MEMO# 32104

December 16, 2019

Update on ICI Global's Meeting with CSRC regarding China Market Access (Part 4)

[32104]

December 16, 2019 TO: ICI Global Members
ICI Global Pacific Chapter
ICI Global Regulated Funds Committee SUBJECTS: Anti-Money Laundering
Distribution
International/Global
Investment Advisers
Privacy
Trading and Markets RE: Update on ICI Global's Meeting with CSRC regarding China Market Access (Part 4)

The China Securities Regulatory Commission (CSRC) announced in a press conference in October 2019 that it will abolish the foreign ownership limit in public fund management companies starting from 1 April 2020. Over the past two months, we have spoken to a good number of our members. Many are in the process of building up or strengthening their onshore operations to prepare for the 2020 opening. Meanwhile, global asset managers have raised questions/enquiries regarding the license application process, rules and regulations governing the operation and management of mutual fund management Wholly Foreign-Owned Enterprises (WFOEs), and the framework underlying the 2020 market opening.

On 6 December 2019, ICI Global met with Madam Sha Yan, CSRC Director General of the department in charge of funds/fund investing, and her team in Beijing. The main purpose of the meeting was to hear directly from CSRC on their current policy thinking regarding the blueprint for the complete opening of China's mutual fund industry, seek clarifications on the rules/requirements, and share with CSRC suggestions/concerns that the global asset management industry would like CSRC to take on board as they craft the final framework for the April 2020 opening. This memorandum highlights the key messages from the meeting.

1. Policy philosophy behind the full opening of China's mutual fund industry

Madam Sha reiterated that China is committed to opening up the capital market and bringing in international best practices to promote the healthy development and competitiveness of China’s mutual fund industry. She had several important messages for us.

First, the Financial Commission of the People’s Bank of China (PBoC) is taking the lead to promote the convergence of rules and regulations for the asset management industry. One important initiative is to migrate the asset management industry and investors from a “guaranteed return” mindset to a market performance and net asset value mindset.

Second, as the transformation and upgrading of the structure of China’s economy continues, capital funding is shifting from indirect to direct financing where professional investors will have a crucial role to play.

Third, the rapid accumulation of wealth among households and changing demographics will drive the demand for medium and long-term investment products for asset growth and retirement needs.

CSRC gave the reassurance that they will adhere to the principle of fairness in reviewing applications for mutual fund company licenses. Foreign asset managers who meet the required qualifications are welcome to participate in China’s mutual fund industry.

2. Application for Mutual Fund WFOEs in 2020

CSRC will start accepting applications for mutual fund WFOEs on 1 April 2020. There are two routes open to foreign asset managers who wish to apply for a wholly-owned mutual fund license in China. One route is for a WFOE private fund management company (PFM) to become a public mutual fund company (FMC). The other route is for the WFOE to retain its current private funds business while its parent company applies to set up a separate WFOE to apply for a mutual fund company license (FMC) in China. CSRC confirmed that they do not have any preference as to which structure an applicant adopts, noting that this is a matter of corporate decision for each asset manager.

For ease of reference, in the remainder of this memorandum, we shall refer to a WFOE that only holds a PFM license as a PFM WFOE, and a WFOE that holds an FMC license as an FMC WFOE. An FMC WFOE can, of course, continue to provide private fund (segregated accounts) management.

3. Forward looking relationship between a PFM WFOE and a FMC WFOE

3.1. Dual-hatting

Dual hatting is a common practice in global asset management companies as it allows for the efficient sharing of human resources and talents within the group. Many global asset managers have asked if CSRC would allow dual-hatting in China. CSRC clarified that under relevant Chinese laws, executive directors, supervisors, and other senior personnel engaged in the management of one fund management company are generally prohibited from concurrently assuming similar roles/responsibilities in another fund management company. Specifically, we clarified with CSRC the possibility of dual-hatting under the following company structures.

3.1.1. The parent company already has a PFM WFOE and will set up a new FMC WFOE

Under this company structure, CSRC would not permit the sharing of key management personnel, such as the CEO, General Manager, Compliance Director or Portfolio Manager between the PFM WFOE and the FMC WFOE. Such dual-hatting will create conflicts of interests between the two entities.

The sharing of the non-executive chairman and other non-executive directors between the two entities, on the other hand, is permitted, as these personnel are not involved in the day-to-day management and operation of either of the two entities. The WFOE will need to hire local personnel to perform compliance, human resources, risk management, research, portfolio management, etc. functions to support the day-to-day operations of the WFOE. These local functions can be part of the global functions performed on a group basis (see Paragraph 3.2 below).

3.1.2. The parent converts its existing PFM WFOE to a FMC WFOE

Under this structure, CSRC allows the sharing of key management personnel (such as the Chairman, CEO, and General Manager) between the two lines of business within the WFOE (i.e., both the private funds and the mutual funds). However, CSRC stressed that portfolio management function cannot be shared between the two lines.

While acknowledging that in other major markets global managers can, upon clear and proper disclosure in offering documents, allow their portfolio managers to select securities across the board for both private and public funds, leaving it to an independent, vigorous internal process to equitably allocate the investments among these funds and in accordance with disclosed principles, CSRC explained that this is not possible under China’s current market infrastructure. China does not have an omnibus trading system (i.e., the ability to place a single buy or sell order on behalf of multiple underlying fund accounts). China has an ID market where trades are made for each individual account. Given this, to ensure fair treatment to all investors, CSRC does not allow the sharing of portfolio managers (PMs) between public and private funds. Paragraph 3.3 below will explain CSRC’s position in better detail.

To make it easier for global asset managers to prepare to apply for an FMC WFOE license, CSRC is prepared to accept an arrangement where the PM for a PFM WFOE temporarily also serves as the PM for the FMC WFOE during the initial transition period (within 30 days after the FMC license is approved). However, once the decision is made to migrate a PM in an existing PFM WFOE to an FMC WFOE, disclosure about the planned change of investment personnel must be made to fund investors.

Within the FMC WFOE, back office functions such as human resources, accounting, and risk management can of course be pooled to support both the private and mutual fund lines of business.

3.2. Sharing of global best practices and resources

Another question frequently raised by global asset managers is the possibility of sharing global best practices, resources, and systems (such as research and risk management) between an asset manager’s global operations and China operations. CSRC clarified that a foreign entity can use its global back office human resources and payroll systems for its

FMC WFOE. However, an FMC WFOE must deploy within China its trading credit system, risk monitoring and control system, and anti-money laundering (AML) system, complete with on-the-ground personnel. CSRC stressed that local client information and transaction details cannot flow across the border. This effectively means that while the results and implications of local monitoring, risk assessments, and controls (such as risk level indicators) can be exported outside China and shared within the group, raw local data and information about customers' identity and other personal details and transactions cannot be shared. CSRC takes the view that AML information also involves sensitive customer information and thus cannot be shared outside China.

At the moment, CSRC is formulating guidelines/regulations to facilitate more effective management and sharing of client information within an organization in order to allow global asset managers to operate more efficiently in the future.

3.3. CSRC's views on managing mutual fund assets vs. segregated account assets within one company

Generally speaking, the investment and management of mutual funds and segregated accounts are governed by different sets of rules due to the differences in fund structure and investment objectives. Segregated accounts are under a more flexible regime while mutual funds are subject to strict investment and governance rules. Since the two set of rules are different, there might be differences in potential return, which could be more pronounced with fixed income investments where fair value may be difficult to establish. As the current system requires each order to be placed from a specific account, fair reallocation after each trade would be difficult if not impossible. Thus, CSRC's view is that mutual funds and segregated accounts should be treated and managed differently.

Going forward, CSRC will study how this matter could be resolved so that the Chinese fund management industry could move towards better convergence with international standards and practices. For now, as China's system does not provide for the ability to place a single buy or sell order on behalf of multiple underlying fund accounts, the trades for mutual fund accounts and segregated accounts must be executed independently in order to ensure that all client trades are executed fairly and to remove all conflicts of interests.

3.4. CSRC's view on whether an FMC WFOE can manage/advise third party funds

Some foreign managers have asked whether an onshore FMC WFOE can also provide services to global investors of the entire group—for example, by acting as investment adviser for the parent company's overseas funds (such as Luxembourg domiciled funds). CSRC explained that there are two methods.

First, according to the revised Qualified Foreign Institutional Investor (QFII)/ Renminbi Qualified Foreign Institutional Investor (RQFII) rules proposed by CSRC on 31 January 2019, WFOEs may begin advising QFII funds belonging to their parent or group companies. Although the final rules have not been released, CSRC has informally started putting these policies to work. Advising QFIIs issued by companies outside the WFOE's group is however not permitted.

Second, CSRC will be relaxing QFII investment rules, under which a PFM or FMC WFOE can set up a segregated account (private fund) into which a QFII (including QFIIs issued by third parties outside the group) can invest. The new rules will permit a QFII to invest in a single private fund (segregated account) managed in China. This will effectively amount to a

WFOE providing discretionary investment management service to another financial institution.

4. Mutual Recognition of Funds (MRF) scheme between HK and Mainland China

The MRF scheme has been running since July 2015. One of the main hurdles faced by foreign asset managers is the long lead time required to get the funds approved by CSRC. Another hurdle is the 50:50 AUM requirement under which MRF funds sold to Mainland investors in China cannot exceed 50% of the fund's total assets under management (AUM).

CSRC said that they have streamlined the application process for northbound funds. The approval time now will be much shorter. As for the 50:50 AUM requirement, CSRC indicated that they are open to reviewing and relaxing the requirement if necessary on a case-by-case basis. According to CSRC, so far only one northbound fund is close to reaching the 50:50 AUM limit.

5. Shenzhen Wealth Management Connect

We asked about the latest status regarding the Shenzhen Wealth Management Connect, an initiative announced by the State Council in August 2019 to foster connectivity between Shenzhen and the financial markets of Hong Kong and Macau. According to CSRC, the Wealth Management Connect is an initiative led by the PBoC and the Hong Kong Monetary Authority (HKMA). CSRC fully supports the idea of including mutual fund products on the connectivity platform. The pilot program is a cross-border investing channel that connects Shenzhen and Hong Kong. Individuals from the Greater Bay Area can go to Hong Kong to buy Hong Kong regulated funds, while Hong Kong individuals can buy Mainland domiciled funds in Shenzhen. The detailed rules are yet to be released.

Alexa Lam
Chief Executive Officer, Asia Pacific
ICI Global

Irene Leung
Regional Lead, Member Relations and Research, Asia Pacific
ICI Global