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Brief Introduction to Laws and Regulations of Fund Sector in 2007

By Christophe Han

With the continuous bullish China stock market in 2007, China's fund sector witnessed a year with rapid development. It has reached a new high in terms of the size of the managed assets, the variety of fund products or the performance of operation. With the constant development of the fund sector in 2007, the China Securities Regulatory Commission (**CSRC**), as a regulatory body for the fund sector, promulgated and implemented a series of departmental regulations and normative documents (**Regulations**) which mainly focus on the corporate governance of fund management companies, standardization of fund businesses and supervision over fund practitioners. In addition, CSRC has promulgated trial measures for the investment by QDII in foreign securities products, which signals the direct investment at overseas securities market by domestic residents through qualified domestic institutions. Although the measures are on trial basis, they will definitely impose a significant impact on the operation of funds in 2008.

The Regulations concerning the fund sector promulgated by CSRC in 2007 include:

Name	**Effective Date**
Supplementary Provisions on the Issues Relevant to Drawing of Risk Reserves by Fund Management Companies	12 January 2007
Provisions on the Administration of Information Management Platforms for the Sales of Securities Investment Funds	15 March 2007
Notice on the Issues Relevant to Improving the Trading Seat System for Securities Investment Funds	1 April 2007

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Notice on Issues Concerning the Implementation of Business Evaluation and Share Net Value Calculation in Enterprise Accounting Standards by Securities Investment Funds	8 June 2007
Notice on the Issues Relevant to Fund Practitioners' Investment in Securities Investment Funds	13 July 2007
Provisional Measures on the Management of Overseas Securities Investment by Qualified Domestic Institutional Investors	5 July 2007
Notice on the Issues Concerning the Implementation of the Provisional Measures on the Management of Overseas Securities Investment by Qualified Domestic Institutional Investors	5 July 2007
Guiding Opinions on the Applicability of the Sales of Securities Investment Funds	12 October 2007
Guiding Opinions on the Internal Control of Sales Agencies of Securities Investment Funds	1 January 2008

Governance of Fund Companies

The regulations issued by CSRC in 2007 concerning the governance of fund companies primarily includes the Supplementary Provisions on the Issues Relevant to Drawing of Risk Reserves by Fund Management Companies ("Supplementary Provisions on Risk Reserves") and the Guiding Opinions on the Internal Control of the Sales Agencies of Securities Investment Funds ("Opinions on Internal Control").

- Supplementary Provisions on Risk Reserves

  In 2006, CSRC issued the Notice on Issues Concerning Drawing of Risk Reserves by Fund Management Companies, stipulating that fund management companies shall withdraw no less than 5% of the fund management revenue as risk reserves each month. In addition, CSRC issued the Supplementary Provisions on Risk Reserves on 12 January 2007 to further regulate the financial management of risk reserves of fund management companies. The Supplementary Provisions on Risk Reserves specifies the definition of the "risk reserves" and stipulates on a supplemental basis that the net asset value of each securities investment fund shall serve as the base figure for the custodian bank to withdraw risk reserves, and no more risk reserves need to be drawn when the risk reserves balance reaches 1% of the net fund asset. The Supplementary Provisions on Risk Reserves also stipulates financial accounting of risk reserves, requiring that, when calculating income tax, a company shall make proper taxpaying adjustments corresponding to the nature of a specific risky event, which might cause the use of risk reserves. With regard to general risk reserves, fund management companies, apart from special requirements, shall carry out the following financial management provisions, i.e. "drawing of general risk reserves", "using and paying for general risk reserves", "returning general risk reserves" and "general risk reserve investment". Special provisions different from the general risk reserves have been made for the accounting of risk reserves for special purposes. In the notes to the annual financial report of a fund management company, a separate item on "risk reserve withdrawals and application thereof" shall be included to disclose general and special risk reserves.

- Opinions on Internal Control

In order to regulate the internal control system of fund sales agencies, CSRC issued the Opinions on Internal Control on 12 October 2007, containing detailed rules on the control principles, business processes, accounting systems, information systems and supervisory and audit of such agencies.

The Opinions specifies the principles on the objectives of the internal control of fund sales agencies. It is requested that fund sales agencies set up relevant authorization control systems for the purpose of controlling the business risk of their branches, establish scientific human resources management systems and emergency response measures and perform their anti-money laundering obligations. With respect to the internal control on business processes, it is requested that fund sales agencies establish controls on sales decision-making process and sales implementation process. It is also requested that fund companies make regulation on various businesses and formulate complete fund clearing procedures. Fund sales agencies shall formulate the Notice on the Investors' Rights and Interests and set up a complete complaint responding system. In addition, they shall set up a monitoring, recording and reporting system for abnormal trading and pay special attention to abnormal trading activities in fund sales business. The agencies are obliged to keep customers' identity information and trading records for 15 years. In respect of the internal control of accounting systems, fund sales agencies are required to have separate accounts to manage their own assets and investors' assets. In addition, there are requirements regarding the internal control of information technology and supervisory and audit of fund sales agencies. It is noteworthy that the Opinions on Internal Control also introduces the concept of service provider, requiring the internal control of the service providers to cooperate with fund sales agencies shall follow the Opinions on Internal Control in respect of their participation in fund sales.

Regulations Relevant to Fund Businesses

The regulations relevant to fund businesses issued by CSRC in 2007 primarily include the Provisions on the Administration of Information Management Platforms for the Sales of Securities Investment Funds ("Provisions on Information Management Platforms), Notice on the Issues Relevant to Improving the Trading Seat System for Securities Investment Funds ("Notice on Trading Seat System"), Notice on Issues Concerning the Implementation of Business Evaluation and Share Net Value Calculation in Enterprise Accounting Standards by Securities Investment Funds ("Notice on Issues Concerning the Implementation of Enterprise Accounting Standards") and Guiding Opinions on the Applicability of the Sales of Securities Investment Funds ("Guiding Opinions on Applicability").

In addition, CSRC has issued Provisional Measures on the Management of Overseas Securities Investment by Qualified Domestic Institutional Investors ("Measures on QDII Management") and Notice on the Issues Concerning the Implementation of the Provisional Measures on the Management of Overseas Securities Investment by Qualified Domestic Institutional Investors ("Notice on QDII").

- Provisions on Information Management Platforms

CSRC issued the Provisions on Information Management Platforms on 15 March 2007, to solve technical problems that hinder the development of fund sales and regulate information management of securities investment funds. It is requested that the establishment and maintenance of the information management platforms should be in compliance with the principles of safety, operability and systemization, and that the platforms should perform various functions for fund sales, including monitoring and checking the information flow and cash flow of fund sales, monitoring the rates of fund sales, and supporting the principle of fund sales' applicability to be used in the fund sales business. It should also serve as a mechanism to manage, supervise and handle complaints about fund sales personnel while offering information to CSRC concerning fund trading, fund security and other sales activities. It is also required that the information management platforms of fund sales agencies should provide CSRC with fund supervision business information system with daily fund trading information, monthly summary of risk rates of the funds subscribed to and purchased by fund investors and the compatibility of the risk bearing capacity of fund investors, monthly summary of abnormal trading of funds, quarterly internal supervision and auditing report of the fund sales agencies, annual financial and operational situation of specialized fund sales agencies, notes on the fund risk evaluation methods, notes on the methods of fund sales agencies investigation and evaluation of the risk bearing capacity of fund investors and so on.

- Notice on Trading Seat System

CSRC issued the Notice on Trading Seat System on 16 February 2007, to further improve the trading seat system. According to the Notice on Trading Seat System, fund companies should rent trading seats from securities companies with solid strength. They should reduce possible related party transactions with securities companies. The annual commission of a fund management company for securities transactions through the trading seats of a securities company cannot exceed 30% of the total commission for the securities transactions of the fund management company in the same year. Fund management companies are not allowed to link the seat opening to the fund sales of the securities companies. They shall not, in any manner, promise to a securities company the volume of trading through the securities company's trading seats. In addition, heavier duties of disclosure by renting fund companies and supervision of custodian banks have been imposed.

- Notice on Issues Concerning the Implementation of Enterprise Accounting Standards

CSRC issued the Notice on Issues Concerning the Implementation of Enterprise Accounting Standards on 8 June 2007 to regulate the evaluation business of various investment products of funds and ensure the prompt and accurate calculation of the net value of shares in accordance with the new enterprise accounting standards, causing a great impact on the evaluation of close-end funds and bonds traded on the inter-bank bond market. The close-end fund's evaluation will be changed from the daily average price of an investment product to the net value of the closing price; the price calculation on the basis of cost for the bond traded on the inter-bank market will be replaced by the means of evaluation technology to determine its fair value. In addition, the Notice on Issues Concerning the Implementation of Enterprise Accounting Standards has also established the evaluation principle for investment products, which are either active or inactive in the markets. In the meantime, the Notice on Issues Concerning the Implementation of Enterprise Accounting Standards has also specified the evaluation methods of various investment products, including those listed and traded at stock exchanges, those issued at stock exchanges but not listed, non-circulating products that have ceased trading at stock exchanges and the bonds traded at the country's inter-bank bond markets and fixed-return products such as the asset-backed securities. Moreover, fund management companies should also work out an identification and emergency plan for the error in the evaluation and calculation of the net value. When the error reaches or exceeds 0.25% of the net value of fund assets, the fund companies should report it to CSRC promptly. During the course of fund evaluation, calculation or review of the net value of fund shares, fund companies and custodian banks should be liable for compensation respectively if they cause damage to the fund assets or fund shareholders. If their joint acts cause damage to the fund assets or fund shareholders, they should be liable for compensation jointly.

➢ Guiding Opinions on Applicability

In order to regulate the sales of fund sales agencies, ensure the applicability of the sales of funds and relevant instruments and remind investors of investment risk, CSRC issued the Guiding Opinions on Applicability on 12 October 2007. According to it, fund sales agencies should adhere to the principles of giving priority to investors' interests, completeness, objectivity and timeliness when implementing the applicability of the sales of funds. The Guiding Opinions on Applicability also stipulates the obligations of diligence of the fund sales agencies and fund managers and risk evaluation of fund instruments. The fund sales agencies shall investigate and evaluate the risk bearing capacity of fund investors.

➢ Measures on QDII Management and Notice on QDII

In 2006, the State Council approved the first QDII overseas securities investment product for individual investors in China - the Hua'an International Allocation Fund - as a trial product for QDII in overseas securities investment. After a year, the fund has proved to be successful and helpful for accumulating operation and supervision experience to gradually expand pilot QDII overseas securities investments.

On 18 June 2007, CSRC issued the Measures on QDII Management and the Notice on QDII (collectively the "Trial Regulations for Domestic Investors"). Although QDII overseas securities investment is still in its trial stage, the Trial Regulations for Domestic Investors have opened an important channel for domestic residents to invest overseas. It is of great significance to satisfy the increasing demand for overseas investments and cultivating the global competitiveness of domestic institutions.

The Trial Regulations for Domestic Investors have provided access requirements for QDII overseas investments, instruments design, fund raising, overseas investment consulting, asset custody, investment operation and information disclosure. According to the provisions, fund companies which apply to operate such business, should have net assets of at least RMB200 million. The length of the fund management business should be over two years. The scale of asset management by the end of the most recent quarter should be not less than RMB20 billion or the equivalent in foreign exchange assets. The securities companies should have net capital of at least RMB800 million, the proportion of net capital to net assets being no less than 70% and the length of the collective asset management plan business being more than one year. Funds can be raised in the form of RMB for overseas investment; the fund raised should be not less than RMB200 million or a currency of the same value and the amount of collective fund raising should be not less than RMB100 million or the currency of the same value. Qualified domestic investors may entrust overseas investment advisors to provide investment consulting services. Asset custody must be provided by domestic banks that are qualified to handle securities investment fund custody. In addition, there are also provisions on the limits on the investment proportion of overseas investment by domestic investors.

Supervision of Fund Practitioners

The regulation of the supervision of fund practitioners issued by CSRC in 2007 is the Notice on the Issues Relevant to Fund Practitioners' Investment in Securities Investment Funds ("Notice on Practitioners' Investment in Funds").

On 13 June 2007, CSRC issued the Notice on Practitioners' Investment in Funds, allowing practitioners working with fund management companies and fund custodian banks to invest in funds, but the investment instruments are only limited to open-end funds and not to close-end funds. The fund shares should be held by practitioners for no less than six months. In addition, fund practitioners investing in funds should also fulfill certain obligations of information disclosure. Fund management companies should disclose the total number and proportion of the fund shares held by the company's fund practitioners in a fund contract validity notice, notice for trading, half-year and annual reports of the relevant funds.

In a word, we can see that in 2007, CSRC made great efforts in the supervision of the fund industry to improve the governance of fund companies, standardize their operation, expand their investment channels and control the risk of fund investment. It is under the supervision of CSRC that the fund industry underwent vigorous development in the year - the earnings have greatly increased and fund-financing has been acknowledged by more investors. With the issuance of new rules, the fund market is likely to have dissension in 2008, which will also place a greater demand for the regulation of CSRC. We believe that in 2008, CSRC will, adhering to the principle of "protecting the fund shareholders" like always, step up supervision efforts and lead to better development of the fund market.

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