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China Launched Consultation on New Investment Advisory Rule

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ICI Global Investing Subcommittee
ICI Global Pacific Chapter
ICI Global Regulated Funds Committee SUBJECTS: Compliance
Distribution
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Operations RE: China Launched Consultation on New Investment Advisory Rule

On April 17, 2020, the China Securities Regulatory Commission (CSRC) launched a consultation on the regulation of investment advisory activities. The CSRC released the *Administrative Measures on Securities and Funds Investment Advisory Services (Consultation Paper)*[\[1\]](#) ("Administrative Measures"). It is open for public comments until May 17, 2020.

Regulatory Objective

In the Drafting Explanation released together with the Administrative Measures, the CSRC underscored the importance of the investment advisory sector in China's capital market development. Investment advisory service helps address the problem of asymmetry of information in the capital market, contributes to the development of professional intermediary services, and strengthens investor understanding and education. The nurturing of informed and mature investors is fundamental to the development of a deep and multi-tiered capital market.

Over the years, the CSRC has released a raft of legislative provisions and regulatory rules governing different types of advisory activities. These include the *Interim Provisions on the Issue of Securities Research Reports*, the *Interim Provisions on Securities Investment Advisor Business*, and the *Securities Investment Fund Law*. As the investment advisory industry continues to develop, the CSRC is concerned with incidences of improper conduct and questionable practices. The CSRC considers that the time has come for the creation of a comprehensive regulatory framework to cover all aspects of investment advisory activities. Administrative Measures aim to encourage compliance and support sustainable growth of the industry by raising qualification requirements; mandating good governance, internal controls, and risk management; and strengthening licensing and supervision.

Global asset managers and financial institutions would likely have an interest in the development of this sector.

Key Components of the Regulatory Framework

The regulatory framework is structured on several key building blocks to give the regulator a comprehensive handle to guide and regulate the industry. These include:

- 1) Identifying the types of securities and funds investment advisory activities that require a license;
- 2) Specifying entry requirements for registration/approval as an investment advisor;
- 3) Establishing qualification requirements for investment advisor employees;
- 4) Strengthening internal control requirements;
- 5) Setting standards of conduct and requirements on business practices;
- 6) Giving the regulator licensing, supervision, and enforcement powers; and
- 7) Providing transitional arrangements.

This memo gives a brief explanation of these provisions.

1. Types and Scopes of Securities Investment Advisory Activities

Three types of activities fall within the definition of Securities and Funds Investment Advisory Services (“Investment Advisory Activities”):

- 1) Advising on securities (including derivatives);
- 2) Advising on funds; and
- 3) Issuing reports/analyses regarding securities. Securities research reports should only provide forecasts on market trends and analysis on investment products without offering specific investment advice to clients (Chapter 1, clause 3).

Without registering/obtaining approval from the CSRC, institutions and individuals are prohibited from conducting directly or indirectly any type of Investment Advisory Activities. Only registered securities companies or their subsidiaries dedicated to the purpose may be granted an advisory license to issue reports/analyses regarding securities under the Administrative Measures, and these securities companies must themselves also hold an investment advisor license to advise on securities (Chapter 2, clause 6).

Where a securities brokerage in the course of its business provides incidental securities investment advice to its client, or where a securities investment mutual fund sales entity in the course of its sales business provides incidental advice, the provision of such advice shall be exempt from licensing requirements under the Administrative Measures provided that there is no separate contract signed and no additional fee is charged for such ancillary services. Both types of institutions must nevertheless ensure that their practices meet the requirements set forth in the Administrative Measures, and they may not accept discretionary investment mandates (Chapter 5, clause 33).

2. Eligibility Requirements for Investment Advisors

To be eligible for an investment advisor license, an institution must have a minimum of RMB 100 million net assets. The applicant is required to demonstrate that it has effective and robust internal control and risk management systems, appropriate operating premises and facilities, and information technology systems to conduct Investment Advisory Activities. The applicant must demonstrate also that in the last three years or since its inception (presumably if less than three years), it has not been subject to material regulatory measures; it is not currently under investigation for suspected material breach or misconduct nor is it undergoing a process of rectification; and it has not been subject to criminal or administrative sanctions due to gross violations of law or regulation (Chapter 2, clause 8).

The Administrative Measures also stipulate requirements for shareholders of investment advisors. A corporate shareholder holding 5% or more of the equity of an investment advisor is required to have net assets of not less than RMB 50 million, while controlling corporate shareholders must demonstrate that their business has been profitable in the last three years and they have net assets of not less than RMB 500 million. All corporate shareholders are required to demonstrate that they have good financial health and capital replenishment ability. All such corporate shareholders are subject to the same integrity and compliance records as are applicable to investment advisor institutions (see paragraph above).

Natural person shareholders are required to have net assets of not less than RMB 30 million. They must demonstrate that they have been in the financial services sector for over 10 years and have held senior management roles for at least three years during that period. Overseas shareholders must be financial institutions established in accordance with the laws of the countries or regions where they are located, and their home regulators have entered into a Memorandum of Understanding signed with the CSRC (Chapter 2, clause 9). Furthermore, the One Control One Participation ("1+1") policy applies. A company cannot be a shareholder of more than two investment advisors, with a controlling stake in no more than one of the two (Chapter 2, clause 10).

Upon registration with or approval by the CSRC, applicants must obtain an investment advisor license from the CSRC before they can commence Investment Advisory Activities.

3. Experience and Qualification Requirements for Advisors

Employees engaged in Investment Advisory Activities, from producing investment advice/research reports to client-facing roles as advisors, should be qualified and registered for conducting Investment Advisory Activities.

Employees who engage in securities or fund advisory activities shall not be involved in issuing research reports concurrently. An investment advisor shall not employ any person who has been subject to serious regulatory measures or administrative or criminal sanctions for material breaches or misconduct in the past five years.

In addition, senior executives generally must have at least three years of experience in securities and fund business, or at least five years of experience in the financial industry. They should also have more than two years of management experience in the Investment Advisory Activities that they propose to engage in.

For an investment advisor that engages in only one type of Investment Advisory Activity, it shall have at least 10 employees who are qualified for the relevant activity, each with more than three years' relevant work experience. Where an investment advisor proposes to engage in two or more types of Investment Advisory Activities, it shall have at least 20 employees that meet similar qualification and experience requirements as per above (Chapter 3, clause 14).

4. Governance, Internal Controls, and Risk Management

An investment advisor shall not engage in business activities other than Investment Advisory Activities unless it has special approval from the CSRC.

While stipulating in general terms that an investment advisor shall establish a healthy corporate governance structure, the Administrative Measures categorically state that investment advisors shall not provide financing or guarantees for their shareholders, controllers, or other affiliated parties (apparently a practice not uncommon among some advisors today).

When establishing internal controls, compliance management, and risk management processes, investment advisors are required to make close reference to the relevant requirements applicable to securities companies and securities investment fund management companies (Chapter 3, clause 12). In addition, an investment advisor must establish a robust information technology system that covers all aspects of its Investment Advisory Activities and maintain a comprehensive set of records supporting those activities in written or electronic form (Chapter 3, clause 16). The power of attorney signed by clients, verification documents, and information on internal management and business operations shall be properly kept for at least 10 years, starting from the date of engagement by the client (Chapter 3, clause 24).

An investment advisor shall have a centralized and uniform management system for its activities, including activities of its branches. Investment advice and research reports shall be produced and revised under a centralized process. Employee advisors may only convey and explain the advice and reports produced under a firm's centralized process. These individuals may not produce or revise the investment advice or research reports themselves. To prevent disorderly expansion, investment advisors, in principle, are not allowed to set up branches outside the province where they are located (Chapter 3, clause 13).

5. Standards and Practices

When providing advisory services, an employee investment advisor shall clearly state his/her name and license/registration number and the name of the investment advisor institution that he/she represents. An advisor may not provide advisory services in his/her own name. No advisor can work for more than two investment advisor institutions (Chapter 3, clause 15).

A written contract shall be signed with the client when an investment advisor provides investment advisory services. The contract shall provide clearly for the rights and obligations of each party and include information relating to the type(s) of service to be provided, a schedule of fees and charges, liability for breach of contract, and complaints handling procedures. To ensure the suitability of advisory services provided to clients, the Administrative Measures require investment advisors to classify clients, perform risk ratings

for the securities and fund investment advisory services provided, make full and proper risk disclosure, and always ensure that their advice is appropriate and suitable given the client's risk profile and risk tolerance (Chapter 3, clause 18).

Investment advisor institutions and their employee advisors shall act honestly, fairly, and in the best interest of their clients. They are required to establish a process to identify, evaluate, disclose, and address any conflicts of interest. Investment advisors shall also strengthen the management and monitoring of related-party transactions. Investment advice that could potentially create conflicts of interest should not be provided to any client unless it can be proved that the advice actually benefitted the client and not providing such advice would have harmed the client's interest. In such case, the investment advisor must disclose any related-party/affiliate relationship to the client and obtain the client's prior consent in writing (Chapter 3, clause 17).

The Administrative Measures impose stringent requirements where an investment advisor gives investment recommendations in relation to high-risk assets, including stocks, structured products, and derivatives, to non-professional investors. If upon clear explanation as to why such high-risk products are not suitable, a non-professional investor still insists on proceeding, the investment advisor must fully disclose the risks including the maximum potential loss that the client may suffer and request a signed risk disclosure acknowledgement letter from the client. In addition, the advisor must obtain an opinion issued by a separate and independent research unit evaluating the feasibility of the investment recommendation and supported by research and analysis published by other (third-party) investment advisors. The investment proposal should be part of an investment portfolio, and the allocation to a single high-risk asset should not exceed 10% of the portfolio. The employee advisor providing the investment advice serves no more than 50 clients and the entire advisory process is documented by video or voice recordings. Where the advisory process is conducted on the internet, there is an electronic record of the entire process (Chapter 3, clause 19).

An investment advisor institution that provides service of an investment management nature or offers advice in relation to high-risk investment products is required to establish a risk reserve fund in accordance with rules established by the CSRC, deposited in a segregated account opened with a commercial bank authorized to provide custodian service.

6. License Extension and Exemptions; Enforcement and Discipline

An investment advisory license is valid for three years. An investment advisor must apply for an extension six months before the license expires. An investment advisor who has not applied for an extension or otherwise fails in its application for extension shall cease advisory business upon expiry of the current term of its license.

The CSRC would not approve a license extension if the investment advisor has been the subject of two business suspension orders pursuant to administrative regulatory measures taken by the CSRC, or the investment advisor has been the subject of a business suspension order pursuant to administrative regulatory measures taken by the CSRC and the advisor has not implemented effective rectification measures as required (Chapter 4, clause 28). Where an investment advisor decides to cease its advisory business or has not engaged in advisory activities for more than three months without appropriate reasons, the Administrative Measures require the advisor to apply for a license revocation (Chapter 4, clause 29).

Securities companies, fund management companies, futures companies, commercial banks, and insurance companies are exempted from certain requirements set forth in the Administrative Measures since there are existing regulations on their advisory operations and set-up requirements. These include requirements on shareholder qualifications, internal control requirements, limitation on expanding outside the provinces where they are located, risk reserves requirements, and extension of advisory licenses (Chapter 5, clause 34).

Where a licensed investment advisor has contravened relevant laws, administrative rules, the Administrative Measures, or other CSRC regulations, the CSRC has at its disposal a range of regulatory tools. These include regulatory meetings, warning letters, rectification orders, or partial or total suspension of business. Where the contravention is committed by senior management personnel, apart from warning letters, regulatory meetings, and rectification orders, the CSRC may also identify them as being not fit and proper.

7. Transitional Arrangements

Institutions that are currently conducting Investment Advisory Activities are given one year from the effective date of the Administrative Measures to fulfill requirements thereunder, while existing shareholders of these institutions must meet the new shareholder requirements within five years. For institutions that currently engage in issuing research reports or offer advice in relation to high-risk assets to non-professional investors, these institutions must meet the corresponding requirements set forth in the Administrative Measures. Otherwise, they cannot take on new business and they are to cease business upon the expiry of their current business undertakings (Chapter 5, clause 36).

Lisa Cheng
Research Analyst
ICI Global

Alexa Lam
Chief Executive Officer, Asia Pacific
ICI Global

endnotes

[1] The Administrative Measures (available in Chinese) are available at:
http://www.csrc.gov.cn/pub/zjhpublic/zjh/202004/t20200417_373987.htm