FMC Measures for Consultation: Impacts on WFOE FMC Application and Business Operation in China

By Sandra Lu

The Administrative Measures on Securities Investment Fund Management Companies (the "**2012 FMC Measures**") which came into effect on November 1, 2012, is the primary rule governing the establishment procedures, business operation, and corporate governance of retail fund management institutions.

On July 31, 2020, China Securities Regulatory Commission ("**CSRC**") consults for public comments regarding the *Measures on the Supervision and Administration of Retail Fund Management Institutions (Draft for Consultation)* and its accessory rules (the "**FMC Measures for Consultation**"). The FMC Measures for Consultation overhauls the 2012 FMC Measures, and has a profound effect on the development of the Chinese retail fund industry. The comments can be sent to jigoubu@csrc.gov.cn and the period of consultation for public comments will expire on August 30, 2020.

On April 1, 2020, CSRC allows eligible foreign financial institutions to set up wholly foreign-owned fund management companies (the "**WFOE FMC**"). As of the date of this article, BlackRock, Neuberger Berman, and Fidelity International have applied to CSRC for WFOE FMC set-up, according to information disclosed on CSRC website. The FMC Measures for Consultation will impose a substantial impact on WFOE FMC application and its business operation in China. This article gives analysis concerning the impacts of the FMC Measures for Consultation on WFOE FMC.

1. Shareholder eligibility requirements of WFOE FMC

Only foreign asset management institutions that satisfy CSRC regulatory requirements may apply for WFOE FMC set-up in China. The FMC Measures for Consultation makes a substantial revision of the WFOE FMC shareholder eligibility requirements.

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Specifically, some of the revision eases the shareholder eligibility requirements, while most of the revisions do the opposite and raises the threshold of WFOE FMC shareholder eligibility.

Same to the 2012 FMC Measures, the FMC Measures for Consultation still requires the foreign shareholder of WFOE FMC to be a foreign financial institution with sufficient financial asset management capabilities, decent business performance, sound internal control mechanism and good integrity and compliance status; besides, the securities regulator of its country where it domiciles shall have entered into a memorandum of understanding in respect of securities regulatory cooperation with CSRC. Beyond the above-mentioned, the FMC Measures for Consultation raises some new requirements to both the primary shareholder and the foreign shareholder of FMC. Thus, the shareholder of WFOE FMC, as the sole and foreign shareholder of FMC, shall comply with all these new requirements. For example:

(1) The shareholder of WFOE FMC shall have good international reputation and decent business performance, the indicators like AUM, revenue, profit, market share of its financial asset management business in the preceding 3 years shall rank top globally. The FMC Measures for Consultation not only requires the WFOE FMC shareholder to have a decent business performance as a general principle, but also further specifies such "decent business performance" as "indicators like AUM, revenue, profit, market share of its financial asset management business in the preceding 3 years should rank top globally". This results in the threshold of the shareholder eligibility drastically increases, and only "top ranked" foreign asset management institutions may set up WFOE FMC in China. Therefore, such requirement, being one of the most significant changes of the FMC Measures for Consultation, may witness a decrease of eligible foreign shareholders.

(2) The shareholder of WFOE FMC shall have run for at least 3 complete fiscal years and be continuously profitable in the preceding 3 fiscal years; its net assets shall be no less than RMB200 million and no less than 50% of the paid-in capital; its contingent liabilities shall not reach 50% of the net assets and it shall be capable of paying all the debts falling due.

(3) The shareholder of WFOE FMC shall have sound corporate governance, effective risk management and control policies, and well-established internal control mechanism, it shall meet all statutory and regulatory indicators stipulated by the laws and the regulators of the jurisdiction where it domiciles in the preceding 3 years. The wording of "shall meet all statutory and regulatory indicators stipulated by the laws and the regulators of the jurisdiction where it domiciles in the preceding 3 years" is a general and broad requirement. Given that the shareholders of WFOE FMC are dispersed worldwide, subject to various regulatory requirements and foreign regulatory authorities have strengthened regulatory supervisions towards financial institutions, even top-ranked asset management institutions can hardly keep 100% compliance with all local regulatory indicators in the preceding 3 years. The *Administrative Measures on Foreign-funded Securities Companies* (currently in force) stipulates similarly that foreign shareholders of securities companies "shall meet all financial indicators stipulated by the laws and the regulators of the jurisdiction where it domiciles in the preceding 3 years". Such requirement under which only financial indicators, rather than all statutory indicators are assessed, seems more practical.

(4) The shareholder of WFOE FMC and the institutions controlled by WFOE FMC shall have good integrity and compliance records. The FMC Measures for Consultation stresses that, not only the shareholder of WFOE FMC shall have good integrity and compliance records, but all institutions controlled by the shareholder shall also have good integrity and compliance records. Foreign asset management institutions usually have a large number of subsidiaries. It is difficult to ensure that such subsidiaries all possess clean "integrity and compliance records", or to say have no record of violations of laws and regulations. Meanwhile, further clarification is needed as the FMC Measures for Consultation does not give a specific period which the integrity and compliance records cover.

(5) The shareholder of WFOE FMC shall not have any guarantee, litigation, arbitration or other material events that may severely affect the ongoing operation. This is newly stipulated by the FMC Measures for Consultation, by contrast, the 2012 FMC Measures only requires the foreign asset management institutions to disclose whether there is any material litigation or arbitration in application materials, rather than taking "not having material litigation, arbitration or guarantee" as one of the shareholder eligibility requirements. Once material litigation and arbitration are taken into account when review shareholder eligibility, there may be extensive statements in the WFOE FMC application materials, demonstrating relevant material litigation and arbitration and proving whether they "materially impact the ongoing business".

(6) The shareholder of WFOE FMC shall be capable of continuously making capital injection to support the FMC's business, and shall formulate rational and effective risk contingency plan for any business interruption of the FMC due to occurrence of risks (including without limitation to the primary shareholder of FMC providing liquidity-support plans, FMC proper exit and disposal plans). Such contents are newly added. On one hand, this emphasizes that the WFOE FMC shareholder shall be capable of continuously making capital injection to support WFOE FMC's business. This is out of the concern that if WFOE FMC suffers losses continually, resulting in capital deficiency, this may negatively impact the normal operation of WFOE FMC and prejudice the interests of fund investors. When the above-mentioned situations occur, the shareholder of WFOE FMC shall be capable of injecting capital into the WFOE FMC. On the other hand, the shareholder of WFOE FMC shall also formulate contingency plans regarding the WFOE FMC, which shall specify shareholders' liquidity-support plans for WFOE FMC to dissolve liquidity risk events of the WFOE FMC or retail funds under its management, and to ensure the WFOE FMC and the fund products to operate smoothly.

2. Requirements for the actual controller of WFOE FMC

The FMC Measures for Consultation not only raises requirements for the shareholder of WFOE FMC, but also for the actual controller (which is the actual controller of the shareholder) of the WFOE FMC. According to the *PRC Company Law,* "actual controller" refers to those who, not being the shareholder of the company, dominates the company behaviors through investment relationship, agreements, or other arrangements. In practice, for foreign institutions, the actual controller usually refers to certain legal entity at the highest/last layer tracing to the group level.

The FMC Measures for Consultation requires the actual controller of WFOE FMC to satisfy the following requirements:

(1) It shall not have any record of material violation of laws or regulations or material negative integrity record in the preceding 3 years;

(2) It shall not under such status where it has been penalized due to criminal liability and there has been no more than 3 years since the enforcement is completed;

(3) It shall not under the investigation due to suspected material violation of laws or regulations or during the rectification period;

(4) It shall have no such situations where it does not actually carry out any business for a long term, suspension of business, bankruptcy and liquidation, weak governance structure, failure of internal control and other conditions that may adversely affect the exercise of shareholder's rights and performance of shareholder's obligations;

(5) It shall not have any guarantee, litigation, arbitration or other material events that may severely affect the ongoing operation;

(6) Its shareholding structure shall be clear and can be penetrated each layer till the ultimate beneficiary owner; there shall be no wealth management product in any layer of the shareholding structure, unless otherwise recognized by CSRC;

(7) It shall not cause any material social doubt or result in any seriously negative social impact and the impact has not been eliminated due to dishonesty or violation of regulations;

(8) It shall have no such situations where it bears significant responsibilities for the failure of operation of any invested company and there has been no more than 3 years since such failure;

(9) It shall not appropriate the clients' assets or conduct other malpractices that may prejudice the clients' interests;

(10) It shall have practicable and feasible plan on optimizing the governance of the FMC and propelling the long-term development of the FMC;

(11) It shall be capable of continuously making capital injection to support the FMC's business;

(12) It shall establish a clear self-discipline mechanism to ensure the independence of the FMC's business management, prevent risk contagion and tunneling, etc.;

(13) It shall formulate rational and effective risk contingency plan for any business interruption of the FMC due to occurrence of risks;

(14) Its net assets shall be no less than 50% of the paid-in capital;

(15) Its contingent liabilities shall not reach 50% of the net assets;

(16) It shall be capable of paying all the debts falling due.

3. Requirements for WFOE FMC

There are not many substantial changes to requirements of WFOE FMC itself. The main changes are about personnel, requiring that there shall be no less than 30 people engaging in research, investment, operation, sales, compliance and other business. By contrast, 2012 FMC Measures only requires for 15.

4. WFOE FMC application materials and procedures

The FMC Measures for Consultation revises substantially regarding the eligibility requirements for the shareholder and actual controller of WFOE FMC. Application materials for WFOE FMC setup may also be substantially adjusted accordingly in response to the newly revised measures.

The FMC Measures for Consultation stipulates that, before submission of the application materials for FMC set-up, the applicant may communicate with CSRC. Such advance communication procedure may facilitate a more expedite communication channel between CSRC and the shareholder of WFOE FMC to communicate about the shareholder eligibility requirements and relevant application details.

The FMC Measures for Consultation further stipulates that, the foreign shareholder shall apply to set up the WFOE FMC, obtain business license and complete preparatory work within 6 months upon CSRC's approval of the set-up of WFOE FMC. WFOE FMC may obtain the license to operate securities business only upon passing the onsite inspections. This is the first time CSRC stipulates in relevant rules that the FMC preparation period is 6 months. There was no such specific requirement as to the FMC preparation period written in CSRC's rules.

As to the WFOE FMC application materials, the FMC Measures for Consultation further stipulates that, If an FMC, its shareholder(s), the actual controller of the shareholder(s) conceal relevant information or provide false materials in applying for approval of relevant matters, CSRC shall not accept such application; if such application has been accepted, CSRC shall not approve such application, and will give a warning and stop accepting applications for relevant regulatory approval in the next 12 months. This is the first time where relevant rules stipulate such 12-months freezing interval.

5. Lock-up period

The FMC Measures for Consultation further stipulates that the primary shareholder shall give written commitment that it will hold the equity interest of FMC for more than 48 months. The shareholder of FMC shall abide by the 48-months lock-up period. However, the FMC Measures for Consultation also stipulates that, the intra-group transfer of equity interest of WFOE FMC is exempted from such lock-up period requirement. It facilitates foreign asset management institutions to make flexible arrangement about holding equity interests of WFOE FMC. But whatsoever, the transferee acquiring the equity interests shall meet relevant requirements for being a shareholder of WFOE FMC.

6. Enhancement of the duties of the independent directors

The FMC Measures for Consultation stipulates that there shall be at least 3 independent directors taking up no less than 1/3 of the board of directors of an FMC, which is in line with the 2012 FMC Measures. However, the FMC Measures for Consultation further stipulates that, for FMCs with only one shareholder, the independent directors shall take up no less than 1/2 of the board of directors. Accordingly, if the number of directors is even, the number of independent directors may equal to the number of non-independent directors; otherwise, the number of independent directors will be greater than that of non-independent directors.

Meanwhile, the FMC Measures for Consultation stipulates that, there shall be at least 1 independent director in each special committee set under the board of directors. This coincides with the practice of most FMCs. In most of existing FMCs, the special committees under the board of directors have independent directors serving as committee members.

More importantly, the FMC Measures for Consultation sets out new requirements on independent directors to pay close attention to the following matters:

(1) Whether the management and operation of the entrusted assets has prejudiced or may prejudice the legitimate rights and interests of fund unitholders;

(2) Whether the information disclosed by regular/interim reports of retail funds are true, accurate and complete, and whether there is any falsehood, misleading statement or material omission in the disclosed information;

(3) Whether the expenses of the entrusted assets, including without limitation the allocation of brokerage commissions, expense of information disclosure and reporting, as well as legal, accounting, other intermediary fees, are true, fair and accurate;

(4) The appointment and dismissal of senior management personnel;

(5) Assurance of the company's compliance performance;

(6) Equity incentive plan;

(7) Changes in the company's shareholding structure and the actual controller;

(8) Substantial amendments to articles of association;

(9) The establishment, member appointments, and formulation of procedure rules of the special committee under the board of director;

(10) Events that may cause material loss or business risks to the company;

(11) Events that may prejudice legitimate rights and interests of minority shareholders;

(12) Other events that may prejudice the legitimate interests of unitholders.

One challenge that all FMCs, including WFOE FMC, face is how to create conditions for independent directors to pay special attention to, look into and inquiry into the above-mentioned matters. To urge independent directors to duly perform their duties, the FMC Measures for Consultation requires the FMC to disclose the independent director's report on performance of duties within 3 months following the end of each year, which shall cover, without limitation, the independent directors' performance of duties and votes on matters under the review of the board of directors, etc.

7. Evaluation of the management personnel

The FMC Measures for Consultation places special emphasis that, the evaluation by the board of directors on the management personnel shall be tied to the elements protecting the interests of fund unitholders such as long-term investment performance of funds, compliance and risk control status, professional ethics levels, whereas the short-term asset under management of funds, earning growth, etc., shall not be the core evaluation criteria. To make it clear, the term "long-term investment performance" herein refers to the investment performance for the preceding five or more years, avoiding use of a single indicator and less stressing the relative ranking.

8. Retail fund management license application for WFOE PFM

As of the date of this article, up to 27 foreign asset management institutions have been licensed as WFOE PFM, this enables them to offer private funds to qualified investors. Previously, there have been discussion among institutions about the feasibility and implementation plan regarding the "conversion from PFM to FMC" scheme. The FMC Measures for Consultation specifies the approach for WFOE PFM to obtain retail fund management license, however, with rigorous requirements. Specifically, WFOE PFM satisfying the following requirements can apply to CSRC for retail fund management license:

(1) Have sound corporate governance, well-established internal control mechanism and good risk management and control;

(2) Have qualified management capability, be of good financial standing, operate smoothly in the preceding 3 years and have the capability to be continuously profitable;

(3) Have run for at least 5 complete fiscal years;

(4) Have good credit and compliance records, with no record of material violation of laws or regulations in the preceding 3 years with regulators, and shall not be under investigation conducted by any regulator due to material violation of laws or regulations or during the rectification period;

(5) Its major indicators for prudent regulation purpose in the preceding 12 months can meet the regulatory requirements;

(6) Have more than 3 years of securities asset management experience, and the monthly average securities asset under management for the preceding 3 years shall be no less than RMB 10 billion, where the equity asset management shall be no less than RMB 5 billion. It shall operate in a standardized and stable manner, have good track records and have not triggered any significant compliance risk event;

(7) Have internal management policies in compliance with the rules of CSRC, and business premises, security facilities and other facilities relating to retail fund management business;

(8) The proposed senior management personnel and personnel engaging in research, investment, operation, sales, compliance and other business in relation to fund management business shall be eligible under laws, administrative regulations and the rules of CSRC with the total number of whom being no less than 30, and such personnel shall have obtained the fund practitioner qualification; the posts shall be set with rational division of functions and well-defined duties;

(9) Have an appropriate liability to assets ratio and leverage level, and possess the capital strength that is able to cover the retail fund management business, with its net assets to be no less than RMB1 billion;

(10) Have a clear self-discipline mechanism to ensure the independence of the retail fund management business, prevent risk contagion and tunneling, etc.;

(11) Other requirements stipulated by CSRC.

As can be seen from the above requirements, only WFOE PFMs with more than 30 qualified practitioners and have run for more than 5 complete fiscal years, been continuously profitable for the preceding 3 years, have net assets value of no less than RMB 1 billion and monthly average securities asset under management for the preceding 3 years being no less than RMB 10 billion, where the equity asset management shall be no less than RMB 5 billion. There is an additional requirement that the shareholder, actual controller of the WFOE PFM shall satisfy the eligibility requirements to establish the FMC (as prescribed by Part 1 and Part 2 of this article). Meanwhile, it is also required that all the AMAC-filed private funds of WFOE PFM should be converted to CSRC-regulated private asset management schemes within 3 years of the conversion from WFOE PFM to WFOE FMC. Taking all these into account, the retail fund management license application for WFOE PFM would be a tough journey.

9. Emphasis that FMC shall take retail fund management business as its core business

As the FMC Measures for Consultation stipulates, an FMC shall take retail fund management business as its core business.

Certain foreign asset management institutions intend, through obtaining the WFOE FMC license, to take the private assets management as its core business, whereas the retail fund management as a subordinate business. Such intention is inconsistent with the statutory principle and inspiration of the FMC Measures for Consultation.

10. Reporting obligations of the foreign shareholder

The FMC Measures for Consultation stipulates that, the shareholder of FMC shall provide following information to the FMC within 3 months from the year end and the FMC shall report the same to CSRC:

(1) The performance of the rights and obligations as a shareholder;

(2) Fulfilment of commitments, implementation of laws and regulations and regulatory rules;

(3) Shareholder eligibilities and changes;

(4) Eligibility of the actual controller of the shareholder and its changes;

(5) Preservation or enforcement on the FMC equity it holds;

(6) Pledge or release of the equity of the FMC it holds;

(7) Other circumstances that may affect eligibility of the shareholder and its actual controller, or those may lead to changes of equity of the FMC it holds.

Meanwhile, the FMC Measures for Consultation also stipulates that, CSRC and its branches may conduct extended inspection on the shareholder(s), actual controller and fund service providers of the FMC. For WFOE FMC, its shareholder and actual controller are all foreign institutions, however, detailed implementation measures regarding the extended inspection still remain to be further verified upon cooperation between foreign regulatory authorities/governments and CSRC.

11. Foreign-related matters

The FMC Measures for Consultation stipulates that, offshore securities regulatory authorities shall not directly conduct activities such as investigation and evidence collection within the PRC. Without consent of CSRC and relevant competent authorities under the State Council, no entity or individual may provide documents and materials in relation to securities business activities to offshore.

Similar rules originate from the *PRC Securities Law*, which came into effect on March 1, 2020. Since the *PRC Securities Law* does not apply to FMC, to bridge the gap, CSRC sets forth such rules in the FMC Measures for Consultation to cover FMC as well.

12. Impacts on the industry landscape

(1) One Participation, One Control, One Non-FMC Retail Fund Management License

For the first time, the FMC Measures for Consultation raises the “One Participation, One Control, One Non-FMC Retail Fund Management License” rule, which is to say, the retail fund management license obtained by wealth management subsidiaries of commercial banks, insurance asset management companies, asset management subsidiaries of securities companies that have satisfied CSRC regulatory requirements (may themselves apply for a retail fund management license without establishing another FMC entity, and this refers to “One Non-FMC Retail Fund Management License”) will not post obstacle to the group they are in to play under the “one participation and one control” rule. This will certainly lead to an increase of retail fund management institutions on the market, confronting WFOE FMCs with more fierce market competition.

(2) FMC may set up subsidiaries to carry out various kinds of business

The FMC Measures for Consultation stipulates that, upon being approved or permitted by CSRC, a subsidiary of an FMC may carry out asset management related business. Asset management related business that subsidiaries may carry out including, retail fund management, private asset management, investment advisory, financial services for pension fund, distribution and administrative services for financial products, etc., where the retail fund management business including without limitation to fund of fund (“FOF”), manager of manger (“MOM”), pension fund products, REITs products.

However, there are rigorous requirements for an FMC to set up a subsidiary, for example, the net assets shall be no less than RMB600 million, the daily average AUM of the actively managed equity funds shall be no less than RMB20 billion for the preceding 2 years, the general risk reserve shall be no less than RMB200 million, etc. WFOE FMC may not be able to satisfy these requirements at the beginning of their business operation, thus, they are not qualified to set up the above-mentioned subsidiaries. This may also confront WFOE FMCs with certain competition in PRC market.

To sum up, the FMC Measures for Consultation raises stricter requirements for foreign asset manager regarding WFOE FMC application in the Mainland China. Whereas, considering the new legislation is still under consultation, foreign asset manager may timely echo their comments and concerns to CSRC.

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