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Interpretation of the Guidelines for Review of ETF Feeder Funds

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Recently, the Department of Fund Supervision of the China Securities Regulatory Commission ("**CSRC**") circulated the guidelines for internal review of securities investment funds No. 8, i.e. the *Guidelines for Review of Feeder Funds of Exchange Traded Funds (ETFs)* (Letter of Department of Fund Supervision [2009] No. 377, "***Guidelines for ETF Feeder Funds***") to fund management companies and other institutions, which explicitly provides the requirements for reviewing feeder funds of exchange traded funds ("**ETF Feeder Funds**") and further guides the launch of ETF Feeder Funds in Mainland China. Based on our participation in previous study and application of ETF Feeder Funds, we make the following analyses on the *Guidelines for ETF Feeder Funds* for further discussion.

ETF Feeder Fund and FOF

ETF Feeder Fund is a type of feeder funds. In accordance with the *Guidelines for ETF Feeder Funds*, an ETF Feeder Fund shall invest more than 90% of its fund assets in the underlying ETF, and a fund of funds ("**FOF**") invests in other funds. In that case, does it indicate that the CSRC becomes open to the existence of FOFs after the promulgation of the *Guidelines for ETF Feeder Funds*?

We understand that, though the structures of a feeder fund and a FOF are similar to some extent, such as investing its fund assets in other funds that operate independently, they have essential differences and neither is subordinate to the other. An ETF Feeder Fund closely traces its underlying ETF, investing more than 90% of its fund assets in the underlying ETF. An ETF Feeder Fund will achieve its investment objective through its investment in the underlying ETF instead of creating its own portfolio. However, a FOF has its own portfolio and criteria for selection of investment instruments. In other words, a FOF will choose certain funds that meet its prescribed criteria for investment from numerous funds and then achieve its investment objective through management of portfolio. To a certain degree, an ETF Feeder Fund is not a fund that can operate independently.

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We also notice that Article 59 of the *Law of the People's Republic of China on Securities Investment Funds* of 2003 provides that a fund cannot invest in other funds unless otherwise stipulated by the State Council. Although an ETF Feeder Fund is different from a FOF, an ETF Feeder Fund will invest its fund assets in the underlying ETF, which is consistent with the nature described in the aforementioned provision. Therefore, we understand that the promulgation of the *Guidelines for ETF Feeder Funds* may have been recognized by competent authorities.

Background and Significance of Developing ETF Feeder Funds

According to relevant regulations, following the close of the initial offer period, subscription of ETFs shall be made with a basket of securities. From the perspective of distribution channels, only a small number of securities firms providing dealing services can distribute ETFs, which limits the other distribution channels such as direct distribution channels and distribution through banks. From the perspective of investors, investment in ETFs needs a large number of monies and stocks and many small investors may thereby be unable to make such investment. The size of ETFs are limited due to various reasons. However, investors are able to subscribe for ETF Feeder Funds in cash, which expands the distribution channels of ETFs, lowers the investment threshold for ETFs and is expected to solve the bottleneck in the size of ETFs.

At present, several fund management companies have applied to the CSRC for the offering of ETF Feeder Funds. The promulgation of the *Guidelines for ETF Feeder Funds* has pointed out the direction for launch of ETF Feeder Funds.

Main Guidelines for Operation of ETF Feeder Funds

The *Guidelines for ETF Feeder Funds* explicitly provides that subscription and redemption of ETF Feeder Funds shall be made in cash, which differs from those of ETFs. During the initial offer period, the subscription of ETFs can be made in cash or with a basket of securities, while following the close of the initial offer period, the subscription and redemption of ETFs must be made with a basket of securities.

As an ETF Feeder Fund will achieve its investment objective through investing in the underlying ETF, if the fund manager and the fund custodian are allowed to charge management fee and custodian fee from the fund assets of the ETF Feeder Fund which are invested into the underlying ETF, double layers of management fees and custodian fees will be created, which is unfair to the unitholders of the ETF Feeder Fund. Therefore, the *Guidelines for ETF Feeder Funds* provides that the fund manager and the fund custodian are not allowed to charge management fee and custodian fee from the fund assets of the ETF Feeder Fund which are invested into the underlying ETF. The fund manager and the fund custodian can collect management fee and custodian fee from the underlying ETF. In addition, an ETF Feeder Fund can impose subscription fee and redemption fee with reference to the fee rates of conventional open-ended index funds.

The *Guidelines for ETF Feeder Funds* also specifies two methods for unitholders of an ETF Feeder Fund to participate in the unitholders' meetings of the underlying ETF: (1) in the event that the fund manager has been managing the underlying ETF and applies for the offering of the ETF Feeder Fund, if the underlying ETF intends to hold a unitholders' meeting, the ETF Feeder Fund shall hold a unitholders' meeting in advance to vote on the proposals of the unitholders' meeting of the underlying ETF and form voting opinions; (2) in the event that the fund manager applies for the offering of the underlying ETF and the ETF Feeder Fund in parallel, unitholders of the ETF Feeder Fund can directly participate in the unitholders' meetings of the underlying ETF and vote based on their holding of the ETF Feeder Fund's units the number of which may be subject to adjustment.

Finally, fund management companies need to be reminded that, according to the *Guidelines for ETF Feeder Funds*, not only can fund managers which have already managed ETFs apply for the offering of ETF Feeder Funds and expand the size of ETFs, but also fund management companies that have not yet offered and managed ETFs have the opportunity to apply for the offering of ETFs and ETF Feeder Funds in parallel.

Interpretation of the Guidelines for Review of ETF Feeder Funds

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