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# The amended Securities Investment Funds Law - significant changes but more expected

The year 2003 was significant to the development of China's securities industry because it witnessed the promulgation of the PRC Securities Investment Funds Law, which came into effect on 1 June 2004 (**2003 Law**). While the promulgation of the 2003 Law has contributed to the accelerated development of China's asset management sector and capital market in the last decade, it has been outgrown by the industry and its amendment is long overdue.

The top legislator in China has started the amendment initiative since 2009 when it was written into the national legislative plan and a special group was established by the Financial and Economic Commission of National People's Congress (**NPC**) to work on the drafting. On 6 July 2012, the *Consultation Draft on the Amendments to the Securities Investment Funds Law* (**Consultation Draft**) was published for public comment.

After three rounds of review, the Standing Committee of the National People's Congress finally approved the *Amended Securities Investment Funds Law* (**Amended Law**) on 28 December 2012, which will take effect as of 1 June 2013.

This briefing will discuss the key changes of the Amended Law and its implications.

## Key changes

The Amended Law is substantially different from the 2003 Law in that three new chapters (namely, "Non Publicly-offered Funds", "Fund Service Institutions" and "Fund Industry Association") have been added and 74 articles revised. The main changes are summarised below.

### Application scope expanded to regulate privately-placed securities investment funds

While only publicly-offered securities investment funds (**Publicly-offered Funds**) were regulated under the 2003 Law, the Amended Law has now expanded its application scope to cover privately-placed securities investment funds (**Privately-placed Fund**) as well . Privately-placed Funds investing in stocks of companies limited by shares, bonds and fund units which are publicly offered and other securities and derivatives as specified by the China Securities Regulatory Commission (**CSRC**) will be subject to the Amended Law. A separate chapter (Chapter 10) is introduced to provide detailed provisions applicable to Privately-placed Funds. Among others, the following key aspects are addressed:

## Key changes

- Application scope expanded to regulate Privately-placed Funds
- PE funds and VC funds still carved out
- Regulations on Publicly-offered Funds loosened
- Further investor-protection measures introduced
- Service providers gaining more support
- Self-regulatory organisations encouraged to play a more active role
- Potential impact on QDLPs

- Safe harbour for private placements

  The Amended Law has introduced an exemption from registration with CSRC for marketing a Privately-placed Fund, i.e., a fund the interests of which are offered via a private placement to less than 200 investors who satisfy certain qualification requirements to be separately promulgated by the CSRC. Such qualification requirements are expected to include minimum income/asset thresholds, minimum subscription and an evaluation of the investor's ability to understand and undertake the risks involved.

  Further, the Amended Law forbids Privately-placed Funds from raising funds by means of public media such as newspapers, radio, TV, and internet, or via lectures, report meetings, analysis meetings, telephones, faxes, emails or SMS.

- Registration of fund managers and filing requirement

  Managers of Privately-placed Funds must register with the fund industry association established according to the Amended Law. One without such registration is prohibited from using the terms such as "fund", "fund management" or other similar terms in its name to carry out securities investment activities. Based on our understanding, the fund industry association should refer to the national Asset Management Association of China ("**AMAC**") which was established in 2012 and sponsored by CSRC.

  In addition, Privately-placed Fund managers must file with the fund industry association upon the completion of a fund-raising. For Privately-placed Funds that have exceeded certain size or number of investors, the national fund industry association will report the relevant information to CSRC. The thresholds for fund size and number of investors to trigger such reporting requirement and the kind of information that will need to be reported to CSRC are yet unknown.

- Custody requirement

  A custodian must be engaged to handle assets custody unless otherwise agreed in the relevant fund contract.

Historically, as the 2003 Law only applied to publicly offered mutual funds, private funds in China have long been unrecognised and operated in a regulatory grey area. The legal recognition of Privately-placed Funds and the introduction of a private placement "safe harbour" under the Amended Law is therefore a great break-through.

While the Amended Law effectively recognises the legitimacy of hedge funds, it takes a relatively "light" regulatory approach. On the one hand, the regulatory framework respects the free operations of Privately-placed Funds, and on the other, it mitigates risks in connection with illegal fund-raising, fraud and unfair competition. Many market participants do believe that the Amended Law will promote the development of the funds industry in China, including the hedge funds sector.

## Private equity (PE) funds and venture capital (VC) funds still carved out

The decision of whether to include PE funds and VC funds under the Amended Law has undergone prolonged debate among various stake-holders including market players, industry self-regulatory organisations and the regulators themselves. Voices that support the inclusion of PE/VC funds under a unified "Investment Funds Law" rather than a "Securities Investment Funds Law" have long persisted. Supporters of the unified regime hold the view that PE/VC funds should not be carved out simply because they invest in private equities, but objectors contest that PE/VC funds should be subject to a separate "regulation-lite" regime, supplemented by industry self regulation.

The Consultation Draft also revealed the regulators' intention to cover PE/VC funds under the Amended Law. However, the approach taken by the Consultation Draft turned out to be rather conservative, which was to interpret "securities" to cover equity in non-listed PRC companies limited by shares (**CLS**). Accordingly, if PE/VC funds invest in shares of unlisted CLS, they would also fall within the regulatory domain of CSRC. This has been strongly resisted by the PE and VC industry. Twenty-five industry self-regulatory organisations representing a large number of market-players have jointly made submissions to the NPC's Standing Committee to express their objection. Their key concern was that the PE/VC funds may be "over-regulated" by CSRC. In addition, as the National Development and Reform Commission (**NDRC**) is currently the key regulator of PE/VC funds, the introduction of another regulator would complicate the regulatory framework and hamper the development of the PE/VC industry.

With a view to striking a balance among various regulators (especially between CSRC and NDRC), the legislator eventually decided to carve out PE/VC funds from the Amended Law. Ms. Wu Xiaoling, the Vice-Chairman of NPC's Financial and Economic Commission who played a key role in the drafting of the Amended Law, has publicly commented that it was unfortunate to have excluded PE/VC funds from the Amended Law as a result of the misunderstanding of the legislator's intention by the industry.

## Regulations on Publicly-offered Funds loosened

To promote innovation and competitiveness of publicly-offered mutual funds, the Amended Law has relaxed requirements for Publicly-offered Funds in areas such as market access, investment scope and business operations. The key relaxations include:

- Removal of the need for CSRC's approvals in respect of (i) the qualification of fund managers and custodians; (ii) establishment of branches of fund managers; (iii) change of shareholders of fund managers with no more than 5% shares; and (iv) amendment of the articles of association of fund managers.
- Fund-raising is now only subject to prior registration with CSRC and prior CSRC approval is no longer required.
- Fund managers can implement share plans for professional persons and set up long-term incentive and restraint schemes.
- Investment scope is expanded to cover derivatives as specified by CSRC, which will provide the legal basis for investment in the futures market and in stock index futures.
- Restrictions over affiliated transactions and securities trading by the staff of fund managers are relaxed.

The Amended Law has also left room to enable asset managers other than CSRC-licensed fund management companies to engage in the management of Publicly-offered Funds and to allow financial institutions other than commercial banks to conduct custody business. In response to this, CSRC published the consultation draft of the *Interim Provisions on the Publicly-Offered Securities Investment Funds Management Business Conducted by Asset Management Institutions* on 30 December 2012, which was intended to allow securities companies, managers of Privately-placed Funds and insurance fund management companies to directly engage in the management business of Publicly-offered Funds. CSRC intends to improve competitiveness and diversify investors' options by enabling different types of asset managers to manage Publicly-offered Funds.

## Further investor-protection measures introduced

To uphold the fundamental spirit of investor-protection, the Amended Law also tightens control over operational risks, strengthen supervision and regulation and enhance the sanction regime. For example, the following additional restrictions have been imposed on Publicly-offered Funds:

- Both shareholders and the actual controllers of the fund managers will be regulated.
- Fund managers and their employees are prohibited from, among other things, insider trading and interest transfer.
- Fund managers and fund custodians should draw risk reserve funds from the relevant remunerations which will be used in priority to pay the indemnity against fund assets or fund unit-holders.
- Enforcement and sanction measures are further enriched. Risk resolution measures, such as receivership, custody and termination, are now made available to fund managers.

Moreover, the Amended Law introduces a "second unit-holders' meeting" mechanism which is intended to facilitate the unit-holders' meetings. Specifically, if the number of attendees of a unit-holders' meeting is fewer than that representing a half of the fund units which is the statutory quorum, a second unit-holders' meeting with the same agenda can be held within six months and the quorum can be reduced to that representing only a third of the fund units. Such mechanism will make convening a unit-holders' meeting much easier in practice and therefore provide more opportunities to fund unit-holders to gain an insight into the fund operations and to better supervise fund managers and fund custodians.

### Service providers gaining more support

The Amended Law permits fund managers to outsource all non-core businesses (i.e., those irrelevant to investment decision-making) to service providers in fund sales, payment, fund units registration, valuation, appraisal, IT support, legal and auditing, etc. By virtue of the wide participation of various service providers, the legislator expects to see a more mature fund market with specialized divisions, so that fund managers may better focus on what they are good at and develop more products. Meanwhile, service providers will be able to act as "doorkeepers" through their independent roles to ensure that the funds operate in a secure, lawful and transparent manner.

### Self-regulatory organisations encouraged to play a more active role

The Amended Law introduces a standalone chapter to address the nature, structure and duties of self-regulatory organisations (i.e., fund industry association). Fund managers and fund custodians must join the fund industry association as members and service providers may join voluntarily. Since Privately-placed Funds will largely be self-regulatory, the fund industry association is specifically required to take charge of the registration of fund managers and the filing of Privately-placed Funds. It is hoped that, with clear regulations, the fund industry association will be able to promote orderly operations of the entire fund industry and thereby reduce government intervention.

### Potential impact on QDLPs

It has been reported that the Shanghai municipal government is rolling out a pilot Qualified Domestic Limited Partners (**QDLP**) programme to permit approved international hedge fund managers , to set up onshore funds and raise RMB capital from domestic institutional and individual investors. The RMB funds may invest in overseas securities markets, and will be required, among other things, to be registered with the Shanghai regulators.

Under the Amended Law, it is expressly provided in Article 153 that onshore fund-raising for overseas securities investment and onshore securities investment by QFIIs must be approved by CSRC based on specific rules promulgated or to be promulgated by CSRC and other relevant regulators, upon the approval of the State Council. It appears that the QDLP program may be subject to the approval requirement under the Amended Law, but it remains uncertain whether or how the Amended Law will impact the QDLP program.

## Conclusion

The Amended Law, for the first time, establishes a legal framework for Privately-placed Funds and represents a milestone in PRC fund industry. It is anticipated that the Amended Law, when effective, will boost the growth and expansion of Privately-placed Funds including the "hedge funds" industry in China. However, since PE funds and VC funds are still subject to a separate regulatory regime, the Amended Law may continue to evolve.

## Contacts

**Yang TieCheng**
Partner
E: tiecheng.yang@cliffordchance.com

**Ying White**
Partner
E: ying.white@cliffordchance.com

**Mark Shipman**
Partner
E: mark.shipman@cliffordchance.com

**Ge Yin**
Senior Associate
E: yin.ge@cliffordchance.com



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Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong



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