

# The Offering of Hong Kong Funds in the Mainland under the Mutual Recognition of Funds

On 22 May 2015, the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (SFC) jointly announced the decision to embark on the long-awaited mutual recognition of funds scheme (MRF). MRF will be implemented on 1 July 2015, and its initial quota is set at RMB300 billion for each of the Hong Kong and Mainland funds. From China's perspective, the MRF represents a big step to open up its capital market and to further its ambition to introduce international competition with a view to developing domestic fund management institutions. Along with the announcement, CSRC and SFC respectively issued the *Provisional Rules for Recognised Hong Kong Funds* (CSRC Rules) and the *Mutual Recognition of Funds between the Mainland and Hong Kong* (SFC Circular) which set out the principles and the mode for operating the MRF. This briefing aims to provide an overview of the key features of the MRF and focuses in particular on the CSRC Rules which regulate the offering of Hong Kong funds in the Mainland (i.e. the People's Republic of China). Please note that a separate briefing would be issued in due course to address and discuss the offering of Mainland funds in Hong Kong under the MRF.

## Key issues

### General principles of MRF

- Streamlined authorization process
- Equal eligibility requirements on recognising funds
- Joint development of a regulatory standard for funds
- Provide more diverse fund products
- Enhance the competitiveness of fund management firms

Eligibility requirements on Hong Kong funds, fund manager and investor

Registration and distribution of fund

Information disclosure

Regulatory enforcement and cooperation

Outstanding issues on quota allocation, account opening and foreign exchange

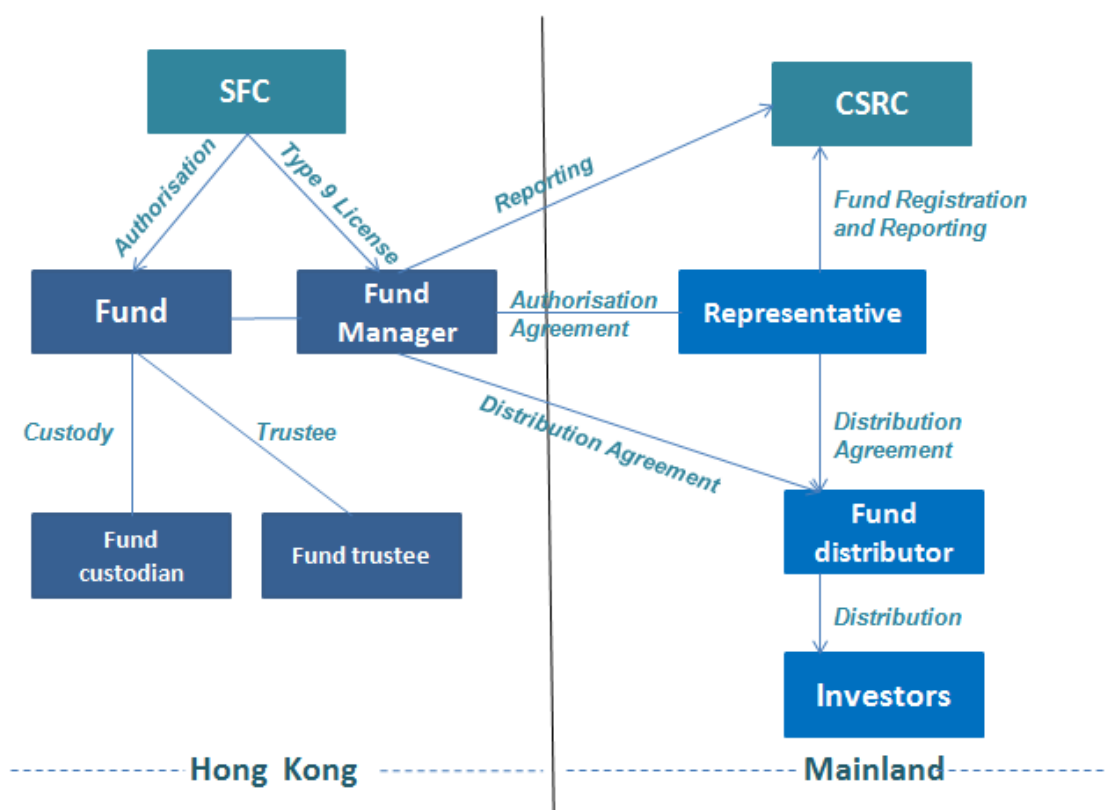
## General principles of MRF

In contrast to the more commonly-seen "passport" regime, MRF allows a fund that has been authorised by or registered with the relevant authority in one jurisdiction (Home Jurisdiction) to obtain authorization or approval from the regulator in the other jurisdiction (Host Jurisdiction) so as to offer to the public in the Host Jurisdiction. According to the SFC Circular, the following general principles must be observed at all times:

1. the fund should meet the eligibility requirements released by the relevant authority in the Host Jurisdiction from time to time;
2. the fund should remain authorised by or registered with the relevant regulator in the Home Jurisdiction and is allowed to be marketed to the public within the Home Jurisdiction;
3. the fund should generally operate and be managed in accordance with the relevant laws and regulations of the Home Jurisdiction and its constitutive documents;
4. the sale and distribution of the fund in the Host Jurisdiction must comply with the applicable laws and regulations of the Host Jurisdiction;
5. the fund will comply with the additional rules released by the relevant authority in the Host Jurisdiction governing the authorization or registration, post-authorization and ongoing compliance, and the sale and distribution of the fund in the Host Jurisdiction; and
6. the fund manager must ensure investors in both the Home Jurisdiction and Host Jurisdiction receive fair and the same treatment, including in respect of investor protection, exercise of rights, compensation and disclosure of information.

We set out below a chart followed by a detailed discussion on the recognition of publicly-offered Hong Kong funds in the Mainland. As CSRC and SFC have reached consensus to establish equivalent recognition thresholds and ensure fair treatment between Hong Kong and Mainland investors, these key arrangements will apply *mutatis mutandis* to publicly-offered Mainland funds in the SFC authorization and their distribution in Hong Kong.

## Overview of the recognition & distribution of Hong Kong Funds in the Mainland



### Eligibility requirements

At the current stage of the MRF, only a qualified publicly-offered Hong Kong fund may be recognised by CSRC (**Recognised Hong Kong Fund**) to be offered publicly to Mainland investors. The eligibility requirements for the fund itself, the Hong Kong fund manager (**Fund Manager**) operating the fund and the investor are set out below.

#### Requirements on the Hong Kong fund:

1. *Domicile and approval from SFC:* the fund is established and operates in Hong Kong in accordance with the laws and regulations of Hong Kong. It is approved by SFC to be publicly-offered and is regulated by SFC. These criteria exclude funds that are publicly-offered in Hong Kong but domiciled in other jurisdictions, such as the UCTIS funds which are registered in Luxemburg;
2. *Custody and trustee arrangement:* the fund has a custody arrangement and its trustee and custodian must meet the qualification requirements imposed by SFC;

3. *Type of the funds*: the eligible funds are general equity funds, mixed funds, unlisted index funds and physical (i.e. not synthetic) index-tracking exchange traded funds;
4. *History and size of the fund*: the fund must have been established for more than one year, and it must have a minimum fund size of no less than RMB200 million or the equivalent in a foreign currency; and
5. *Investment destination and source of funds*: the fund must not primarily invest in the Mainland and the value of units in the fund sold to investors in the Mainland should not be more than 50% of the value of the fund's total assets. An issue arises here as to whether a Hong Kong Qualified Foreign Institutional Investor (**QFII**) or Renminbi QFII (**RQFII**) fund is eligible, and whether any concern arises on the PRC source of funding.

#### **Requirements on the fund manager:**

1. *License*: the Fund Manager is registered and operates in Hong Kong. It must hold a Hong Kong asset management license (i.e. Type 9 License);
2. *No delegation*: the Fund Manager has not delegated its investment management function to an *institution* in another country or region. Subject to further interpretation by CSRC, a partial delegation should not be permitted either, but the mere receipt of non-discretionary investment advice from non-Hong Kong advisors may be acceptable; and
3. *Track record*: the Fund Manager has not been subject to any material penalty by SFC in the past three years *or* since its date of establishment. The term "material" awaits further clarification by CSRC.

The fund manager is obliged to ensure that the Recognised Hong Kong Fund satisfies all relevant eligibility requirements such as the size and source of funds on an ongoing basis. Any deviation must be reported to CSRC in a timely manner and fund distribution in the Mainland must be suspended until the relevant requirements are met. If the type of funds or operation method undergoes any major change, the Fund Manager must suspend the funds distribution in the Mainland and submit a new application to CSRC for registration.

#### **Requirements on the investor:**

The MRF scheme makes publicly-offered Hong Kong funds available to Mainland retail investors. Presumably, institutional investors such as the Qualified Domestic Institutional Investors (**QDII**), the asset management schemes and the insurance funds, etc. may also subscribe for Recognised Hong Kong Funds, but this may require consent or coordination with other regulators in the Mainland. The Mainland has not yet introduced a "safe harbour" mechanism to allow any offshore fund (including a Hong Kong-domiciled fund) to be offered to Mainland qualified investors on a private placement basis.

## Key arrangements

### Fund registration

To take advantage of MRF, a qualified publicly-offered Hong Kong fund must apply to CSRC for registration as a Recognised Hong Kong Fund. Certain application documents are required for such registration, such as an application letter, the trust deed or articles of the fund, its prospectus and latest audited annual report, the authorization agreement with the Mainland representative, certificates to prove the qualification of the fund, the fund manager, the trustee, the custodian and the Mainland representative, a legal opinion issued by a qualified law firm, etc.. CSRC will review the applications in accordance with the *PRC Securities Investment Funds Law* and may consult with SFC in the review process.

### Authorization agreement

Since offshore fund managers are generally prohibited from conducting business in the Mainland, the CSRC Rules provide an authorization mechanism between the Fund Manager and a Mainland representative (**Representative**) whose role is to facilitate the registration and distribution of the Recognised Hong Kong Funds in the Mainland. The relevant requirements are:

1. The appointed Representative must have obtained the management or custody qualification in respect of publicly-offered funds from CSRC.
2. The authorization agreement must specify the content of the authorization as well as the rights and obligations of the Fund Manager and the Representative. The Representative will handle fund registration, information disclosure, distribution, data exchange, cash settlement, regulatory reporting, correspondence and communication, client service and supervision in accordance with the authorization. While the CSRC Rules are not as clear, CSRC's FAQ on the MRF published on 22 May 2015 suggests that the registration with CSRC should be handled by the Representative rather than the Fund Manager itself.
3. The obtaining of the authorization does not imply that the Fund Manager has been exempted from any of its statutory duties. Rather, the Fund Manager must exercise due diligence in appointing a Representative and must ensure that its duties are effectively performed by the Representative through continuous supervision and the conduct of periodical appraisals.

### Information disclosure

The CSRC Rules explicitly impose a number of information disclosure obligations on Fund Managers regarding the Recognised Hong Kong Funds. In particular, the following issues are worthy of attention:

1. The information disclosure documents, including but not limited to offering documents, net asset value announcements and regular financial reports must be compiled in accordance with the regulatory requirements of SFC and the constitutive documents of the Recognised Hong Kong Fund, unless otherwise set out in the CSRC Rules, such as where CSRC requires

additional content to be included in the offering documents. Such documents must be published or disclosed to Hong Kong and Mainland investors and regulators simultaneously.

2. Along with the offering documents, the Fund Manager must disclose the fund units offering announcement, which provide specific operation matters including account opening, clearing, registration as well as the time, channel and method of the offering. However, it is still unclear how and where such accounts should be opened and what the relevant settlement mechanism is. Detailed rules are anticipated for practical guidance.

### **Fund distribution**

The distribution of the Recognised Hong Kong Funds is subject to the CSRC Rules and the regulations relating to the publicly-offered Mainland funds. Both the Fund Manager and the Representative (with authorization) may take the initiative to engage fund distributors for the purpose of distributing the Recognised Hong Kong Fund in the Mainland.

1. The engaged fund distributors must have obtained fund distribution qualification from CSRC. The CSRC Rules did not indicate whether the Fund Manager, the Representative and distributors could be connected parties. This may be subject to further interpretation by CSRC and other regulatory practices. Where the Representative may also act as the fund distributor, proper and adequate segregation structure should be established to avoid potential conflict of interests.
2. Where the Fund Manager enters into distribution agreements with fund distributors, it must ensure that the Representative is able to perform relevant obligations under the authorization agreement. The Fund Manager, the Representative and the fund distributors must, in relation to the fund unit-holders, clearly stipulate the ongoing obligations such as the performance of anti-money laundering obligations and the allocation of responsibilities.
3. Both the fund distributors and the Fund Manager (by itself or by delegating to other institutions) may produce marketing materials for the Recognised Hong Kong Fund to be distributed in the Mainland. Regulatory compliance of the marketing materials produced by the Fund Manager must first be reviewed by the Representative and then filed with the local branch of CSRC at the main business place of the Representative within five working days since the date of the distribution or publication. Apart from the regular requirements on the accuracy and usage of simplified Chinese, it is especially required that the marketing materials clearly indicate that the Recognised Hong Kong Fund is established in accordance with Hong Kong laws and that the standard of the relevant activities must conform to Hong Kong laws and the applicable rules of SFC.

### **Regulatory enforcement and cooperation**

Generally speaking, SFC and CSRC will exercise their regulatory powers on the principle of territoriality as follows:

- SFC will be in charge of supervising the investment and operation of the Recognised Hong Kong Funds in Hong Kong, while CSRC will supervise the distribution, information disclosure and any non-compliant activities taking place in the Mainland as well as the performance of the Representatives.
- SFC and CSRC aim to establish a regulatory cooperation mechanism to ensure equal protection and to effectively protect the legitimate interests of fund unit-holders in Hong Kong and the Mainland.
- Notwithstanding the above, according to the CSRC Rules, CSRC may go beyond the borders to require a Fund Manager to explain any major regulatory matters and seek assistance from SFC on regulatory enforcement.

### Outstanding issues

The respective rules issued by CSRC and SFC have established the basic framework for implementing the MRF between the Mainland and Hong Kong. However, a number of outstanding issues still remain to be addressed. For example, it is not entirely clear how the initial quota of RMB300 billion would be allocated among the Recognised Hong Kong Funds, and whether it would be allocated at the Fund Manager level or rather to each respective fund. In addition, it remains unclear how the Mainland investors could open accounts for subscription, and whether they may invest in the Recognised Hong Kong Funds in RMB or other currencies. If they may invest in a foreign currency, how would the relevant foreign exchange conversion and settlement mechanism be arranged? Certain tax issues also remain to be clarified. In light of these uncertainties, it is hoped that CSRC and other relevant authorities such as the State Administration of Foreign Exchange and the People's Bank of China would issue further rules and interpretations to clarify these arrangements.

### Conclusion

The MRF between the Mainland and Hong Kong marks a big step forward in deepening their financial ties. Taking into account the considerable potential financial capabilities of investors in the Mainland and the experience and expertise available in Hong Kong, the MRF is expected to promote the competitiveness of the funds industry of both the Mainland and Hong Kong, and going forward, enhance the integration of the asset management industry in Asia.

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