

Analysis under PRC Law and Hong Kong Law on the Legal Relationship among the Involved Parties of RQFII Funds

By Sandra Lu and Lily Luo

With the promulgation of *Pilot Measures for Securities Investment in Mainland China by Renminbi Qualified Foreign Institutional Investors of Fund Management Companies and Securities Companies* (“**RQFII Pilot Measures**”) and the ancillary rules and regulations issued by relevant domestic and offshore regulators (e.g., CSRC, SAFE, PBOC, CSDCC and SFC), RQFII products having launched and raised money in Hong Kong are allowed to invest in securities markets (including the exchange markets and the inter-bank market) through the Renminbi investment quota granted by SAFE.

The first batch of RQFII funds, dominantly investing in fixed-income products and complying with the so-called “Two-Eight Principle”, has been successfully authorized by SFC and launched during the first season of 2012. The second batch of RQFII products will be RQFII ETFs which invest in China’s A-Share market. According to relevant news reports, the Hong Kong subsidiaries of ChinaAMC, Harvest, E Fund and China Southern have taken the lead in obtaining the approvals from CSRC and SAFE to develop RQFII ETFs which respectively track CSI 300 Index, MSCI China A Index, CSI 100 Index and FTSE China A50.

Involved Parties of RQFII Funds and Relevant Agreements

The publicly offered RQFII funds are usually established in the form of umbrella unit trusts with such parties as fund manager, trustee, global custodian, PRC custodian getting involved. The instruments used to establish and identify the legal relationship among the parties usually include:

- Trust deed entered into between the manager and the trustee

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The manager appoints the trustee, who is qualified under the *Trustee Ordinance, Code on Unit Trusts and Mutual Funds* and acts as the legal owner of the trust assets under the trust deed, to perform the trustee's duties like holding trust assets, being the registrar of the trust and procuring the operation of unit trust to be in line with the trust deed.

- Global custodial agreement entered into between the trustee and the global custodian

The trustee, on behalf of the unit trust, may delegate certain powers and duties to a Hong Kong-licensed bank to act as the global custodian of the specific sub-funds under the umbrella unit trust. Such delegated powers and duties usually include the custody of fund assets, opening of accounts, execution of the investment instructions given by the manager and then delivered through the trustee, etc.

- Arrangement between the global custodian and the PRC custodian

The global custodian usually appoints its PRC subsidiary to perform sub-custodial services for RQFII fund assets in the PRC. Such internal arrangement may be established expressly through written agreement or impliedly through its intrinsic systems.

- PRC custody agreement

It is provided in Article 5 of RQFII Pilot Measures that RQFII shall appoint PRC commercial bank(s) having the qualification of QFII custody services to provide custodial services within the PRC. The PRC custody agreement, compulsorily required by the PRC regulator, purports to clarify powers and duties among the involved parties, specify such duties of the PRC custodian as applying for investment quota, opening cash account(s) and securities account(s), taking custody of fund assets, conducting compliance review on the investment, submitting periodic reports to PRC regulators, doing settlement, company action, proxy voting and record keeping for specific RQFII funds. The executing parties thereof differ from one custodian to another, howsoever should at least include the RQFII and the PRC custodian.

- Participation Agreement

The participation agreement does not constitute an essential document for RQFII funds and is dedicated to make the specific sub-funds utilize the investment quota obtained by the RQFII and to involve the trustee into the agreement, so that the trustee's powers and duties under Hong Kong law could be incorporated into the cross-border RQFII legal structure.

Issues in Question

Based on the above brief introduction on the relevant instruments of RQFII funds, it turns out that certain inconsistencies exist in respect of the duties and the roles of relevant parties of RQFII funds. The requirement of PRC regulators on executing PRC custody agreement may stem from the habitual understanding of the dual-trustee model under the *Law of the People's Republic of China on Securities Investment Funds* where the custodian bank and the fund manager are identified as the co-trustees of a specific public offering fund. However, under Hong Kong law, it should be the “trustee” (as defined by the *Trustee Ordinance, Code on Unit Trusts and Mutual Funds*) who appoints the custodian bank for the unit trust other than the fund manager who should focus on the investment management of the unit trusts but not act as the trustee thereof.

In practice, there appears to be two solutions to cope with the above-mentioned conflict. One is to additionally execute a participation agreement (as described in Item v of Paragraph I of this article), another is to insist on the original agreements framework which involves trust deed, global custodial agreement, sub-custodial arrangement between the global custodian and the PRC custodian, as well as the PRC custody agreement which lays less emphasis on substantial provisions of rights and obligations, whilst mainly embodying the restatement of the provisions of the trust deed, global custodial agreement and the sub-custodial arrangement, the acknowledgement and confirmation by the RQFII on the global custodian’s delegation to PRC custodian, and the communication arrangement between RQFII and PRC custodian, etc. It indicates that the latter solution aims to maximally respect the existing legal structure of unit trusts under Hong Kong law while simultaneously meeting the regulatory requirement of executing PRC custody agreement.

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