chinese government on offshore state-owned banks to their advantage. State-Owned banks in Hong Kong have started implementing a required reserve ratio (RRR) on offshore RMB (CNH) (The Economic Times, 2016). This requirement of RRR on banks will increase the interest rate on CNH especially due to banks having to have the RRR which lowers the availability of CNH to lend. The lack of supply of currency which leads to increased cost of borrowing could be a great option to increase the profitability of moving money offshore. The business model could be such that Chinese clients who wish to move their money offshore be directed through one of the above channels into Hong Kong. They will pay us be it either as a fine or investment capital in RMB which will be deposited in our Hong Kong account where the interest rates in January reached a record high of 13.4% (Wildau, China opens new front in war on speculators, 2016). Interest on CNH have been much higher than that of inflation rates in most developed economies thus holding foreign Chinese CNH in Hong Kong could drastically increase our profits. The profitability could be further heightened if the company moving the money held a lot of foreign currency to buy Chinese offshore yuan however earning an interest rate in the range of 10-13.4% is highly attractive no matter the capital amount invested.

Regular research on government policies and increased pressure on the government to open up more doors to financial services would be the way to go to increase profitability in the future. Not falling for one's own trap is also a very important recommendation for service providers as the speculation of a depreciating RMB will lead many citizens to pull or push money out of China thus actually decreasing the value of the RMB. The purpose of making money during such times is to get into the market at a cheaper level. It is also advisable for companies to pay their taxes to the government on time in order to protect themselves from heavy invigilation and unwanted attention in the future.

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