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September 16, 2019

Update on ICI Global's Recent Meetings in Beijing Regarding China's Market Access (Part 3)

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September 16, 2019 TO: ICI Global Members
Global Operations Advisory Committee - Asia
ICI Global Pacific Chapter
ICI Global Regulated Funds Committee SUBJECTS: Distribution
International/Global
Investment Advisers
Trading and Markets RE: Update on ICI Global's Recent Meetings in Beijing Regarding China's Market Access (Part 3)

ICI Global met with officials from the China Securities Regulatory Commission (CSRC), the Asset Management Association of China (AMAC), State Administration of Foreign Exchange (SAFE), and People's Bank of China (PBoC) in Beijing in early September 2019. The purposes of the meetings were to hear directly from the regulators about the state of progress of China's capital market opening, and better understand the implications of the measures unveiled in July 2019 by the PBoC under which foreign investors are allowed to take majority stakes in "grandchildren" wealth (asset) management subsidiaries of banks.[1] This memo highlights the key messages from our meetings.

1. Mutual Fund WFOEs in 2020

CSRC expects to be in a position to release rules to regulate connected (intra group) transactions between onshore asset managers/brokers and other members within their groups (including offshore parents, sister companies, and affiliates)[2] quite soon. Designed to restrict excessive build-up of financial risks by onshore financial institutions under CSRC's regulatory remit, these rules will also set out a date in 2020 when CSRC will start accepting applications for mutual fund licenses from WFOEs.

2. Policy Philosophy Behind the Full Opening of the Asset Management Market

Currently, China runs on an uneasy mix of planned economy and market economy principles. The state-owned sector is still large and powerful, albeit saddled by outdated planned economy concepts. The private sector has been growing, thriving on innovation and nimble decision-making that swiftly adapts to emerging market opportunities. When the state-owned sector becomes powerful, the private sector suffers. When the private sector develops more robustly, the state-owned sector recedes, presenting ideological challenges. This has been an uneasy balance. One of the objectives of the opening-up of the capital market to global players with well-developed and best-in-class technology, systems, operations, and controls is that as global players introduce maturity, transparency, governance, and expertise into the market, they could help develop a “third” sector or a balancing force that could move the market structure towards a healthy and stable equilibrium.

3. Competition in the Asset Management Industry

The regulators tell us that currently the asset management business is in vogue – every financial institution from banks to securities firms, trust companies, fund companies, insurance companies, advisers, *etc.,* is actively seeking opportunities to enter the asset management market. Many commercial conglomerates are also aggressively positioning themselves to enter the competition. These conglomerates include not just household names such as Alibaba, Ant Financial, and Tencent, but also a whole host of others in information technology, mass commerce, and consumer finance like P2P platforms. Currently, the regulatory bodies are facing a state of confusion in supervising financial institutions in different industries. Banks, insurance companies, trust companies and P2P lending are under the supervision of the China Banking and Insurance Regulatory Commission (CBIRC), while securities firms and fund companies are under the supervision of CSRC. That said, there is a lack of unified standards in supervision and a lack of common set of rules in regulating the asset management industry. When the market opens to global players next year, the competition that global players face could be very tough. CSRC and AMAC expect the global players to play to their strength in long-term investing. In comparison, local players, especially the nimble ones, are more focused on short-term plays.

4. Opportunities for Foreign Investors to Take Majority Stakes in Asset Management Businesses in Bank Groups

We understand that global asset managers are eyeing opportunities under the new arrangement announced recently by PBOC – that foreign asset managers can become majority shareholders of “grandchildren” asset management subsidiaries of banks. Given that banks’ asset management activities are regulated by the CBIRC under a different system, we asked whether a foreign asset manager could hold a majority stake in a bank asset management company, and at the same time enjoy the 1+1 policy (*i.e.,* hold a mutual fund WFOE and a 49% interest in another mutual fund company) under the CSRC regime. The CSRC acknowledged that this kind of diverse holdings is not legally prohibited. However, the regulators and policy makers across the spectrum are looking at this area with the objective of rationalizing the entire regulatory framework in a holistic manner. In any event, when a foreign manager invests and engages in multiple asset management companies at the same time – for example, in a bank’s mutual fund grandchild, a mutual fund WFOE, and a mutual fund JV – this may raise the question of what the overall strategy of the manager is.

The regulators also pointed out that, in their view, the new measures present a “love-hate option” to global managers. For global managers trying to build market presence and traction in China, large state-owned banks present the coveted prospects of access to a large distribution network. Yet, it is well-known that large state-owned banks move and think in bank-centric ways; owning a majority interest in a bank’s grandchild subsidiary may not give the foreign investor effective leverage and control. The regulators also pointed out that large state-owned banks would likely be reluctant to relinquish majority control of their grandchildren subsidiaries. Even if they did give up majority ownership, it does not mean that they cannot wield and retain effective control.

Ultimately, it is for global managers to evaluate the benefits and the risk and return of investing substantial amounts of capital and technology in a bank grandchild. One attractive option for global managers could be to work with banks to provide the products that banks' asset management subsidiaries need to build their clients' diversified portfolios. Banks are strong in providing asset allocation types of advice, but they are usually weak in creating products.

5. Abolition of QFII/RQFII Quotas

China has just called an end to quotas for the qualified foreign institutional investors (QFII) and RMB qualified foreign institutional investors (RQFII) schemes.[3] According to SAFE, even when global assets under management have been suffering from outflows, the China market in Q2 witnessed a net inflow of USD 120 billion, with approximately 75% investing in bonds (mostly treasury bonds) and 25% in equity. From here on, foreign managers who wish to invest in China's capital market will only need a QFII license from the CSRC. The license will entitle them to open accounts with banks, and it is for the banks to report to SAFE the foreign exchange movements (inflow and repatriation) in these accounts.

6. State Council Announcement for Shenzhen to Spearhead Financial Market Reforms

The regulators also referenced the State Council's announcement on 18 August 2019 on plans to accelerate financial reform in Shenzhen, including plans to foster connectivity between Shenzhen and the financial markets of Hong Kong and Macau. The regulators explained that Shenzhen has been the vanguard of market opening experiments on the mainland. Until now, the Chinese central government has been very conservative in financial regulatory policy – even the signature initiative of the Shanghai Free Trade Zone has not made any significant break-through.

The government believes that the time is ripe for pushing forward wider reform opening using Shenzhen as a pilot. One example is the Wealth Management Connect (□□□) initiative in Shenzhen that connects Shenzhen and Hong Kong. This can be a major break-through involving a devolution of financial regulatory authority to the local Shenzhen government. This initiative is a cross-border investing channel. Hong Kong individuals can go to Shenzhen to buy funds, while individuals in the "reform opening pilot area" (basically the Greater Bay Area) can go to Hong Kong to buy Hong Kong-regulated funds. These are early, broad-brush policy concepts that need to be developed. The PBOC has the responsibility of concretizing these ideas in the form of implementing rules, guidelines, *etc*.

Implementing this policy proposal is not without challenge. Difficult operational issues will need to be ironed out. These will include questions such as: how to determine whether an individual is in a Hong Kong or reform opening pilot area, what documents are required to provide proof of identity, whether there is any overall quota, who will serve/advise these investors, how are these advisers regulated, *etc.*

We asked if this new initiative would ultimately usher in the demise of the Mutual Recognition of Funds (MRF) between China and Hong Kong, *i.e.,* the MRF scheme would become obsolete. CSRC explained that even if the Shenzhen experiment went ahead, the scope would be restricted, probably with just simple products and circumscribed within a limited geographical area. The MRF scheme, on the other hand, covers a broad and deep range of products, and is nationwide.

7. Forum for Asset Managers on Opportunities in Asset Management

The Chinese Think Tank, *China Wealth Management 50 People*, will be hosting a forum on 21 September 2019 from 2:00 p.m. to 7:00 p.m. in Beijing where local and global managers are invited to share ideas and discuss opportunities in China's asset management industry, particularly given the latest move to allow global managers to invest in grandchildren asset management subsidiaries of banks. The topic of the Forum is *Strategic Investment and Partnership of Global Players in Chinese Asset Management Industry in the Context of Financial Opening*.

The financial regulators – CSRC, CBIRC, PBoC and others – are sending technical level personnel to the forum to collect the views of market players. We noticed that a good number of our members have been invited. We will be sending out a separate ICI Global memorandum to all members providing them with details of the forum, should they wish to send any representatives to the forum.

Alexa Lam
Chief Executive Officer, Asia Pacific
ICI Global

endnotes

[1] *See* Section 3 of ICI Global Memorandum No. 31902, *Update on ICI Global's Meetings in Beijing Regarding China Market Access(Part 2)*, dated 14 August 2019, *available at* https://www.iciglobal.org/iciglobal/pubs/memos/memo31902.

[2] *Id.*, at Section 1.

[3] *See* Press Release, *Abolish Restrictions on the Investment Quota of Qualified Foreign Investors (QFII/ RQFII) and Further Expand the Opening up of Financial Markets*, State Administration of Foreign Exchange (10 Sept 2019), *available at* https://www.safe.gov.cn/en/2019/0910/1552.html.