

June 2015

*Practice Group:*

*Investment  
Management, Hedge  
Funds and  
Alternative  
Investments*

## Launch of Mutual Recognition of Funds Between Mainland China and Hong Kong

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On 22 May 2015, the Securities and Futures Commission of Hong Kong (SFC) and the China Securities Regulatory Commission (CSRC) signed a Memorandum of Regulatory Cooperation on Mainland-Hong Kong Recognition of Funds, which will enable Mainland Chinese and Hong Kong funds to be distributed in each other's markets through a streamlined vetting process (Mutual Fund Recognition Scheme). The Mutual Fund Recognition Scheme will be subject to an initial aggregate net quota of RMB300 million each way and will go into effect on 1 July 2015.

Once the Mutual Fund Recognition Scheme is in effect, eligible Mainland Chinese and Hong Kong funds will be able, upon successful registration with the relevant regulator through a streamlined vetting process, to offer the fund to retail investors in each other's market. Of key interest to non-Mainland Chinese fund managers will be their ability to enter the Mainland Chinese retail funds market through Hong Kong (Northbound Selling).

### Eligibility Requirements for Northbound Selling

The CSRC has issued the "Provisional Rules for Recognised Hong Kong Funds" (Provisional Rules), which set out the eligibility requirements for Hong Kong funds seeking to conduct Northbound Selling. Hong Kong funds meeting the eligibility requirements under the Provisional Rules registered with the CSRC will be able to engage in Northbound Selling once they have registered with the CSRC (Registered Fund).

#### *Eligible Fund Types*

According to the Provisional Rules, only equity funds, mixed funds, bond funds and index funds (including exchange-traded funds) would be eligible for Northbound Selling under the Mutual Fund Recognition Scheme.

#### *Eligibility Requirements Applicable to the Fund*

According to the Provisional Rules, Hong Kong funds seeking registration with the CSRC under the Mutual Fund Recognition Scheme must fulfil the following key requirements:

- the fund must be incorporated in Hong Kong and operated in accordance with Hong Kong law
- the fund must be authorized and regulated by the SFC
- the fund must adopt a trust structure, and the fund's trustee and/or custodian must comply with the SFC's eligibility requirements
- the fund must have been established for more than one year
- the fund must have a minimum fund size of not less than RMB200 million (US\$32.3 million) (or the equivalent in any other currency)
- the fund must not invest primarily in the Mainland Chinese market

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- the value of shares or units in the fund sold in Mainland China to Mainland Chinese investors must not constitute more than 50 percent of the value of the fund's total assets.

### *Eligibility Requirements Applicable to the Fund's Investment Manager*

The Provisional Rules provide that the investment manager (Investment Manager) of a Hong Kong fund seeking registration with the CSRC under the Mutual Fund Recognition Scheme:

- must be registered and operate in Hong Kong
- must hold a Type 9 (Asset Management) licence issued by the SFC
- must not have delegated its management duties to a non-Hong Kong entity or institution.
- must not have been subject to major disciplinary action from the SFC during the past three years or since the date of its incorporation (if incorporated for less than three years).

### **Operational Requirements for Northbound Selling**

A key aspect of the Mutual Fund Recognition Scheme would be its reliance upon the substantial rules and regulations of the fund's home jurisdiction.

Under the Provisional Rules, the main operations of a Registered Fund (such as the investment activities, subscriptions and redemptions, fees and tax issues) as well as the form, substance and disclosure arrangements of the disclosure documents of a Registered Fund (such as the offering circular, fund product information and periodic financial reports of the fund) will continue to be regulated by the regulations and requirements of the SFC and Hong Kong laws generally, as well as the provisions of the fund's constitutive documents.

However, the sale and distribution of Registered Funds through Northbound Selling will be governed by the laws and regulations of Mainland China.

Set out below are some additional key operational requirements contained in the Provisional Rules.

### *Appointment of Mainland Agent*

The Investment Manager must appoint an agent in Mainland China to carry out the fund's operations in Mainland China (Agent). The Agent must be an institution duly licensed by the CSRC to manage a publicly offered fund or to provide fund custodian services in Mainland China.

The duties and responsibilities of the Agent include, among others:

- registration of the fund with the CSRC
- ensuring compliance of the marketing and promotional materials of the Registered Fund with the Provisional Rules
- conducting data reconciliation with the distribution agent of the Registered Fund, through a platform designated by the CSRC
- disclosure of information through designated newspapers or through the website of the Agent.

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- sale and distribution of the fund
- settlement of payments
- regulatory reporting
- liaison and communications, customer service, monitoring and general supervision.

### *Distribution of Fund Units*

The distribution of the units of a Registered Fund through Northbound Selling must be carried out by a distribution agent qualified in the PRC to conduct sales of fund units. Either the Investment Manager or the Agent may enter into the distribution agreement with the distribution agent.

The following information should be publicly disclosed in CSRC approved newspapers or through the website of the agent at least three days before the offering of units in the Registered Fund.

1. Offering circular.
2. Key facts statement of the Registered Fund.
3. Announcement on the offering of units in the Registered Fund.
4. Trust deed or articles of association of the Registered Fund.
5. Latest audited annual and semi-annual reports of the Registered Fund.

### **The Offering Circular**

The offering circular of a Registered Fund must be approved by the SFC and must meet certain content requirements, including the following (among other things).

1. Risk factors and specific statements in relation to the Registered Fund.
2. The type, timing, and method of distribution of disclosure documents of the Registered Fund in Mainland China, including the location of these documents, and the method through which these documents may be available for inspection.
3. The rights and obligations relating to the Investment Manager; the rules and regulations relating to meetings of fund investors; and the grounds and procedures for the termination of fund documents and dispute resolution provisions.
4. Material differences between the rights of Hong Kong investors and Mainland Chinese investors.
5. Any other information that would materially affect Mainland Chinese investors.

### **The Key Facts Statement**

The key facts statement of a Registered Fund must be approved by the SFC and, additionally, requires disclosure of information about the risk factors and specific statements in relation to the Registered Fund.

### **Marketing and Promotional Materials**

Marketing and promotional materials of a Registered Fund must be submitted to the CSRC within five working days of its distribution to the public in Mainland China.

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Marketing and promotional materials of a Registered Fund distributed or released to the public in Mainland China shall be comprehensive, accurate, clear and effective, and shall clearly state that the Registered Fund was established according to the laws of Hong Kong, and that its investment operations and information disclosure shall be regulated by Hong Kong laws and the rules and regulations of the SFC.

### *Investor Protection*

The Investment Manager will be required to adopt reasonable procedures to ensure equal treatment between Hong Kong investors and Mainland Chinese investors in relation to investor protection, the exercise of investors' rights, the disclosure of information and compensation.

### *Language of Disclosure Documents*

According to the Provisional Rules, all relevant documents to be disclosed in Mainland China, submitted to the CSRC, or distributed to the public in Mainland China shall be written in Simplified Chinese. For source documents that are written in English, a true, accurate and complete translation of the document into Simplified Chinese should be provided.

## Application

According to the Provisional Rules, a Hong Kong fund seeking registration with the CSRC under the Mutual Fund Recognition Scheme would need to submit the following documents to the CSRC.

1. An application.
2. The trust deed or the articles of association of the fund.
3. The offering circular and product information of the fund.
4. The latest audited annual report of the fund.
5. The agency agreement signed between the fund's investment manager and Agent.
6. Supporting documents evidencing that the fund, its investment manager, the custodian, the trustee, and the Agent has complied with the CSRC's requirements.
7. A legal opinion regarding the eligibility of a Hong Kong fund to participate in the Mutual Fund Recognition Scheme.
8. Any other documents as may be requested by the CSRC.

The aforementioned documents shall be written in Simplified Chinese. For those documents that are written in English, a true, accurate and complete translation of the document into Simplified Chinese should be provided.

If there are differences between the aforementioned documents and the corresponding versions approved by the SFC, the fund would need to clearly indicate to the CSRC the major differences and the reasons for such differences.

The Provisional Rules currently indicate that applications for registration with the CSRC under the Mutual Fund Recognition Scheme will likely be accepted beginning on 1 July 2015.

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### Quota

At a media briefing held on 22 May 2015, the SFC confirmed that the Mutual Fund Recognition Scheme will be subject to an initial aggregate net quota (i.e., for all funds) of RMB300 million applicable each way. Previous statements by Alexa Lam, deputy chief executive of the SFC, indicate that each Registered Fund will have individual quotas that would be calculated based on a set percentage of the amount of assets under management by a Registered Fund.

According to the SFC, the final rules on the management of quotas will be finalized by the State Administration of Foreign Exchange on 1 July 2015.

### Next Steps

Hong Kong and foreign funds and their managers intending to take advantage of the Mutual Fund Recognition Scheme for purposes of Northbound Selling should consider taking the following steps:

- reviewing and/or conducting due diligence of their current fund structure to ensure, among other things:
  - eligibility for the Mutual Fund Recognition Scheme. Among other things, many “Hong Kong” funds do not, in fact, qualify as Registered Funds for Northbound Selling in their current structure, as eligible Hong Kong funds must be incorporated in Hong Kong and have a track record of at least one year, and as some funds may already have a Mainland Chinese focus that may be substantial enough for them not to meet the requirement not to invest primarily in the Mainland Chinese market
  - suitability of their products for a Mainland Chinese market that may not be as sophisticated or developed as non-Mainland Chinese markets or may already have some exposure to the Mainland Chinese market, which may affect their product’s ability to comply with the requirement that it must not invest primarily in the Mainland Chinese market
  - that their overall group structure is capable of dealing with Mainland Chinese investors and the disclosures and additional compliance required as a result of becoming a Registered Fund for the purposes of Northbound Selling.
- establishing relationships with potential Agents and distribution agents in Mainland China as these parties will be responsible for registering and marketing the fund under the Mutual Fund Recognition Scheme with the CSRC
- working with seasoned advisers and service providers who are familiar with issues endemic to Hong Kong and Mainland China, among other things, authorised funds in Hong Kong, Hong Kong-incorporated companies, traditional and simplified Chinese translation and usage and Mainland Chinese tax withholding and capital gains tax applicable to trading of funds units

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- building a proper and skilled compliance team to monitor the Agent and to consider and deal with relevant disclosure, regulatory and compliance issues under both Hong Kong and Mainland Chinese laws
- as the quota appears preliminarily to be based on a set percentage of a fund's assets under management, funds and their investment managers should consider whether the quota they are likely to obtain for their fund will justify the business, legal, and compliance costs needed to participate in the Mutual Fund Recognition Scheme.

### Going Forward

The Mutual Fund Recognition Scheme is the next, long overdue step in the development of the Mainland Chinese funds market, providing international asset managers with a means to access a huge and previously untapped retail investor market in Mainland China, boosted by a growing middle class and a huge pool of domestic savings. Both non-Mainland Chinese investors through Hong Kong and Mainland Chinese investors will have access to a wider selection of fund products. By providing an avenue to convert domestic savings in Mainland China into cross-border investments, it will expand the cross-border flows of Renminbi (RMB) and facilitate China's efforts to open up its capital markets and internationalise the RMB.

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