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Northbound MRF Being Optimized: Relaxing the 50% Sales Limit and Allowing the Delegation of Investment Management

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On 19 April 2024, the CSRC promulgated five measures for the cooperation with Hong Kong with respect to the capital market, aiming to strengthen Hong Kong's role as an international financial center and promote the collaborative development of the capital markets of the Mainland China and Hong Kong. The fourth measure, the enhancement of Mainland-Hong Kong Mutual Recognition of Funds ("**MRF Enhancement**"), is intended to promote the moderate relaxation of the 50% limit on the AUM sourced from the distribution of MRF funds in host jurisdictions ("**50% Limit**"), and to allow the investment management functions of Northbound MRF funds to be delegated to overseas asset managers in the same group with the Hong Kong managers. Such MRF Enhancement will bring unprecedented opportunities to the MRF market participants and enrich the asset allocation options of the Mainland investors investing in offshore funds to a large extent.

I. Detailed Arrangement of the MRF Enhancement

The "moderate relaxation of the 50% Limit" is intended to relax the current limitation that the value of fund units sold to the Mainland investors shall not be more than 50% of the fund's total assets. The specific extent to which "moderate relaxation" will be applied is still pending clarification by the CSRC in conjunction with the SFC and other relevant parties on the implementation requirements. After the implementation of this MRF Enhancement, the 50% Limit for the distribution of Northbound MRF funds in the Mainland, as stated in the Mainland offering documents of the existing Northbound MRF funds, shall be amended accordingly.

With respect to "allowing the delegation of investment management functions to overseas asset managers within the same group", it is to uplift the current restriction that, for Northbound MRF funds, the Hong Kong managers shall not delegate their investment management functions to institutions in other countries or regions. After the implementation of MRF Enhancement, where Hong Kong managers delegate the investment management function of Hong Kong-domiciled funds to the group affiliates in other countries/regions, such Hong Kong funds with investment delegates will also have chance to apply for Northbound MRF. As to whether there will be specific eligibility requirements on the investment delegate and whether the investment management agreement with the investment delegate will be required to be submitted when lodging the application with the CSRC, it remains to be clarified by the CSRC together with the SFC and other relevant parties on the implementation requirements.

As the prevailing *Interim Provisions on the Administration of Recognised Hong Kong Funds* still have the 50% Limit and prohibition on delegation of investment management functions to institutions in other countries or regions, it is anticipated that the implementation of the MRF Enhancement will need to await CSRC's amendment to the *Interim Provisions on the Administration of Recognised Hong Kong Funds*.

To facilitate the understanding, the changes in eligibility requirements for Northbound MRF funds before and after the MRF Enhancement are illustrated in the table below:

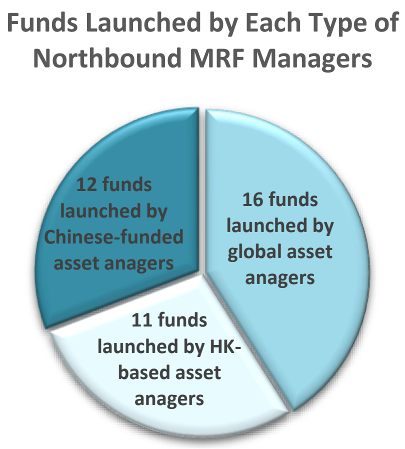
	Existing Eligibility Requirements for Northbound MRF Funds	After the Implementation of MRF Enhancement
Fund Domicile	Northbound MRF funds shall be domiciled in Hong Kong and operate in accordance with Hong Kong laws, and shall be authorized for public offering and regulated by the SFC.	Still applicable
Manager Eligibility and Compliance Requirements	Hong Kong manager shall be registered and operate in Hong Kong, holding the Hong Kong asset management license, shall not delegate the investment management function to institutions in other countries or regions, and shall not be subject to any material punishment imposed by the SFC in the most recent three years or since its establishment.	Permission of delegation of investment management functions to overseas asset managers within the same group
Trustee/Custodian	Northbound MRF funds shall adopt custody structure, with trustee or custodian that meets the qualification requirements of the SFC.	Still applicable
Fund Type	Northbound MRF funds shall be regular equity funds, mixed funds, bond funds or index funds (including ETFs).	Still applicable
Inception of Fund	Northbound MRF funds shall be established for more than one year. * If an SFC-authorized fund that is re-domiciled in Hong Kong from overseas jurisdictions, the 1-year period is calculated from the day on which the fund is re-domiciled in Hong Kong.	Still applicable
Fund Size	A Northbound MRF fund's AUM shall be no less than RMB200 million (or its equivalent in foreign currency).	Still applicable
Investment Target	Northbound MRF funds shall not primarily invest in the Mainland markets.	Still applicable
Distribution Target	The value of fund units sold to the Mainland investors shall not be more than 50% of the MRF fund's total assets.	Moderate relaxation of the 50% Limit
Dispute Resolution	Where the constitutive document provides for dispute resolution by way of litigation, the jurisdiction of Mainland courts cannot be excluded.	Still applicable

Mainland Agent	A Hong Kong manager shall appoint the institution with Mainland retail fund management license or fund custodian license as the Mainland agent. Mainland agents shall be responsible for handling such matters as product registration, information disclosure, distribution arrangement, data exchange, fund settlement, regulatory reports, communications, customer services and monitoring.	Still applicable

II. Necessity and Urgency of MRF Enhancement

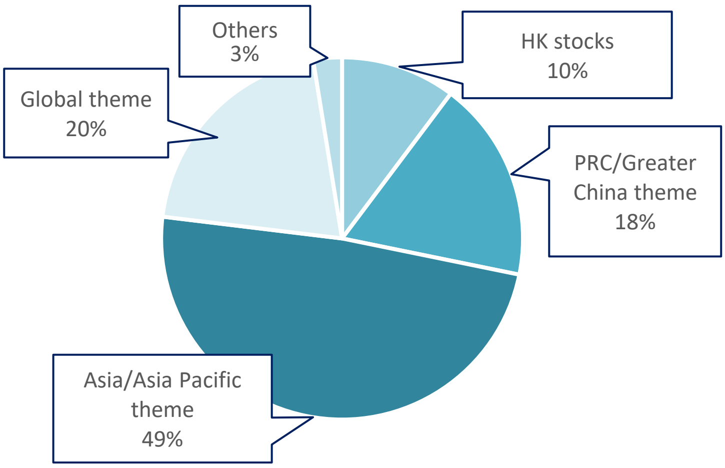
Since the launch of the MRF regime in 2015, so far, 39 Hong Kong funds launched by 21 Hong Kong managers have been registered with the CSRC as Northbound MRF funds and publicly offered in the Mainland. By the end of February 2024, the net outflow of Northbound MRF funds exceeded RMB 21.4 billion.

The 21 Hong Kong managers include 6 global asset managers (JPMorgan Funds (Asia), Schroders, Amundi, HSBC AM, Pictet, UBS AM), 6 HK-based asset managers (Hang Seng Investment, ZEAL, BEA Union, Value Partners, Income Partners, GaoTeng) and 9 Chinese-funded asset managers (CCBI, BOCHKAM, BOCI-Prudential, Haitong International, Bosera International, ChinaAMC HK, E Fund HK, China Industrial Securities International and CSOP). The Northbound MRF funds of global asset managers account for a higher proportion. Among them, JPMorgan Funds (Asia) has six approved Northbound MRF funds and HSBC AM has four, with the product lines covering equity funds and bond funds.



There are 10 Hong Kong managers engaging affiliates in the Mainland as their Mainland agents of the Northbound MRF funds. For example, JPMorgan Funds (Asia) engages JPMorgan Asset Management (China) Company Limited, HSBC AM engages HSBC Jintrust Fund Management Company Limited, Amundi engages ABC-CA Fund Management Co., Ltd., Schroders engages BOCOM Schroders Fund Management Co., Ltd. as their Mainland agents. In these cases, Hong Kong managers may take the most advantage of the solid market foundation, rich client resources and compliance experience of their Mainland affiliated fund management companies. There are 11 Hong Kong managers managing total 15 funds that engage independent non-affiliated fund management companies or banks with fund custodian license as Mainland agents. Among these independent Mainland agents, Tianhong is the most active one, which provides agency services for total 8 Northbound MRF funds of 5 Hong Kong managers. In addition, BlackRock, Neuberger Berman, FIL, Schroders, AllianceBernstein, Allianz, Manulife, JPMorgan, Morgan Stanley already have their WFOE FMCs (wholly foreign-owned retail fund management companies) in China. WFOE FMCs have a unique advantage in terms of onshore resource integration and in promoting the deep involvement of offshore affiliates in the Northbound MRF business.

For the product type, funds with global theme account for a small share, while the predominance are the funds with major investment in Hong Kong stocks, PRC theme and Asia/Asia-Pacific theme.



That global theme taking a small market share is resulted from the current restriction of no delegation under Northbound MRF regime. This means that the investment management of a fund should be solely undertaken by the Hong Kong local investment team. As the investment and research capabilities of the Hong Kong local team are mainly concentrated on Hong Kong equity, PRC theme and the Asia-Pacific region, it is difficult to extend the investment research to global markets. Global investment usually relies on investment teams located in the invested markets, each of which knows the local market and has geographic advantages. This is also the basic principle for global asset managers to equip investment teams and personnel globally. It can be easily observed that a global asset manager, even though having a Hong Kong entity holding the asset management license and launching a series of mature Hong Kong unit trust, will still delegate the investment management functions of a significant number of funds with global themes (e.g. global asset allocation, asset allocation in Europe, US, Australia, emerging markets such as South America) to its non-Hong Kong affiliates located in relevant markets for investment. Otherwise, it will bring huge cost pressure to the Hong Kong manager, and it is impracticable to build a global investment research team in Hong Kong or to relocate a mature team from other countries/regions to

Hong Kong. Using a Hong Kong-based investment team to cover the investment locations and markets such as US that are geographically distant and have time differences, would lead to a lack of professional research support, and may further cause insufficient investment expertise and even failure of delivering good investment performance.

The prohibition from delegating the investment management functions under the Northbound MRF regime has led to the convergence of investment markets and even the convergence of performance of most Northbound MRF funds. That is, when the market is going up, most Northbound MRF funds might perform well and share the benefits of a rising market; on the contrary, when the market goes down, the similar allocation of investment markets results in a collective decline of the performance of the funds. The limited investment markets and investment themes of Northbound MRF funds also bring the limited investment choices, and makes it difficult for Mainland investors to truly achieve global asset allocation and diversification of investment risks.

The above situation will be substantially improved by the MRF Enhancement of "allowing the investment management functions of Northbound MRF funds to be delegated to overseas asset managers in the same group with the Hong Kong managers". In particular, it will be a great boost for the global asset managers which have established presences in major countries and regions. The pool of potential Northbound MRF funds will be greatly enlarged. And global asset managers can make a medium-long term arrangement to include more diversified investment strategies to Northbound MRF funds.

The current 50% Limit presents a significant obstacle for Hong Kong managers to achieve revenue growth and cost coverage through scale effect. Due to the population, market size and adequate competition of Hong Kong, a single Hong Kong fund whose AUM exceeds RMB 200 million is considered as a large-size fund in Hong Kong, while Hong Kong funds whose AUM reach RMB 1 billion or RMB 10 billion are rare. Per the 50% Limit requirement, Hong Kong managers usually set a threshold at 45% - 48% of the total AUM of the Northbound MRF fund as the distribution ceiling in the Mainland. Once the threshold is reached, the Hong Kong managers have to suspend the fund distribution in the Mainland by issuing an announcement of suspension, and shall not resume the distribution in the Mainland until the AUM sourced from the distribution in the Mainland drops below the threshold. Due to the fact that many service providers are involved in the Northbound MRF, the costs of compliance, marketing, information disclosure and customer service are relatively high, the initiative and motivation of Hong Kong managers to participate in the Northbound MRF business are weak in the absence of scale effect, which also affects the sustainable and healthy development of the Northbound MRF regime. Participants in the Northbound MRF have made repeated appeals and eagerly awaited the relaxation of the 50% Limit in the Mainland. The CSRC and the SFC have listened to the call of the market and now decide to "moderately relax the 50% Limit".

III. Profound Impact of the MRF Enhancement

The 50% Limit and the requirement for localization of investment management function of Northbound MRF funds have, to a certain extent, dampened the initiative of global asset managers to participate in the

Northbound MRF regime. The relaxation of these two restrictions will have a profound impact on market participants, Mainland investors and even the whole Hong Kong market.

1. Hong Kong managers

On one hand, Hong Kong managers can delegate investment management functions to the affiliates within the group and leverage the local investment management capabilities and market expertise of their affiliates in various countries/regions with no concern of negatively impacting the eligibility of Northbound MRF funds. Hong Kong managers can make more effective asset allocation and risk diversification globally. On the other hand, Hong Kong managers can design and provide diversified fund products more flexibly and refine their product lines in the Mainland to satisfy the multiple investment needs of investors. This will not only promote the growth of AUM of Hong Kong managers, increase the income of management fee (and indirectly increase the income of investment management fee charged by affiliated sub-managers), but also enhance the managers' brand recognition in the Mainland and strengthen their competitive edge in the market.

2. Mainland agents

The agency fee charged by Mainland agents is usually linked to Northbound MRF funds' AUM sourced from distribution in the Mainland. However, given the current 50% Limit, the agency fee that Mainland agents can charge is relatively limited. The MRF Enhancement will also bring new vistas to the agency business of Mainland agents. Firstly, the agency fee charged by Mainland agents may experience a qualitative leap with the increase of Northbound MRF funds' AUM sourced from the Mainland. If Mainland agents also act as the distributor of Northbound MRF funds, the distribution fee they can charge is also expected to increase. Secondly, under the Northbound MRF regime, Mainland agents can cooperate with well-known global asset managers to build broader and deeper business ties. Mainland agents can also accumulate international operational experience, laying a good foundation for implementing their internationalization strategies. Furthermore, Mainland agents can also, by way of international products, enhance their brand image and market influence, provide a diversified range of fund products to their clients, and attract more investors and business partners.

3. Mainland investors

Currently, Mainland investors can have access to offshore funds through QDII/QDLP/QDIE products, and Northbound MRF funds, or, in the case of Mainland investors in the Guangdong-Hong Kong-Macao Greater Bay Area ("**GBA**"), can purchase offshore products through GBA Wealth Management Connect.

From the perspective of investors' investment costs, the QDII/QDLP/QDIE products that feed into the offshore funds are issued by domestic QDII/QDLP/QDIE qualification and quota holders, which might involve multiple layers of fees charged onshore and offshore. The investment costs for Mainland investors to directly invest in Northbound MRF funds are comparatively lower.

From the perspective of investment quota, the issuance of QDII/QDLP/QDIE products is subject to the investment quota granted to each product issuer. Once the investment quota is used up, the subscription of QDII/QDLP/QDIE products will be suspended. However, all the Northbound MRF funds are only subject to the overall limit of the Northbound MRF regime (RMB300 billion), and there is no quota limit for a single Northbound MRF fund or an individual Hong Kong manager. By the end of February 2024, the net outflow of Northbound MRF funds amounts to RMB21.4 billion, leaving substantial room for further increase.

From the perspective of investment thresholds, QDLP/QDIE products, QDII private asset management schemes and QDII trust schemes are required to raise funds from specific qualified investors in a non-public manner, while Wealth Management Connect is currently only available to Mainland investors in the GBA. In contrast, Northbound MRF funds have no geographical restrictions and can be sold publicly to retail investors in the Mainland. Obviously, Northbound MRF funds can target a broader group of Mainland investors.

The MRF Enhancement will greatly enrich the channel for Mainland investors to get access to global assets with lower investment costs. Mainland investors will no longer face the subscription suspension due to the fact that the Northbound MRF funds' distribution in the Mainland approaches the 50% Limit. At the same time, more and more Northbound MRF funds with global themes are expected to enter the Mainland market, providing Mainland investors with a convenient and efficient way for global asset allocation.

4. Hong Kong's role as an international financial centre will be further consolidated and enhanced through the MRF Enhancement

With the MRF Enhancement, Hong Kong managers will have more flexibility to cooperate with teams in other countries/regions within the group, offer diversified fund products and integrate the investment strategies of offshore affiliates into their products, so as to apply for the Northbound MRF and expand the Mainland market. As the Mainland only has MRF arrangement with Hong Kong, through the cooperation between Hong Kong managers and their overseas affiliates, it is expected that Hong Kong will be chosen as the domicile of more funds, which will enhance the attractiveness and competitiveness of Hong Kong as an international financial centre. Hong Kong can continue to build a better fund ecosystem, attract more financial institutions and professionals to settle in Hong Kong, and further consolidate its status as a global financial centre by building Hong Kong into a fund registration and management centre in Asia and even the whole world.

IV. Outlook

The introduction of the MRF Enhancement may bring positive impacts and optimistic expectations for a win-win outcome for overseas asset managers, Mainland agents and Mainland investors. It also demonstrates the more open stance of China's capital market and the CSRC's determination to implement the "coordinating the high-level institutional opening-up of the capital market" provided in the "Nine Policies". We look forward to the early implementation of the MRF Enhancement.

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