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Inclusion of APIFs in the Scope of Northbound MRF Funds

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Since the official launch of the mutual recognition of funds (MRF) between the Mainland China and Hong Kong on 1 July 2015, 39 Hong Kong funds have been registered with the China Securities Regulatory Commission ("**CSRC**") and offered in Mainland. By the end of October 2023, the cumulative net inflows of Northbound MRF funds have reached approximately RMB 17 billion. All of the 39 funds are general funds, and none of them is an Approved Pooled Investment Fund ("**APIF**") in Hong Kong.

At the end of 2022, the CSRC and the Securities and Futures Commission of Hong Kong ("**SFC**") specifically sorted out the MRF related matters such as the development of the regime, ongoing reporting and information disclosure requirements, and fully communicated with the market players such as Hong Kong fund managers and Mainland agents. During this process, CSRC expressly confirmed that qualified APIFs can be included in the scope of the Northbound MRF funds. The qualification requirements include: (i) having complete public offering documents; (ii) being authorized by the SFC to offer to retail investors in Hong Kong; and (iii) meeting the eligibility requirements of the Northbound MRF funds. In addition, Q&A 8 of the *Frequently Asked Questions on Mainland-Hong Kong Mutual Recognition of Funds* (the "**SFC MRF FAQ**") issued by the SFC also provides that, APIFs that are currently invested by MPF schemes and authorized by the SFC for public offering in Hong Kong and meet MRF eligibility requirements are eligible for application to the CSRC under the MRF. These APIFs must have complete offering documents in accordance with the requirements of the *Code on Unit Trusts and Mutual Funds* for offering to retail investors in Hong Kong. Accordingly, there are no barriers at the regulatory level for qualified APIFs to be registered as Northbound MRF Funds.

I. MPF and APIF

APIF is a kind of underlying investment in the Hong Kong MPF system.

Mandatory Provident Fund ("**MPF**") system, launched in 2000, is a compulsory contribution policy of the Hong Kong government for the living of the elderly in Hong Kong and the second pillar of Hong Kong's retirement protection framework. Except for specific exemptions, employees of working age in Hong Kong are required to join an MPF scheme, with both the employer and the employee making contributions.

An MPF scheme shall operate in the form of a trust and be managed by the trustee of the MPF. The trustee of the MPF scheme shall engage an investment manager for investment management and a custodian for assets custody. The Mandatory Provident Fund Schemes Authority (the "**MPFA**") is the regulatory authority responsible for, among other things, regulating and supervising the operation of the MPF schemes, and for the ongoing supervision of trustees.

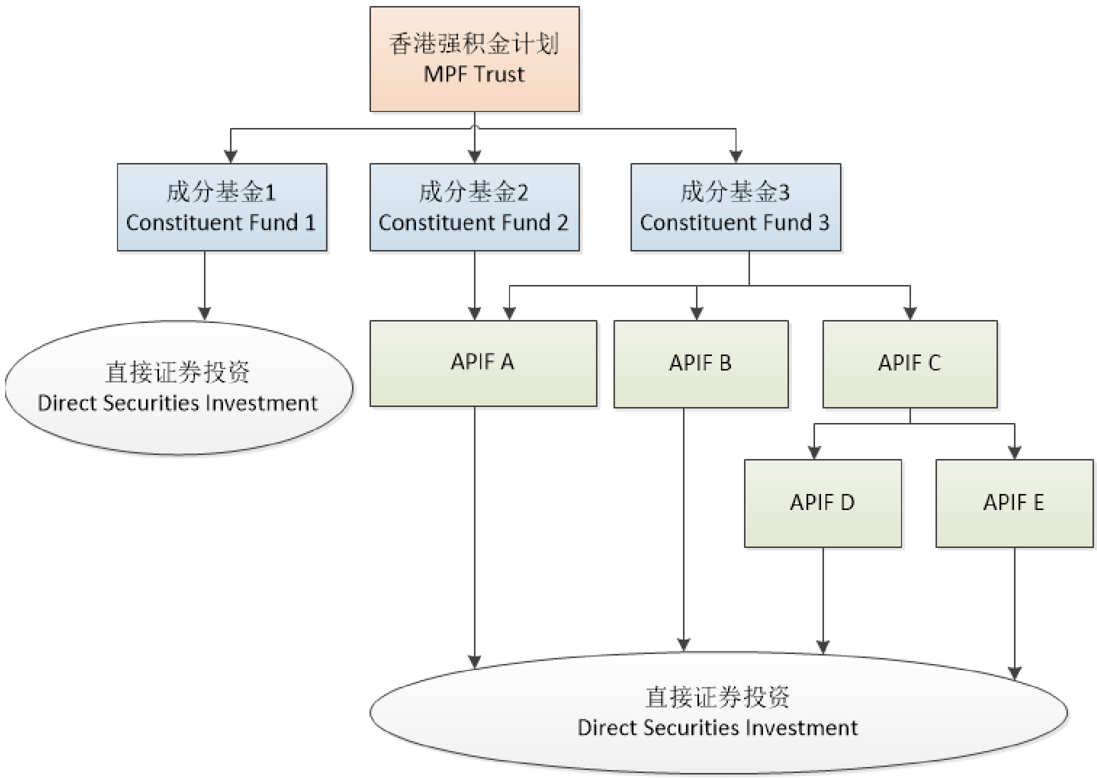
An MPF scheme may consist of one or more constituent funds, and each constituent fund has its own independent investment strategies. Constituent funds may directly invest in investment targets permitted by the MPFA, which not only include, without limitation, shares, bonds, etc., but also the APIFs. If a constituent fund makes direct investments, it shall comply with a number of restrictions and requirements of the *Mandatory Provident Fund Schemes (General) Regulation*. If a constituent fund invests in APIF(s) and which further makes investment, such APIF(s) shall also comply with the foregoing restrictions and requirements.

According to the requirements of the MPFA and the SFC, an APIF[1] shall be approved by the MPFA and authorized by SFC, shall satisfy the investment restrictions and requirements of both regulators, and shall be subject to the supervision of both regulators. Different constituent funds may invest in the same APIF, and an APIF may accept other investors in addition to the constituent funds. An APIF may invest directly in securities, or invest in other APIFs in the form of fund of funds (FOF).

There are two authorizations granted to an APIF by the SFC. One is the authorization for pooled investment fund to be offered to the MPF schemes, which is granted by the SFC in accordance with the *SFC Code on MPF Products*, and the other is the authorization for public offering in Hong Kong, which is granted by the SFC in accordance with the *Code on Unit Trusts and Mutual Funds*. Some APIFs in the market only obtain the first authorization but not the second, i.e. such APIFs can only be invested by the constituent funds of the MPF schemes and are not allowed to be publicly offered to retail investors in Hong Kong. Only the APIFs with both authorizations (i.e., APIF I as commonly known in the market) can be registered as Northbound MRF funds.

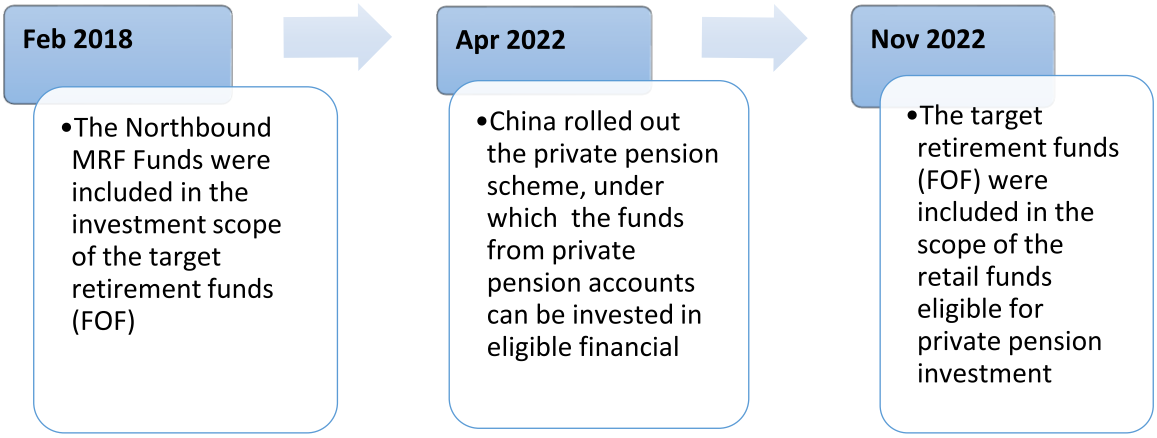
Below is a simplified structure chart of MPF schemes:

[1] According to the *Mandatory Provident Fund Schemes (General) Regulation*, an APIF can be in form of an insurance policy, a unit trust or a mutual fund. This article only discusses the situation where an APIF is either unit trust or mutual fund.



II. The Linkup of Inclusion of APIFs into the Scope of the Northbound MRF Funds and the Private Pension Scheme in Mainland

Like other Northbound MRF funds, APIFs, after being registered with CSRC, can be publicly offered to retail investors in the mainland China, providing mainland investors with more diversified investment options. In addition, APIF managers are mostly overseas asset managers with rich pension investment management experience. Against the backdrop of the implementation of the private pension scheme in the mainland China, the APIFs, as included in the scope of the Northbound MRF funds, may also indirectly accept the private pension of the mainland China by becoming the underlying investments of the target retirement funds (养老目标基金), enriching the investment varieties of the private pension in the mainland China.



In early 2018, the CSRC issued and implemented the *Guidelines for Target Retirement Securities Investment Funds (Trial)*, including the Northbound MRF funds into the investment scope of the target retirement funds[2], provided that the Northbound MRF funds to be invested in shall be subject to the conditions therein and the selection criteria set by the fund manager of the target retirement fund. In April 2022, China's State Council released the *Opinions on Promoting the Development of Private Pensions* ("**Private Pension Opinions**"), rolling out the private pension scheme by way of "pilot first and gradual roll-out". The Private Pension Opinions provides that funds from private pension accounts can be invested in eligible financial products, including deposits, commercial endowment insurance, wealth management products of banks, retail funds, etc., and the participants of the private pension scheme will be entitled to tax breaks. To echo the Private Pension Opinions, the CSRC released the *Interim Provisions on the Administration of the Business of Private Pension Investment in Publicly-Offered Securities Investment Funds* in November 2022, clarifying the relevant arrangements for investors to invest in retail funds through private pension accounts. Amongst others, during the pilot of the private pension scheme, the CSRC would include eligible target retirement funds into the scope of the retail funds eligible for private pension investment.

For the Hong Kong fund managers, upon the APIFs are included in the scope of the Northbound MRF funds, APIFs may expand the scale by both raising funds from retail investors in the mainland China and indirectly accepting private pension through the above-mentioned arrangements.

III. Key Points for APIFs to be Registered as Northbound MRF Funds

If an APIF is intended to be registered as a Northbound MRF fund, the APIF shall comply with the eligibility requirements set forth in the *Interim Provisions on the Administration of Recognized*

[2] According to Article 3 of the *Guidelines for Target Retirement Securities Investment Funds (Trial)*, the target retirement funds shall be operated in the form of fund of funds or other forms recognized by the CSRC.

Hong Kong Funds ("**Provisions on Recognized Hong Kong Funds**"), as well as the specific requirements of the CSRC as described at the beginning of this article.

Based on our observation of the Hong Kong APIF market, we summarize the following key points with respect to the APIFs to be registered as Northbound MRF funds:

1. Having complete public offering documents

   The public offering documents of the fund in Hong Kong include the prospectus (commonly referred to as the Explanatory Memorandum, "**EM**") and the product key facts statement ("**KFS**"). We notice that although some Hong Kong authorized funds are authorized by the SFC for public offering in Hong Kong, they are not actually offered to the public and therefore only the EM but no KFS will be prepared and available to public. Although certain APIFs are authorized for public offering (i.e., APIF I), they are actually only offered to constituent funds of MPF schemes, and are not indeed offered to the public in Hong Kong. Therefore, such APIFs only have the EM but have no KFS.

   As required by the CSRC, APIFs to be registered as Northbound MRF funds shall have both of the EM and KFS in Hong Kong. Therefore, if a PRC KFS is prepared solely for the purpose of registering the APIF as a Northbound MRF fund, such APIF will not meet the requirements of the CSRC.

2. Being authorized by the SFC for offering to retail investors in Hong Kong

   We note that, some APIF I, even though authorized by the SFC for the public offering to retail investors, do not have a retail class, or are not indeed offered to the public although there is a retail class. It remains to be further discussed and clarified whether it would be qualified as long as the APIFs have been authorized to be offered to the public in Hong Kong, or the APIFs shall be actually offered to the public in Hong Kong.

3. To be registered as a Northbound MRF fund, an APIF shall also meet the eligibility requirements set out in the Provisions on Recognized Hong Kong Funds. For example, the investment management function of the fund manager shall not be delegated to any institution in other countries or regions outside of Hong Kong, the fund has been established for more than one year, and the AUM of the fund shall be no less than RMB 200 million.

   It is noteworthy that, according to Article 17 of Schedule I of the *Mandatory Provident Fund Schemes (General) Regulation* of Hong Kong, the APIFs may make qualified investments directly in securities, and may also invest in one or more APIFs in the form of FOF (such as the APIF C shown in the chart above). It is uncontroversial for an APIF directly investing in securities to be registered as a Northbound MRF fund. However, there are obstacles for the APIFs in the form of FOF. According to Article 4 of the Provisions on Recognized Hong Kong Funds, the fund type of Northbound MRF funds should be “general equity, hybrid, bond and index (including exchange traded index funds)”, and the FOF is not a type of “general fund”. Meanwhile, the SFC also clearly provides in Q&A 10 of the SFC MRF FAQ that FOF is not eligible under the MRF at this stage.

4. Share classes in the mainland China

Currently, among 39 Northbound MRF Funds that have been registered and offered, the mainstream model is to set up retail share class(es) only in the mainland China. In order to ensure the fair treatment to retail investors in the mainland China and Hong Kong, the level of fees paid out of the fund assets of the mainland retail share class shall be the same as that of the Hong Kong retail share class, including management fees, trustee fees, custodian fees, fund administration fees, etc.

Now that APIFs are included in the scope of the Northbound MRF funds, it is expected to explore the possibility of setting up both institutional and retail share classes in the mainland China after communicating with the regulator. If an APIF is registered as the Northbound MRF fund, there is a chance that such APIF can be the investment target of target retirement funds. APIFs would be more attractive for the fund managers of target retirement funds if they set up mainland institutional share classes specifically for the target retirement funds with relatively lower fee rates (including management fees, trustee fees, etc.) which are the same with those of Hong Kong institutional share classes.

If you would like to know more information about the subjects covered in this publication, please contact:

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