

Mutual Fund Recognition Scheme Further Opens China's Financial Markets

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact **Christopher W. Betts**, 852.3740.4827, christopher.betts@skadden.com or call your regular Skadden contact.

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42/F, Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong
852.3740.4700

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

The liberalization of China's financial markets continues at a rapid pace. For April and May 2015, the combined average daily value of trade on China's stock exchanges¹ was around US\$150 billion, compared to around US\$40 billion for the New York Stock Exchange and under US\$10 billion for the London Stock Exchange. This significant growth trade has been driven in large part by the adoption of the Shanghai-Hong Kong Stock Connect program. (See "[Shanghai-HK Connect Opens Possibilities for Companies Looking to Tap Chinese Investor Demand](#).")

Building on the success of the Shanghai-Hong Kong Stock Connect, on May 22, 2015, the Securities and Futures Commission of Hong Kong (SFC) and the China Securities Regulatory Commission (CSRC) signed the Memorandum of Regulatory Cooperation on Mainland-Hong Kong Mutual Recognition of Funds (MRF). The framework will allow qualified mainland Chinese and Hong Kong fund managers to offer eligible funds to retail investors in each other's market — effectively giving Hong Kong fund managers direct access to a large part of what the World Bank estimates is in the vicinity of US\$5 trillion in Chinese gross national savings. The scheme will take effect on July 1, 2015.

To begin with, only general equity funds, bond funds, mixed funds, unlisted index funds and physical index-tracking exchange-traded funds will be eligible, though the SFC and CSRC have indicated that they may consider extending the MRF scheme to include other types of products in the future. Fund flows between Hong Kong and mainland China also will be initially capped at RMB300 billion each way.

For a Hong Kong fund to be eligible to seek CSRC registration for distribution into mainland China, its management company: (1) must be licensed by the SFC to conduct Type 9 (Asset Management) regulated activities, (2) must not delegate its investment management activities to entities outside Hong Kong, and (3) must not have been subject to any major regulatory action in the preceding three years or since inception. The management company also must appoint a mainland China-based agent, which must be an entity that has been approved by the CSRC to perform fund management or custodial activities and manage its domestic Chinese operations, including registration with the CSRC, distribution and settlement, and reporting to the CSRC. Furthermore, the fund itself must:

- be authorized by the SFC;
- be established, operated and publicly distributed in accordance with Hong Kong laws and regulations;
- have a trustee/custodian that meets the SFC's regulatory requirements;
- have a track record of at least one year, with no less than RMB200 million in assets under management (or foreign currency equivalent);
- not primarily invest in the mainland market; and
- offer no more than 50 percent of the value of its fund to mainland Chinese investors.

The CSRC has issued the Provisional Rules for the Administration of the MRF, pursuant to which eligible Hong Kong funds may apply to the CSRC for registration starting July 1, 2015. The application must be accompanied by the documents prescribed in the provisional rules, which include the constitutive documents of the fund, the offering document and product disclosure statement, a legal opinion from a Hong Kong law firm on the authorization status of the fund and its management company, the most recent

¹ Including the Hong Kong, Shanghai, Shenzhen stock exchanges.

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audited annual report and the agency agreement entered into with the mainland Chinese agent.

While the fund-offering document can follow the same form as used in Hong Kong, it must be supplemented with disclosure covering, among other things:

- risk factors and information specific to the mutual recognition of the fund under the MRF scheme;
- the types, timing and means of fund disclosures to mainland Chinese investors;
- the rights and obligations of investors, including the procedures and requirements of investor meetings, the grounds on which fund documents may be terminated and a dispute resolution mechanism;
- any other material differences between mainland Chinese investors' rights compared to their Hong Kong counterparts.

One point not addressed in the memorandum of cooperation or provisional rules is whether mainland Chinese investors can

subscribe for Hong Kong funds in foreign currencies, or whether only renminbi subscriptions are permitted, leaving the finer details on how funds will expatriate subscription monies for foreign investment (which must remain the focus of the fund) to a later date.

The CSRC and SFC also have signed a memorandum on cross-border regulation and enforcement to ensure that mainland Chinese and Hong Kong investors (under both the Shanghai-HK Stock Connect and MRF scheme) will receive equal protection, and we understand from comments made by the chief executive of the SFC in a recent public forum that the first joint investigation has commenced under the auspices of this memorandum.

The MRF represents another watershed moment in the opening up of China's financial markets, not only providing more diverse fund investment products to mainland and Hong Kong investors but also expanding business opportunities for mainland Chinese and, perhaps more significantly, fund managers licensed in Hong Kong.