Hong Kong: The Investment Fund Industry's Gateway to China

The QDII scheme enables PRC persons to invest in overseas financial products through QDII funds established by PRC banks and fund management companies. Limited in the types of investments which they can make, QDII funds may use SFC authorized funds to obtain global exposure. With applications to subscribe for 4 QDII investment funds reaching US$37 billion in September and October, 2007 alone, global investment managers should not ignore the possibility of establishing an SFC authorized fund platform to access the growing PRC market.

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For investment managers around the world, the race to capture market share in the People's Republic of China ("**PRC**") has begun. For anyone doubting the potential of this emerging market for wealth management:

- in September and October, 2007, 4 investment funds launched under the Qualified Domestic Institutional Investor ("**QDII**") scheme raised a combined total of RMB 120 billion (approximately US$16 billion);
- all 4 issues were heavily oversubscribed, often within the first day of the offer period; and
- aggregate actual subscription applications exceeded RMB 280 billion (approximately US$37 billion), more than twice the QDII quota allotted to these 4 funds.

QDII

The QDII scheme allocates foreign exchange investment quotas to qualified domestic institutional investors. These investors may, in turn, accept assets from PRC persons for investment and, subject to prescribed regulations, invest those assets into overseas financial products.

Banks

The China Banking Regulatory Commission ("**CBRC**") was the first to establish regulations for QDII, announcing on April 13, 2006 that qualified PRC banks with QDII allocation would be permitted to invest in fixed income and money market instruments. Since then, the CBRC has relaxed investment criteria, permitting in May, 2007 qualified PRC banks to invest assets of a sponsored QDII fund in securities which are listed, and funds which are authorized, in jurisdictions which have signed a Memorandum of Understanding ("**MOU**") with the CBRC.

The Hong Kong Securities and Futures Commission ("**SFC**") is currently the only securities regulator with whom the CBRC has signed an MOU. As a result, SFC authorized funds now serve as a crucial point of access for PRC banks with QDII quota wishing to gain exposure to global equities markets.

Fund Management Companies

Not to be left out, on June 20, 2007, the China Securities Regulatory Commission ("**CSRC**") announced regulations allowing qualifying fund management companies with QDII allocation to invest 100 per cent. of the net assets of a sponsored QDII fund in securities which are listed, and funds which are authorized, in jurisdictions whose regulators have signed an MOU with the CSRC.

As the SFC is one of the regulators with an MOU with the CSRC, SFC authorized funds are eligible investments for QDII funds established by qualifying PRC fund management companies.

Growth in AUM

Following the announcements of the CBRC and the CSRC earlier this year, retail interest in QDII products has been enormous. Against the backdrop of inflated domestic stock markets and the need to diversify investments, investment funds sponsored to take advantage of QDII allocations ("**QDII funds**") have been overwhelmed by subscriptions. In September and October this year alone, QDII funds have seen extraordinary investor demand.

China Southern Fund

A QDII fund sponsored by China Southern Fund Management Co. received more than RMB 49 billion (approximately US$6.6 billion) in subscriptions on the first day of its offer period. The fund's QDII initial quota was only RMB 15 billion (approximately US$2 billion), although this was subsequently increased to RMB 30 billion (approximately US$4 billion) due to the overwhelming demand.

China AMC Fund

A QDII fund sponsored by China AMC received RMB 63 billion (approximately US$8.5 billion) in subscriptions, more than double the QDII quota which had been allocated to the fund.

Harvest Fund

A QDII fund sponsored by Harvest Fund Management Co. received RMB 73.8 billion (approximately US$9.9 billion) in subscriptions, against a QDII quota of RMB 30 billion (approximately US$4 billion).

China International Fund

A QDII fund sponsored by China International Fund Management Co. received more than RMB 100 billion (approximately US$13.32 billion) in subscriptions on the first day of its offer period. The fund's QDII quota was RMB 30 billion (approximately US$4 billion).

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… an SFC authorized fund offers maximum flexibility in pursuing distribution channels in the PRC

Opportunities Ahead

For investment managers outside of the PRC, the QDII scheme presents opportunities to advise on the management of assets of a QDII fund and to manage those assets by offering investment funds into which QDII fund assets may be invested. In the latter case, whilst the establishment of a distribution partnership presents its own issues, the establishment of an SFC authorized fund offers an attractive point of entry into the PRC market.

SFC Funds Eligible as QDII Investments

As noted above, SFC authorized funds currently serve as a crucial point of access for PRC banks with QDII quotas to obtain global exposure to equities. Furthermore, SFC authorized funds are eligible investments for fund management companies with QDII quotas. Consequently, an SFC authorized fund offers maximum flexibility in pursuing PRC distribution.

SFC Funds Key to Untapped Bank QDII Quotas

To date, 21 PRC banks have received QDII allocations, with a combined QDII quota of US$16.1 billion. A large proportion of this quota remains unused.

SFC Funds Key To Distribution

PRC banks offer the widest retail distribution network in the PRC with approximately 80 per cent. of all fund sales taking place through bank branches.

Hong Kong Contingency

At the same time, Hong Kong investment funds account for approximately 2.7 per cent. of the global investment market, roughly comparable to Canada which trails at approximately 2.5 per cent. In the first half of 2007, the Hong Kong investment funds industry registered gross sales of US$20 billion and net sales of US$4 billion. As a result, SFC authorization brings with it not only access to the PRC market but also a major and growing global funds market in the form of Hong Kong.

SFC Authorization

The SFC is receptive to a range of different fund structures. There is no requirement for the fund to be domiciled in Hong Kong. Indeed, as at the end of March, 2007, approximately 51 per cent. of SFC authorized funds were domiciled in Luxembourg, 19 per cent. in the Cayman Islands, 17 per cent. in Ireland and 5 per cent. in Hong Kong.

To be authorized in Hong Kong, investment funds should comply with the Code on Unit Trusts and Mutual Funds ("**Mutual Fund Code**") or, in the case of specialized funds such as real estate investment trusts, other applicable codes. Broadly, to obtain authorization, overseas investment funds must satisfy the SFC on 2 matters:

- the suitability of their structural and operational requirements and investment restrictions; and
- the suitability of their investment manager.

Core Structure

In assessing the suitability of an investment fund's structural and operational requirements and investment restrictions, the SFC differentiates between investment funds domiciled in recognized jurisdictions ("**Recognized Jurisdiction Schemes**") and other investment funds.

Recognized Jurisdiction Schemes

Recognized Jurisdiction Schemes are investment funds regulated in recognized jurisdictions, namely France, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, the United Kingdom and the United States.

Recognized Jurisdiction Schemes are fast tracked and are reviewed by the SFC on the basis that the investment fund's structural and operational requirements and core investment restrictions already comply in substance with the Mutual Fund Code. However, the SFC expects recognized jurisdiction funds to comply in all material aspects with the Mutual Fund Code and reserves the right to require such compliance as a condition of authorization.

UCITS Investment Funds

UCITS investment funds regulated in Luxembourg, Ireland or the United Kingdom form a special category of Recognized Jurisdiction Schemes which may benefit from fast track authorization. However, UCITS investment funds which use financial derivatives instruments for investment purposes are subject to a higher degree of scrutiny.

Other Schemes

If an investment fund is not a Recognized Jurisdiction Scheme, authorization generally requires full compliance with the provisions of the Mutual Fund Code unless the SFC grants a waiver. For investment funds which have already been commercialized, compliance with the Mutual Fund Code may present hurdles, particularly where the existing constitutive documents do not comply substantially with the Mutual Fund Code.

Investment Manager

The SFC generally requires that the investment manager be based in a jurisdiction ("**AIR Jurisdiction**") with an acceptable inspection regime (currently Australia, France, Germany, Ireland, Hong Kong, Luxembourg, the United Kingdom and the United States). However, exemptions from this requirement may be granted on a case by case basis.

A sub-manager to whom the investment manager delegates investment discretion need not be based in an AIR Jurisdiction provided that the sub-manager meets certain requirements, including that it be within the same corporate group as the investment manager, that it have internal controls commensurate with those expected under the Mutual Fund Code, and that it be regulated in its jurisdiction of operation. ■

TIMOTHY LOH, SOLICITORS serves as Hong Kong and International Legal Counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.