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**Llinks Asset Management Bulletin**
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# Llinks Insights on the New Asset Management Rules

# No.2: Impact on WFOE PFMs

**By Sandra Lu and Eric Zou**

The Guiding Opinion on Regulating Financial Institutions' Asset Management Business (the "**Guiding Opinion**") was jointly promulgated by the People's Bank of China ("**PBOC**"), China Banking and Insurance Regulatory Commission, China Securities Regulatory Commission ("**CSRC**") and State Administration of Foreign Exchange ("**SAFE**") (hereinafter referred to as the "**Financial Regulators**" collectively) on 27 April 2018 with a view to resolve existing problems in the asset management industry of China such as multi-layer nesting, unclear leverage, serious arbitrage, frequent speculation and rigid payment.

Wholly foreign owned private securities investment fund managers ("**WFOE PFMs**") are new players in the China market. They were not allowed to enter into the market until the issuance of the *FAQs regarding Registration and Record-Filing of Private Funds (No. 10)* by the Asset Management Association of China ("**AMAC**") on 30 June 2016. The FAQs permit eligible wholly foreign owned enterprises ("**WFOEs**") to apply for registrations with AMAC as private securities investment fund managers. Until now, only 11 WFOEs have completed the registrations and more than ten private funds have been

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or are being launched. The Guiding Opinion will unlikely impact fundamentally WFOE PFMs due to the fact that WFOE PFMs usually have greater awareness of compliance and operate in a more compliant manner. Therefore, generally speaking, they are seldom involved in the aforesaid problems such as multi-layer nesting, unclear leverage or rigid payment. Moreover, WFOE PFMs are more likely to benefit from more friendly regulatory regime built by the Guiding Opinion which has established the basic principles of unifying regulatory rules and combing institution supervision and function supervision.

The Guiding Opinion came into effect immediately upon its promulgation. Further, according to Article 29 of the Guiding Opinion, it also requires that CSRC amend existing regulatory rules or formulating new rules according to the Guiding Opinion ("**Implementing Rules**"), so as to better guide the industry to implement the Guiding Opinion. Meanwhile, AMAC is also expected to amend existing self-disciplinary rules or making new rules according to the Guiding Opinion. Therefore, it is still uncertain whether private fund managers are required to implement the Guiding Opinion immediately upon the promulgation of the Implementing Rules.

WFOE PFMs, as new participants in China's asset management market, generally speaking, have no historical problems requiring corrections according to the Guiding Opinion, and only need to keep compliant with the Guiding Opinion and its Implementing Rules when carrying out asset management business. Below are a few points under the Guiding Opinion.

## 1. Application of the Guiding Opinion

The Guiding Opinion directly applies to non-guaranteed wealth management products offered by banks, cash-based trust schemes, asset management products issued by securities companies, subsidiaries of securities companies, fund management companies, subsidiaries of fund management companies, futures companies, subsidiaries of futures companies, insurance asset management institutions and financial asset investment companies[1].

According to Article 2 of the Guiding Opinion, special laws and administrative regulations apply to private funds, but where these laws and administrative regulations are silent, the Guiding Opinion shall apply.

Currently, in the China's legislative regime, only the National People's Congress (and its standing committee) and the State Council have the power to make national laws and administrative regulations. Therefore, the literal interpretation of the Guiding Opinion is that[2], currently, the *Law of the People's Republic of China on Securities Investment Funds* (the "**Funds Law**") is the only law on private securities investment funds, and that there is no administrative regulation on private securities investment funds yet[3]. The Funds Law provides for principle rules for China's fund business, and contains the most fundamental and generic principles and provisions for private securities investment fund managers and private securities investment funds. Therefore, generally speaking, the entire Guiding Opinion will apply to private securities investment funds.

## 2. Multi-layer Nesting and Entrustment of Investment Management Function

### (1) Two-layer Restriction

Remained unchanged from its consultation paper issued on 7 November 2017 by PBOC, Article 22 of the Guiding Opinion stipulates that an asset management product may invest in another layer of asset management product, provided that the latter must not further invest in other asset management products (except for public securities investment funds).

For instance, if a WFOE PFM adopts master-feeder structure, where the WFOE PFM launches several sub-funds to feed into a master fund with the same WFOE PFM as manager, to keep compliant with the aforesaid requirements, the WFOE PFM must ensure that the master fund does not further invest in other asset management products other than public securities investment funds and that the investors to the sub-funds are not asset management products. This also applies to the circumstance where WFOE PFMs launch FOF funds.

In practice, there is a special type of funds, named the QDLP funds, to which the two-layer restriction shall also be applicable. We understand that, when launching a QDLP fund, the manager should be deemed as having met the requirements under the Guiding Opinion if it is able to ensure that there are no more than two layers of onshore asset management products (including the QDLP fund) with the offshore asset management products being excluded from counting for the number of layers.

### (2) Entrustment of Investment Management Function

Pursuant to Article 22 of the Guiding Opinion, where a financial institution invests its asset management products in other asset management products issued by other institutions, thereby entrusting the funds of its own asset management products to the latter institutions for investment, the entrusted institutions must be institutions having professional investment capabilities and qualifications and subject to the regulations by the Financial Regulators. The entrusted institutions for publicly-offered asset management products must be financial institutions, while the entrusted institutions for privately-raised asset management products can be private fund managers.

The final version revised qualified entrusted institutions from "financial institutions regulated by Financial Regulators" in the consultation paper into "institutions regulated by Financial Regulators." According to the Funds Law, WFOE PFMs are non-financial institutions regulated by CSRC. Private funds could be greatly affected by the provisions in the consultation paper according to which asset management products issued by financial institutions are not allowed to act as investors of private funds. Therefore, such improvement from the consultation paper to the Guiding Opinion is good news to private fund managers. According to Article 22:

(a) WFOE PFMs may accept investment from or entrustment by privately-raised asset management products such as trust products, asset management products of securities companies, segregated account asset management products issued by subsidiaries of fund management companies;

(b) Public funds launched by public fund management companies as well as insurance asset management companies, securities companies, and securities asset management companies which maintain public fund management licenses must not invest in private funds issued by WFOE PFMs;

(c) Wealth management products offered to the public by commercial banks cannot invest in private funds launched by WFOE PFMs;

(d) The current market practice whereby banks entrust private fund managers to manage investment functions will likely be severely affected by the Guiding Opinion. For example, if a bank invests its wealth management product in a trust scheme issued by a trust company, and the trust scheme further invests in a private fund, then this approach will no longer be permitted because each of the wealth management product of the bank, the trust scheme and the private fund will be respectively counted as one layer of investment resulting in the total number of layers of investment violating the two-layer restriction.

(e) Although in principle, WFOE PFMs is allowed to accept investment/entrustment by other privately-raised asset management products according to the Guiding Opinion, such investment/entrustment is subject to other regulatory requirements. For example, insurance fund must not invest directly into private securities investment funds, and mandate products issued by pubic fund management companies are also not allowed to invest in private securities investment funds, etc. [4]

In addition, WFOE PFMs which act as entrusted institutions need to accept due diligence investigation by the entrusting institutions. The entrusting institutions need to maintain a list of qualified entrusted institutions, and to specify the admission criteria and procedures, responsibilities and obligations, ongoing management, mechanism for preventing conflict of interest, information disclosure obligations and exit mechanism applicable to the entrusted institutions.

## 3. Type of Funds

According to Article 4 of the Guiding Opinion, asset management products are divided into four categories according to the nature of investment, namely fixed-income products, equity products, commodities and financial derivatives products, and hybrid products (see below table 1). When issuing an asset management product, a financial institution must, in accordance with the foregoing classification criteria, explicitly explain to investors the type of the asset management product, and then invest accordingly.

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| # | Types of asset management products | Classification criteria |
|---|---|---|
| 1 | fixed-income products | At least 80% of a fixed-income product must be invested in debt assets such as bank deposits and bonds. |
| 2 | equity products | At least 80% of an equity product must be invested in stocks, unlisted equities and other equity assets. |
| 3 | commodities and financial derivatives products | At least 80% of a commodities and financial derivatives product must be invested in commodities and financial derivatives. |
| 4 | hybrid products | A hybrid product invests in debt assets, equity assets and commodities and financial derivatives assets, where none of the foregoing three types of assets have reached the corresponding threshold as specified above. |

Table 1: Classification of asset management products provided by the Guiding Opinion

Please note that although in the foregoing classification of asset management products under the Guiding Opinion, there is no further differentiation between stocks and unlisted equities, or between bonds traded in stock exchanges and inter-bank markets and other debts which are not standardized. However, this does not mean that WFOE PFMs launching "fixed-income funds" or "equity funds" may invest in unlisted equities or non-standard debts with the fund assets. According to AMAC's requirement on specialized operation, WFOE PFMs that have successfully registered as private securities investment fund managers, are only allowed to launch and manage private funds investing in onshore securities (including stocks and bonds and etc.), namely private securities investment funds.

In fact, as far as private securities investment funds are concerned, the classification criteria provided by the Guiding Opinion are generally consistent with those provided by AMAC (see below table 2)[5], except that the Guiding Opinion has provided more specific investment ratio for commodities and financial derivatives products.

| # | Types of funds | Classification criteria |
|---|---|---|
| 1 | Fixed-income Funds | Referring to private securities funds with more than 80% (inclusive) of assets invested in bank deposits, standardized bonds, bond funds, stock collateralized repos, and such financial products as trust schemes and wealth management products of banks with expected yield, according to the investment scopes provided in the fund contracts. |

| | | |
|---|---|---|
| 2 | Equity Funds | Referring to private securities funds with more than 80% (inclusive) of assets invested in stocks or stock funds according to the investment scopes provided in fund contracts. |
| 3 | Futures and other derivatives funds | Referring to private securities investment funds mainly invested in futures, options and other financial derivatives, and cash according to the investment scopes provided in fund contracts. |
| 4 | Hybrid funds | Referring to private securities investment funds with investment scopes including stocks, bonds and money market instruments but without primary investment direction according to the fund contracts. |

Table 2: Classification of private funds provided by AMAC

## 4. Qualified Investors

The definition of qualified investors provided by the Guiding Opinion is significantly different from that provided by the *Interim Measures for the Supervision and Administration of Private Investment Funds* ("**Interim Measures for Private Funds**") promulgated by CSRC in 2014 (see below table 3).

| # | Indicators | Interim Measures for Private Funds | Guiding Opinion |
|---|---|---|---|
| 1 | Minimum investment amount in a single fund | No less than RMB 1 million | The amount invested in a single (a) fixed-income product, (b) hybrid product, and (c) equity product or commodities and financial derivatives product shall be no less than RMB 300,000, RMB 400,000 and RMB 1 million respectively. |
| 2 | Financial indicator: Assets of an institutional investor | Institution with net asset no less than RMB 10 million | The qualified investor must be an entity of which the net asset is no less than RMB 10 million at the end of last year. |
| 3 | Financial indicator: Assets or income of an individual investor | Financial assets of no less than RMB 3 million or average annual personal income of no less than RMB 500,000 in the past three years | The qualified investor must have two or more years of investment experience, and must at the same time have household financial net assets of no less than RMB 3 million, household financial assets of no less than RMB 5 million, or average annual personal income of no less than RMB 400,000 in the past three years. |

Table 3: Criteria on Qualified Investors

**Please note:**

(1) Besides the changes in minimum investment amount and the amount in the two financial indicators, the term "financial assets" in the Interim Measures for Private Funds have been changed to "household financial net assets" and "household financial assets" in the Guiding Opinion.[6]

(2) Before the promulgation of the Guiding Opinion, investors' investment experience has already been one of the important items to be assessed when fundraising institutions conducting "investor suitability" investigations. The Guiding Opinion further provides for the criteria of "two or more years of investment experience" for individual "qualified investors".

(3) According to the Interim Measures for Private Funds, investors listed below are naturally qualified investors. However, according to the Guiding Opinion, investors that are deemed by Financial Regulators as naturally qualified investors are exempted from satisfying the two financial indicators listed in table 3, but the minimum investment amount in a single fund must still meet the relevant requirements under the Guiding Opinion.

(a) Social security funds, enterprise annuities and other types of pension funds, and charitable funds and other social non-profit funds;
(b) Duly-established investment schemes that have been filed with the AMAC;
(c) Managers of private funds and their practitioners who invest in the private funds under their management; and
(d) Other investors prescribed by the CSRC.

WFOE PFMs are required to prepare documents such as qualified investor criteria, fund contracts and fund prospectus based on the aforementioned criteria when launching and raising new private funds; for existing open-ended private funds, WFOE PFMs must amend fund contracts and fund prospectus etc. as necessary to reflect the aforementioned criteria and notify existing investors of such amendments by appropriate methods agreed upon in the fund contracts.

In addition, the Guiding Opinion requires that qualified investors not use bank loans, funds raised by issuing bonds and such other non-proprietary funds to invest in asset management products. It is suggested that WFOE PFMs include this requirement in the fund contract and ask investors to make explicit statement and undertakings.

## 5. Accrual of Risk Reserves

According to Article 17 of the Guiding Opinion, a financial institution must allocate risk reserves at an amount of 10% of the income from managing asset management products. Risk reserves are not required to be allocated when the accumulated amount of reserve reaches 1% of the outstanding amount of asset management products. Risk reserves are primarily used to make up for the losses of the assets of asset management products or the losses suffered by investors provided that such losses result from violations of laws and regulations committed by the financial institutions, their breach of the agreements on asset management products, operating errors or technical failures, etc.

We are of the view that private fund managers may also be required to allocate risk reserves according to this provision unless otherwise clarified by Financial Regulators. Further, pursuant to Article 2 of the Guiding Opinion, performance fee accrued from the private fund assets is also considered a part of the management fee. Therefore, both the performance fee and the management fee constitute the base for calculating the amount of risk reserves to be allocated.

## 6. Net Asset Value Management

According to Article 18 of the Guiding Opinion, a financial institution must calculate net asset value of the asset management products they manage according to the provisions in the Accounting Standard for Enterprises, and must promptly reflect the returns and risks of its underlying assets. The net asset value must be checked by custodians of the asset management products and then included into periodical reports. Upon audits by external auditors, the asset manager must disclose the audit results and report the same to Financial Regulators.

The content, format and frequency of reporting etc. of the reports to be formulated by the private fund managers are still pending further clarifications. However, regardless of the form of the report, the requirement that such reports be audited by external auditors does not exist in any current effective self-disciplinary rules of AMAC.

## 7. Tiered-returns Products

Tiered-returns asset management products refer to products with multiple share classes where, among all the share classes, one or more share classes provide risk compensation for other share classes, and the dividend distribution of the asset management products will be conducted as otherwise agreed upon in the asset management agreements rather than by proportion of shares. Consistent with CSRC and AMAC's existing requirements, Article 21 of the Guiding Opinion stipulates that tiered-returns asset management products must not directly or indirectly guarantee principal and returns for holders of superior shares; and further it provides that open-ended privately-raised products must not have tiered-returns arrangement。

It is important to note that in the market, many private funds have two or more share classes according to special needs, but there is no one or more share classes providing any risk compensation to other share classes. Such private funds are not tiered-returns asset management products referred to in the Guiding Opinion.

## 8. Investment Advisory Services

According to Article 22 of the Guiding Opinion, a financial institution may engage a duly-qualified institution which Financial Regulators regulate as its investment advisor. Therefore, it is reasonable to conclude that, in principle, WFOE PFMs are eligible to provide investment advisory services for asset management products of various types.

However, we understand it is likely that competent Financial Regulators further provide for specific requirements on investment advisors providing investment advisory services to the asset management products under their regulations. Regulations that have been promulgated by Financial Regulators before the promulgation of the Guiding Opinion remain effective unless otherwise specified.

For example, both the *Interim Regulation on the Administration of the Operation of Privately-raised Asset Management Business of Securities and Futures Business Institutions* issued by CSRC and the *Guidelines for Securities Investment Trust Business of Trust Companies* published by the former China Banking Regulatory Commission have provided for qualification requirements for investment advisors providing investment advisory services for asset management products issued by securities and futures business institutions and private securities investment fund managers and the securities investment trusts issued by trust companies (e.g., the 1+3+3 requirements).

## 9. Practitioners Management

According to Article 7 of the Guiding Opinion, a financial institution must adopt and improve internal policies on practitioners' qualification recognition, training, appraisal and assessment and accountability. Practitioners who violate relevant laws, regulations or the Guiding Opinions must be subject to sanctions, and, in serious cases, their practitioners' qualifications may be revoked and they may be prohibited from engaging in asset management business in financial institutions of other types.

Currently, according to the *Provisions on Banning the Entry into the Securities Market* issued by CSRC, in cases where any person violates laws, administrative regulations or the relevant provisions of the CSRC, if the violation is serious, CSRC may exclude such person from the market (e.g. person subject to such exclusion will be banned from taking positions in fund management companies or securities companies, either as practitioners or as senior management personnel, and from taking the positions of senior management personnel in listed companies) in accordance with the severity of the violations. According to Article 7 of the Guiding Opinion, such exclusion is not limited to ban on taking positions in institutions regulated by CSRC. Taking practitioners of private fund managers as an example, practitioners that violate relevant laws severely may be banned from engaging in asset management business in all types of financial institutions and private fund managers.

## 10. Unified Reporting Standard for Asset Management Products

(1) According to Article 25 of the Guiding Opinion, a financial institution must submit the basic information and the initial fund-raising information of each asset management product to both PBOC and the competent Financial Regulators within 5 working days from product establishment, submit information about fund-raising and about assets/debts of the said product during the life of each product within the first 10 days each month, and submit information about product termination within 5 working days after the termination of each product.

(2) Prior to the formal operation of the asset management product information system, PBOC will, in conjunction with Financial Regulators, develop uniform data submission templates to be used during the transition period according to the statistics policies. Financial Regulators are required to provide PBOC with data on the asset management products launched by the financial institutions regulated by them, using the data submission templates, within the first 10 days each month and communicate with PBOC about major cross-industry or cross-market risk or events in a timely manner.

The content and channel of such reporting to be adopted by WFOE PFMs are pending further notification from Financial Regulators.

## 11. Adjustment to Investment Portfolios

(1) According to Article 4 of the Guiding Opinion, where a financial institution fails to comply with the restrictions on investment percentages corresponding to the product type as agreed in the contract, due to factors not attributable to its willful acts, the financial institution must make adjustments to resume the required percentage within 15 trading days from the date when the assets with restricted liquidity become sellable, transferrable or tradable.

(2) According to Article 16 of the Guiding Opinion, where a financial institution fails to comply with the restrictions on concentration of the assets invested by asset management products due to factors not attributable to its willful act, the financial institution must make adjustments to resume the required percentage within 10 trading days from the date when the assets with restricted liquidity become sellable, transferrable or tradable.

## 12. Transitional Period

The Guiding Opinion requires that a transitional period be set based on a clear cut-off principle to ensure smooth transition. The transitional period expires by the end of 2020.

During the transitional period, new products launched by financial institutions must meet the requirements in the Guiding Opinion. For exiting products which are not in compliance with the Guiding Opinion, financial institutions must make correction plans for such asset management products during the transitional period, which plan must have clear timeline for the corrections, and report the same to Financial Regulators for approval and supervision, and then file the same with PBOC.

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Generally speaking, the Guiding Opinion does not have significant difference from the current effective regulations for private securities investment funds in terms of, among other requirements, the requirements on qualified investors, private placement, internal control policies, risk management, investor suitability, and risk disclosure. However, there are many details which are worthy noting and also many issues which require further clarifications by Financial Regulators.

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[1]We view the financial asset investment companies as entities established by commercial banks to carry out debt-to-equity swap.
[2]The legislative intention is to be further clarified by Financial Regulators.
[3]The Office of Legal Affairs under the State Council issued a consultation paper of the Interim Regulation on the Administration of Private Investment Funds on 30 August 2017 to seek comments from the public.
[4]Please refer to C*apita-Raising Channels for WFOE PFMs*, published in September 2017 issue of Llinks Asset Management Bulletin, Sandra Lu and Eric Zou.
[5]Please refer to the *Explanation of Business Types, Fund types and Product Types of Private Investment Funds* issued by AMAC.
[6]Definitions of family financial assets or family financial net assets are to be confirmed by Financial Regulators.