

China opens up the securities investment fund management industry: the first in a journey of ten thousand steps?

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Background and Overview

On 30 June 2016, the industry self-regulating body, the Assets Management Association of China (“**AMAC**”) published what, on the face of it, appeared to be a fairly innocuous document *Questions and Answers regarding the Registration and Filing of Private Funds (No. 10)* (私募基金登记备案相关问题解答 (十)) (“**Q&A (No. 10)**”). The importance of its contents only became clear later, when on the same day, the China Securities Regulatory Commission, the main securities regulator in China (“**CSRC**”), confirmed the Q&A (No. 10) in a press conference. The Q&A (No. 10) provides that foreign investors are permitted to establish a wholly foreign-owned enterprise (“**WFOE**”) or a Sino-foreign equity joint venture (“**JV**”) engaging in private securities investment fund management. This development, within its limited scope, breaks through the long-standing restriction that the foreign shareholding in a securities investment fund manager must not exceed 49%.

In January 2017, AMAC announced that FIL Investment Management (Shanghai) Company (富达利泰投资管理 (上海) 有限公司) had been registered with it as the first WFOE private securities investment fund manager under the new policies (“**PFM WFOE**”).

This note provides a brief overview of China's securities investment fund management industry, the policies on foreign investment in such industry prior to and after the implementation of Q&A (No. 10), and outlines the procedures for setting up a PFM WFOE.

General Regulatory Framework on Securities Investment Fund Management Industry

Governing authorities

The main regulatory bodies relating to securities investment fund management in the People's Republic of China (the “**PRC**” or “**China**”)¹ are:

- **CSRC**

CSRC is the central government authority with jurisdiction over the securities investment fund management industry. CSRC is a ministerial-level public institution, directly under the State Council, and regulates the securities and futures markets in China. CSRC's regulatory supervision and oversight functions in relation to the securities investment fund management industry are performed by an internal division named the Fund Regulatory Division (基金管理部).

- **AMAC**

The Asset Management Association of China is a self-regulatory organisation that represents the PRC funds industry. In practice, many of the powers of CSRC, such as the registration of fund managers and record-filing of funds, have been delegated to AMAC, and therefore AMAC is now the *de facto* regulator for the fund industry in China. As regulators go, even the concept of a self-regulatory body is very unusual in China, where a top-down, government-dominated approach typically predominates.

¹ For the purposes of this note, references to “the PRC” and “China” exclude Hong Kong, Macau and Taiwan.

Complex legal framework governing securities investment fund management

As can be seen below, China has put in place a fairly elaborate regulatory framework governing the securities investment fund management industry which applies equally to both foreign and Chinese investors:

- *The People's Republic of China Law on Securities Investment Funds* (中华人民共和国证券投资基金法), issued by the Standing Committee of the National People's Congress and effective 24 April 2015 (the "**Funds Law**").

The People's Congress and its standing committee are the highest legislative body in China. Laws sit above and prevail in the event of a conflict over all other types of legislation in China (other than the PRC Constitution).

- *Supervision and Administration of Privately-Raised Investment Funds Interim Measures* (私募投资基金监督管理暂行办法), issued by CSRC and effective 21 August 2014 (the "**Interim Measures**")
- **Suite of CSRC rules**

Within the regulatory framework established by the Funds Law, in addition to the Interim Measures, CSRC has promulgated a suite of rules relating to the operation and management of funds and fund managers, including the following:

- Sales of Securities Investment Funds Administrative Measures* (证券投资基金销售管理办法), effective 1 June 2013;
- Securities Investment Fund Management Companies Administrative Measures* (证券投资基金管理公司管理办法), effective 1 November 2012;

- Duties of Senior Executives in the Securities Investment Fund Industry Administrative Measures* (证券投资基金行业高级管理人员任职管理办法), effective 1 October 2014;
- Information Disclosure of Securities Investment Funds Administrative Measures* (证券投资基金信息披露管理办法), effective 1 July 2004; and
- Administration of the Business of Appraising Securities Investment Funds Interim Measures* (证券投资基金评价业务管理暂行办法), effective 1 January 2004.

Under this regulatory framework, all key aspects of the industry, from the offering and marketing of securities, registration, trading, day-to-day management, custody, valuation and accounting, taxation, through to profit distribution, and information disclosure in relation to securities investment funds are all heavily regulated.

- **Suite of AMAC rules**

AMAC has itself also promulgated a suite of detailed rules on the operation and management of funds and fund managers. For instance, the *Registration of Fund Managers and Record-filing of Funds Administrative Measures* (私募投资基金管理人登记和基金备案办法(试行)), effective 7 February 2014.

Policies on foreign investment in the PRC securities investment fund management industry

General rule

Pursuant to the *Guidance Catalogue for Foreign Investment Industries (2015 Revision)* (外商投资产业指导目录(2015年修订)), issued by the National Development and Reform Commission ("NDRC") and the Ministry of Commerce ("MOFCOM") and effective 10 April 2015 (the "**2015 Catalogue**"), securities investment fund management falls into the "restricted" category for foreign investment and, in line with China's World Trade Organisation ("WTO") accession commitments, the foreign shareholding in a securities investment fund manager must not exceed 49%. The securities investment fund management industry is now *de facto* included in the Negative List under the new record filing regime².

Limited exceptions

- **CEPA (X)**

The *Supplement No. 10 to the Mainland and Hong Kong Closer Economic Partnership Arrangement* ("**CEPA (X)**"), issued by the MOFCOM and Financial Secretary of the Hong Kong Special Administrative Region on 29 August 2013, allows qualifying Hong Kong-funded financial institutions to set up

joint venture fund management companies in China with a shareholding exceeding 50%. This provided the basis for the first breakthrough in this area.

In June 2016, CSRC announced that it has approved the establishment of HangSeng Qianhai Fund Management Co. Ltd., a joint venture between HangSeng Bank (70%) and Shenzhen Qianhai Financial Holdings Co. Ltd. (30%) and the first majority foreign-owned fund manager in China. Its business scope is raising funds, sales of funds units, asset management for specific clients, asset management and other activities approved by CSRC. It should be noted that this is a breakthrough in the public funds space, regulated by CSRC.

- **QDLP**

In 2013, Shanghai launched the pilot Qualified Domestic Limited Partner ("**QDLP**") program, followed by other cities like Tianjin, Chongqing, Qingdao and Beijing.

The QDLP allows qualified WFOE fund managers to set up domestic private RMB funds and invest into offshore securities markets. The WFOE fund manager can be established as a corporation or a partnership. Establishing a WFOE or joint venture fund manager involves making an application to the Shanghai Administration of Industry and Commerce ("**AIC**") or Shanghai MOFCOM (depending on whether the underlying vehicle is a partnership or a company), which will then seek opinions from the Shanghai Municipal Office of Financial Services. In practice, few such pilot qualifications have been issued, since the authorities have tended to take quite a restrictive approach to the amount of the overseas investment quota given to foreign managed QDLPs. As at June 2016, only 10 QDLP WFOE fund managers had been approved.

² Since 1 October 2016, the establishment of, and changes to, foreign invested enterprises ("**FIE**") which are not related to sectors subject to special market admission administrative measures are subject to record-filing administration instead of approval. To be more specific, the establishment of, and changes to, FIEs in the sectors categorized within the "restricted" category under the 2015 Catalogue as well as those involving caps on foreign shareholdings and/or requirements for senior personnel are still subject to formal approval by MOFCOM and its local counterparts, while the establishment of, and changes to, FIEs in other industry sectors are only subject to record-filing with MOFCOM. NDRC approval or record filing may also be required for the establishment of FIEs, but there are separate rules governing this.

Breakthrough: Q&A (No. 10)

The Chinese government has made a second, voluntary series of commitments regarding the opening-up of its funds industry market as a result of agreements hashed out through several rounds of dialogues with the United States and the UK during 2015 and 2016³. As a result of the above commitments, CSRC authorized AMAC to release the Q&A (No. 10) on 30 June 2016, which confirmed that foreign financial institutions are able to establish a WFOE in China to engage in the private securities investment fund management business. It also sheds some light on issues around the procedures for private securities fund manager registration.

Opening-up in private securities investment fund management industry only

The Q&A (No. 10) only lifts the market entry ban for foreign investment in the private securities investment fund management industry, which means the 49% ceiling on the foreign shareholding is still applicable to a public securities investment fund manager.

Based on the suite of CSRC rules and AMAC rules referred to above, the position with respect to managers of private funds and the role of foreign investors in them is now as follows.

- **Private Funds: raising fund non-publicly**

The Interim Measures provide a definition of privately-raised investment funds: "investment funds established by raising capital within China other than through a public fund raising" ("**Private Funds**")⁴.

- **Investment scope of Private Funds**

The Interim Measures also provide that the assets of Private Funds may be invested in shares (股票), equity interests (股权), bonds (债券), futures (期货), options (期权), fund units (基金份额) and other underlying investments agreed upon in investment contracts⁵.

- **Registration and record-filing of Private Funds**

A manager of Private Funds of any type must register with AMAC⁶, and the manager must record file with AMAC each time a Private Fund is raised⁷. AMAC has an obligation to compete the above registration/record filing within 20 working days from the date all required materials are submitted and accepted⁸.

Furthermore, a registered manager of Private Funds must record file its first private fund raised with AMAC within six months of the completion of its private fund manager registration, otherwise it will be deregistered⁹. This means that a manager of Private Funds has to formulate a stage-by-stage business strategy before it comes into existence, and also has to commence preparation work to

³ Including (1) the Seventh China-U.S. Strategic and Economic Dialogue (2015.6.23) whereby the Chinese government committed to increase participation of foreign financial services firms and investors in the PRC capital markets through several detailed policies, (2) the Seventh China-UK Economic and Financial Dialogue (2015.9.21) whereby the Chinese government agreed to further facilitate investment in and capital flows into the markets of the two nations, and (3) the Eighth China-U.S. Strategic and Economic Dialogue (2016.6.6) whereby the Chinese government committed to lift the ban on foreign investment in the private securities investment fund management industry.

⁴ Article 2 of the Interim Provisions.

⁵ Article 2 of the Interim Provisions.

⁶ Article 7 of the Interim Provisions.

⁷ Article 8 of the Interim Provisions.

⁸ Article 7 and Article 8 of the Interim Provisions.

⁹ Article 2 of the *Announcement on Several Issues relating to Further Standardizing the Registration of Private Funds Managers* (关于进一步规范私募基金管理人登记若干事项的公告), issued by AMAC and effective 5 February 2016 ("**Announcement**").

launch a fund as early as possible. This can cause huge practical issues: for example, what happens if the fund manager resigns or falls ill and/or the preparations for the fund launch get delayed for business reasons?

- **Fundraising targets of Private Funds: not exceed 200 qualified investors**

A "qualified investor" in a Private Fund refers to an entity or an individual that has the commensurate ability to identify risk and risk tolerance, that invests at least RMB 1 million in a single Private Fund and meets any one of the following criteria:

- (i) if an entity, it has net assets of not less than RMB 10 million;
- (ii) if a natural person, he/she has financial assets¹⁰ of not less than RMB 3 million or average income of not less than RMB 500,000 over the past three years.¹¹

The following investors shall automatically be deemed to be qualified investors:

- (i) social security funds, enterprise annuity and other pension funds, charitable funds and other non-profit social funds;
- (ii) investment schemes filed with AMAC in accordance with law;
- (iii) managers of Private Funds and their professionals who invest in their funds under management; and
- (iv) other investors specified by CSRC¹².

The number of investors in a Private Fund must not exceed 200¹³.

- **Requirements on managers of Private Funds**

- (i) Company name

Certain specified Chinese characters such as "fund management (基金管理)", "investment management (投资管理)", "asset management (资产管理)" must be included in the company name¹⁴.

- (ii) Business scope

The permitted business scope of managers with respect to Private Funds only includes "[raising] investment funds", "fund management", "investment management", "asset management" or the like. Other items that are irrelevant to the private fund management business, such as "business information consulting", "international economy information consulting" must not be included in the business scope¹⁵. This is presumably designed to ensure that fund managers remain focused on the core business, and to avoid conflicts of interests, such as providing consultancy services to investee companies.

- (iii) Senior management personnel

A manager of Private Funds must have at least two senior management personnel and such senior management personnel must have fund practitioner qualifications. The senior management personnel in a manager of Private Funds includes, (without limitation) the legal

¹⁰ "Financial assets" includes bank deposits, shares, bonds, fund units, asset management schemes, bank wealth management products, trust schemes, insurance products, futures and so forth. (Article 12 of the Interim Provisions.)

¹¹ Article 12 of the Interim Provisions.

¹² Article 13 of the Interim Provisions.

¹³ Article 87 of the Funds Law.

¹⁴ Article 4 of the *Guidelines for Legal Opinions on Registration of Private Fund Managers* (私募基金管理人登记法律意见书指引), issued by AMAC and effective 5 February 2016 ("**Legal Opinions Guidelines**").

¹⁵ Article 4 of the Legal Opinions Guidelines.

representative, general manager, deputy general manager, and the compliance/risk control officer.¹⁶

- (iv) Risk management and internal control systems

A manager of Private Funds must formulate a complete set of risk management and internal control systems that cover key operational processes such as operational risk control systems, information disclosure systems, record-keeping systems for internal transactions, and so forth.¹⁷

- **Prohibitions on managers of Private Funds**

Under the Interim Measures, managers of Private Funds are not allowed to:

- (i) raise capital from investors who are not qualified investors¹⁸;
- (ii) promote Private Funds to non-specific investors, through newspapers, periodicals, radio, television, the Internet or other public media or by way of lecture, seminar or analysis forum, notices or blogs, SMS, Wechat or email¹⁹; or
- (iii) make any commitment or promise to investors that their principal is protected or any guaranteed minimum return²⁰.

Qualification criteria for a PFM WFOE under Q&A (No. 10)

Pursuant to Q&A (No. 10), in addition to the common requirements for a manager of Private Funds mentioned in Section 4.1

above, a PFM WFOE must meet the following additional qualification criteria:

- **Form of incorporation**

A PFM WFOE established by a foreign institution must be a limited liability company rather than a partnership enterprise.

- **Requirement on foreign shareholders**

The securities regulatory authority in the country or region (such as Hong Kong) where the shareholder of the PFM WFOE is domiciled must have entered into a Memorandum of Understanding for Securities Regulatory Cooperation ("MOU") with CSRC or another institution recognized by the CSRC²¹, and such securities regulatory authority must have approved or licensed the shareholder as a financial institution.

This effectively excludes applications from companies set up in tax-haven type jurisdictions, such as the Cayman Islands, British Virgin Islands and Bermuda, as the securities regulatory authorities in those countries or territories have not entered into an MOU with CSRC.

- **Clean record of the WFOE and its shareholder**

Neither the PFM WFOE nor its foreign shareholder has suffered or had imposed

¹⁶ Article 4 of the Announcement.
¹⁷ Article 4 of the Legal Opinions Guidelines.
¹⁸ Article 14 of the Interim Provisions.
¹⁹ Article 14 of the Interim Provisions.
²⁰ Article 15 of the Interim Provisions.

²¹ As at February 2017, CSRC has entered into MOUs with the securities regulatory authorities in the following countries or regions: Hong Kong, the United States, Singapore, Australia, the United Kingdom, Japan, Malaysia, Brazil, France, Germany, Italy, Egypt, Korea, Romania, South Africa, the Netherlands, Belgium, Canada, Switzerland, Indonesia, New Zealand, Portugal, Nigeria, Vietnam, India, Argentina, Jordan, Norway, Turkey, United Arab Emirates, Thailand, Liechtenstein, Mongolia, Russia, Dubai, Ireland, Austria, Spain, Taiwan, Malta, Kuwait, Pakistan, Israel, Qatar, Laos, Sweden, Luxembourg, Cyprus, Ukraine, Lithuania, Guernsey, Belarus, Brunei, Jersey, Isle of Man, Poland, Kazakhstan, and Azerbaijan.

any material punishment by any regulatory authorities or judicial authorities in the preceding three (3) years.

There is no definition of "material punishment" and different regulatory authorities may have different standards in practice. If in doubt, and there is a choice, it probably makes sense to use a 'clean' entity with a 'clean' shareholder.

- **Requirement on its foreign actual controller**

The actual controller of the PFM WFOE (if any) must meet the requirements in (b) and (c) above.

Q&A (No. 10) does not provide a definition for "actual controller". We believe the following two standards can be taken into consideration when considering which entity is the actual controller of a PFM WFOE:

(i) The *Private Funds Manager Registration and Information Updating Explanation* (管理人登记和信息更新填报说明) published by AMAC in 2015 states that to identify the actual controller, one needs to trace back to the ultimate natural person, state holding enterprise/collective enterprise, or a foreign institution regulated by an overseas financial regulator; and

(ii) The *People's Republic of China Company Law* provides that the actual controller refers to a person who is not a shareholder of a company but who is able to actually control the acts of the company through investment relations, agreements or other arrangements.²²

- **Independence of a PFM WFOE**

Another key restriction is that Q&A (No. 10) provides that a PFM WFOE must make investment decisions independently, and must not place trading orders through foreign institution(s) or foreign-based system(s).

This requirement may have a profound impact on the model for WFOEs or JVs which are subsidiaries of global asset management institutions that have unified asset management systems which are used all over the world, and who would have wanted the WFOE or JV to use those systems. Furthermore, if the PFM WFOE pays a significant level of investment consulting service fees to its shareholder, it might be seen as not making investment decisions independently. This requirement will clearly restrict the scope for benefitting from economies of scale, and effectively requires China to be a separate dealing hub, which is likely to be costly and inefficient.

- **Only investment in China Securities**

Another key restriction under Q&A (No. 10) is that the fund manager can only invest the funds raised in securities in China. There is a *possibility* that China will offer quotas for overseas investments going forward, but for the moment it is only that.

Procedures for setting up a PFM WFOE under Q&A (No. 10)

Step 1: Enterprise name pre-registration with local AIC

The first step in establishing an FIE in China is choosing a name in Chinese, and filing that name with the local AIC in the place of establishment.

²²

Article 216 of the revised *People's Republic of China Company Law*, issued by the Standing Committee of

the National People's Congress and effective from 1 March 2014.

The WFOE needs to run name checks to assess whether the proposed Chinese name is acceptable to the AIC (for instance, whether it has been used by other entities already, and/or whether it is similar to other registered names). The WFOE will need to keep coming up with alternative Chinese names until one is acceptable to the authorities. Every new name requires an independent name check. As such, the timeline for this process is open-ended if the AIC keeps turning down the proposed Chinese names.

Step 2: Record-filing with local MOFCOM

As indicated above, securities investment fund management is classified in the 'restricted' category in the 2015 Catalogue. However, the restriction on the proportion of foreign investment has been effectively removed by the Q&A (No. 10). Furthermore, according to the *Standards for Classification of Different National Economic Sectors* (国民经济行业分类标准), securities investment fund management falls into the scope of "J671 securities marketing services (证券市场服务)" under the 2015 Catalogue. However, in practice, a PFM WFOE is classified under "L7212, investment and asset management (投资与资产管理)". Therefore it is our understanding that a PFM WFOE only needs to go through a record-filing procedure with local MOFCOM, not approval.

Timing-wise, the FIE record-filing can be completed within three (3) working days, provided that the matters being applied for fall within the scope of the record filing criteria.

Step 3: Enterprise establishment registration with local AIC

Registration with the appropriate local AIC will complete the establishment of an FIE and a business license will be issued upon completion. From the date of the issuance of the business license, the WFOE has separate legal personality.

Based on applicable regulations, the AIC registration normally takes fifteen (15) days from acceptance of all required documents.

Step 4: Post-establishment registrations

To operate in full compliance with PRC laws and regulations, the PFM WFOE is required to file post-establishment registrations with several local authorities following issuance of its business license, such as the Public Security Bureau, the State Administration of Foreign Exchange via the account opening foreign exchange bank, the State Administration of Taxation, and so forth.

These post-establishment registrations are typically very straightforward and are often conducted by the WFOE itself. Moreover, starting from 1 October 2016, China has rolled out the "Five-in-One Business License" system, combining the previous business license, tax registration certificate, organizational code certificate, statistical registration certificate and social security registration certificate into one. This has significantly simplified and sped up the post-establishment process.

Step 5: Registration and record-filing with AMAC

Please refer to Section 4.1 (c) above.

Conclusions

The opening up of the PFM WFOE market to foreign investment has been the topic of much market and industry chatter, and has been seen by many commentators as a breakthrough. In a way it is, in that it finally allows overseas private equity or hedge fund managers to set up shop in China without the heavy burden of managing a relationship with a Chinese partner. However it has to be seen in its proper context: it is limited in scope by two key issues:

- the independence of decision-making rule; and
- the requirement to only invest in local securities.

Many fund managers we have spoken to see it as a stepping stone, and are considering making the investment with a view to putting themselves in a better position when further liberalization (especially the granting of overseas investment quotas) takes place. The 'holy grail' of China fund management remains taking the huge pool of capital in China to invest it on global markets, and there is huge pent-up demand currently especially given the downward pressure on the Renminbi.

With the latest set of currency controls imposed by China (see our note on this [here](#)) on outgoing payments at the end of 2016, in part due to downward pressure on the RMB caused by overseas investments by Chinese companies, the chances of China granting outbound quotas for securities investment do not look good at time of writing, but this could change over time. China has taken 15 years post WTO accession to reach this stage, and it is notable that China was not under any WTO commitment to liberalise this sector. So tapping into that reservoir of funds looking for a home remains the long game, and setting up a PFM WFOE the first in ten thousand steps on the road to reaching the holy grail of China fund management.

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