

Analysis on “Interim Provisions on the Administration of Recognised Hong Kong Funds”

By Sandra Lu and Vivien Teu

On 22 May 2015, the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (SFC) have entered into a *Memorandum of Regulatory Cooperation on Mainland-Hong Kong Mutual Recognition of Funds*, and the CSRC has issued the *Interim Provisions on the Administration of Recognised HK Funds* (“**Provisions on Recognised HK Funds**”), which formally permits eligible Hong Kong retail funds to be registered and distributed in Mainland China and opens the “North-bound” path for Hong Kong retail funds (“**Recognised HK Funds**”).

Correspondingly, the SFC has issued the *Circular on Mutual Recognition of Funds (MRF) between the Mainland and Hong Kong*, permitting Mainland retail funds to be “south-bound” upon fulfilling the required regulatory procedures, to be distributed in Hong Kong. The *Provisions on Recognised HK Funds* shall be implemented from 1 July 2015, and North-bound funds, South-bound funds are respectively subject to a total initial investment quota amount of RMB 300 billion for fund-flows each way.

We set out below our brief analysis on the stipulations of the *Provisions on Recognised HK Funds* and relevant legal issues in the Mainland distribution of Recognised HK Funds. The relevant issues in relation to the Hong Kong distribution of Recognised Mainland Funds are discussed in a separate article of our firm.

I Eligibility requirements for Recognised HK Funds

According to the *Provisions on Recognised HK Funds*, Hong Kong funds that meet the following conditions (according to CSRC official statistics, as at the end of 2014, there are approximately 100 Hong Kong retail funds that meet such standard for mutual recognition) in order to be registered and distributed in the Mainland:

如果您需要本出版物的中文本，请与下列人员联系：

郭建良: (86 21) 3135 8756
Publication@llinkslaw.com

If you would like other Llinks publications, please contact:

Roy Guo: (86 21) 3135 8756
Publication@llinkslaw.com

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1. Domicile of the Fund

Recognised HK Fund should be the unit trust, mutual fund or other form of collective investment scheme that is domiciled, operating and publicly offered in Hong Kong; hence, funds that are publicly offered in Hong Kong but not domiciled in Hong Kong are not included; further, as the mutual recognition arrangement is a scheme directed at publicly raised funds in the Mainland and in Hong Kong, private-raised funds that are established and operating in Hong Kong are not within the scope for mutual recognition.

2. Manager Eligibility

The management company must be registered and operating in Hong Kong, holding the relevant Hong Kong asset management license (i.e. licensed for Type 9 regulated activity), and it has not delegated its investment management function to any organization in another country or region. It is notable that this does not exclude a scenario where the management company delegates the investment management function to another Hong Kong licensed entity.

3. Manager’s Good-standing

The management company has not suffered major punishment imposed by the SFC in the most recent three years or since its establishment; it should be noted that this requirement does not imply that the management company must have been established for three years, but expressly states that where a management company has not been established for three years, the requirement not to have suffered major regulatory punishment shall apply only from its date of establishment. For the interpretation of “major regulatory punishment”, this will need to be determined based on the regulatory requirements and practice in Hong Kong.

4. Custodian Requirement

Recognised HK Fund should adopt custody structure, with trustee or custodian that meets the qualification requirements of the SFC.

5. Fund Type

Recognised HK Funds shall be general equity funds, balanced funds, bond funds or index funds (including physical index-tracking ETFs), and not primarily investing in the Mainland markets. According to the said requirement, money market funds are not eligible for mutual recognition, and similarly excluded are special equity funds, balanced funds, bond funds and index funds. For the interpretation of what is “general”, this will need to be considered taking into account the regulatory

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requirements in Hong Kong, the regulatory requirements in the Mainland, against the specific features of specific funds. For the interpretation of “not primarily investing in the Mainland markets”, this is subject to further official clarification by the CSRC.

6. Fund Size

Recognised HK Fund shall have been established for at least one year, with asset-under-management of not less than RMB 200 million (or its equivalent in foreign currency). In view that a Recognised HK Fund will need to submit the fund’s audited annual report when submitting its registration application to the CSRC, we are of the view that a fund may use its most recent annual report and the fund’s published net value of assets to determine whether the requirement of RMB 200 million AUM is met, and the management company does not need to conduct a special fund audit for this purpose.

7. Fund Distribution Target

Recognised HK Fund shall not have more than 50% of its total assets raised from distribution in the Mainland.

It is note-worthy that the above-mentioned conditions for mutual recognition are continuing requirements. Following completion of registration and distribution in the Mainland, if a Recognised HK Fund’s AUM, primary investment focus or primary fund distribution target ceases to fulfill the recognition conditions, the Hong Kong management company should forthwith report to the CSRC, and suspend the distribution activities of the fund in the Mainland until it again comes within the qualifying conditions. Similarly, if there is a major change to the Recognised HK Fund’s fund type or operating model, the Hong Kong management company should suspend the distribution activities of the fund in the Mainland, and re-submit a registration application to the CSRC. For the interpretation of what may be a major change to the “fund type” or “operating model”, it will need to be interpreted based on the *Securities Investment Funds Law of the People’s Republic of China* (“**Funds Law**”) and CSRC regulations.

II Mainland Registration of Recognised HK Funds

1. Recognised HK Funds shall be registered with the CSRC before it may be distributed in the Mainland

Article 51 of the *Funds Law* provides that “public-offered funds shall be registered with the State Council appointed securities regulatory body; if not registered, public or effectively public offer of funds are not permitted”. Accordingly, Recognised HK Funds must be registered with the CSRC before its public offer, and in the registration process, subject to CSRC review of its eligibility meeting the said conditions for mutual recognition.

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2. Timeline for registration of Recognised HK Funds

The timeline for CSRC’s review of Recognised HK Funds should follow Article 55 of the *Funds Law* – the CSRC shall review registration application of Recognised HK Funds according to the regulations and issue its decision whether or not the registration is approved, within 6 months of accepting the application; and the CSRC shall give the reasons if registration is not approved.

Certainly, the industry has also observed that the CSRC approves registration of general funds in the Mainland within 20 working days. However, in view that the Mainland-Hong Kong MRF is at its initial stage, and the CSRC would need to progressively gain understanding and consolidate its regulatory approach on the MRF, it is unlikely that the registration of Recognised HK Funds will initially not follow the 20 working days registration timeline for Mainland general funds, but may more likely be closer to 6 months.

3. Documents required to be submitted to CSRC for registration of Recognised HK Funds

Hong Kong management companies should engage Mainland Agent (as defined below) to handle the registration of Recognised HK Funds, and, through the Mainland Agent, submit the following materials to the CSRC:

- (1) Application report – according to CSRC usual practice, the application report should be signed by the authorized representative of the Hong Kong management company;
- (2) trust deed or articles of association;
- (3) offering document (such as explanatory memorandum) and product key facts statement (KFS);
- (4) Most recent audited annual report of the fund;
- (5) Documents evidencing that the fund, management company, trustee, custodian, agent each meets the qualifying requirements – we understand that such documents should be jointly prepared by the management company and Mainland Agent, and should at least include the proof of the asset management license of the management company and the SFC’s authorization of the fund;
- (6) Legal opinion issued by a law firm – according to Article 52 of the *Funds Law*, a legal opinion issued by a law firm is required in connection with the public offer of a publicly raised fund, and therefore, a Hong Kong management company will also be required to furnish such legal opinion when making a registration application to the CSRC. We understand that such legal opinion should be issued by a Mainland law firm regarding the proposed MRF eligibility, the qualifications of the management

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company, trustee, custodian and the Mainland Agent, and with its opinion on the signing and stipulations of the agency agreement;

- (7) Where the afore-said documents differ from SFC-authorized versions, to list and explain the key differences; and
- (8) Other materials required by the CSRC.

As required under the *Provisions on Recognised HK Funds*, these relevant materials to be submitted to the CSRC shall be prepared in Simplified Chinese, with relevant terms and language as those customary for Mainland funds; where the source document is in another language, a true, accurate and complete translation into Simplified Chinese version shall be provided. In view that the list of required materials include documents of extensive length such as trust deed, offering document and fund annual report, Hong Kong management company will need to prepare ahead to organise Chinese translation of the relevant documents. Not only should the Chinese translation be true, accurate and complete in reflecting the English version, it should be easily reviewed and readable using terms and language that the Mainland fund industry and regulatory bodies are accustomed to – this should be somewhat challenging.

III Agency Arrangement

1. Mainland Agent and Qualification Requirements

According to the relevant requirements of the *Provisions on Recognised HK Funds*, the management company of Recognised HK Funds should appoint qualifying Mainland institutions as agent (“**Mainland Agent**”), for handling the fund’s onshore affairs. The Mainland Agent should be an institution qualified to engage in public-offered fund management business or fund custodian business in the Mainland.

A list of the Mainland retail funds management institutions, and a list of Mainland retail funds custodians as at March 2015 (in Chinese) are available at CSRC’s website (and as regularly updated):

http://www.csrc.gov.cn/pub/zjhpublic/G00306208/201504/t20150424_275543.htm

http://www.csrc.gov.cn/pub/zjhpublic/G00306208/201504/t20150424_275550.htm

After the Hong Kong management company has selected the Mainland Agent, it is required to continually supervise and regularly assess the performance of the Mainland Agent, to ensure that the duties and responsibilities of the management company will be carried out effectively.

2. Duties and Responsibilities of Mainland Agent

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According to the *Provisions on Recognised HK Funds*, the main duties and responsibilities of the Mainland Agent include:

- (1) Handling the fund’s registration in the Mainland;
- (2) Conducting compliance review on the fund’s marketing and promotional materials;
- (3) Entering into distribution agreements with Mainland fund distributors (the management company may also itself enter into such agreements directly with distributors);
- (4) Data reconciliation with fund distributors, funds settlement and clearance;
- (5) Information disclosure through designated media or the website of Mainland Agent;
- (6) Fulfilling anti-money laundering requirements as agreed with the management company and fund distributors;
- (7) Customer service.

3. Main Content Requirements of Agency Agreement

The Hong Kong management company shall enter into an agency agreement with the Mainland Agent, and such agency agreement is one of the documents to be submitted to CSRC in the registration application of the fund. The agency agreement should expressly set out the agreed terms on (1) the content of principal-agent arrangement; (2) the respective duties, responsibilities, rights and obligations of the management company and the Mainland Agent; (3) a plan for orderly handling of affairs upon the expiry of the agency agreement or termination of cooperation between the parties.

4. Obligations of the Hong Kong Management Company under the Agency Arrangement

Even though the Hong Kong management company shall appoint the Mainland Agent as its agent to handle the affairs of the fund, according to the requirements in Article 21 of the *Provisions on Recognised HK Funds* and China agency concept, the duties and responsibilities of the Hong Kong management company to investors in the Mainland are not diminished by its appointment of the Mainland Agent.

IV Investment Operation, Information Disclosure and Distribution of Recognised HK Funds

1. Basic Principles

According to the *Provisions on Recognised HK Funds*, the operation, distribution and information disclosure of Recognised HK Funds should comply with the following principles:

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- (1) The investment operation shall comply with Hong Kong laws and regulations and the constitutive documents of the fund.
- (2) Distribution of the fund in the Mainland shall comply with Mainland laws and regulations.
- (3) Information disclosure shall mainly be in accordance with Hong Kong laws and regulations and constitutive documents of the fund, but shall be suitably supplemented according to Mainland laws and regulations.

2. Information Disclosure

Documents to be disclosed in the Mainland in respect to Recognised HK Funds include:

(1) Offering document:

The offering document shall be supplemented with the following information for the Mainland market:

- (i) specific statement and risk disclosures regarding Recognised HK Fund;
 - (ii) types of documents, frequency and manner of information disclosure documents to be furnished by the fund in the Mainland, and the location and arrangement for inspection of documents;
 - (iii) rights and obligations of the parties to the fund, procedures and rules of meetings of fund holders, grounds and procedures for termination of fund contract, dispute resolution;
 - (iv) types, content and manner of services provided to fund holders, and contact details; and
 - (v) other information such as any major difference to information provided to Hong Kong investors or with major impact on Mainland investors.
- (2) Product key facts statements (KFS): KFS should be supplemented with specific statement and risk disclosures regarding Recognised HK Fund.
- (3) Announcement on offering of fund units: this document is not required in the Hong Kong sale and distribution of a Recognised HK Fund, but it is a requisite document in fund offering for Mainland registered funds. According to the requirements of the *Provisions on Recognised HK Funds*, the Hong Kong management company shall prepare an announcement on the offering of fund units which shall include information regarding specific operational matters such as account opening, settlement and clearance, registration, timing, channels and manner for distribution of fund units.
- (4) Trust deed or articles of association:

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The *Provisions on Recognised HK Funds* require that where the dispute resolution mechanism set out in the trust deed or articles of association of the fund adopts litigation, the jurisdiction of Mainland courts shall not be excluded. On the one hand, this will require a number of Recognised HK Funds to amend its dispute resolution mechanism set out in the constitutive documents, while on the other hand, from the perspective of Mainland courts, it shall be a new issue as to how potential cases relating to the MRF may be adjudicated in the future.

- (5) Publication of net asset value (NAV)
- (6) Periodical financial reports (quarterly, semi-annually, annually)
- (7) Ad hoc announcements

The materials referred to in (1) to (4) above and the fund’s latest annual report and semi-annual report shall be made public available, three days prior to its initial offer in the Mainland.

The above information disclosure documents shall be disclosed to Hong Kong and Mainland investors at the same time, and shall be published in CSRC-designated national newspapers or the website of the Mainland Agent.

3. Fund Distribution

The Hong Kong management company shall itself or through the Mainland Agent engage institutions qualified to distribute retail funds to distribute the Recognised HK Funds. The Hong Kong management company, Mainland Agent and fund distributor (or as the case may be, the Hong Kong management company and fund distributor) shall enter into fund distribution agreement so as to agree on the respective duties and obligations to ongoing services towards fund holders, allocate duties and obligations for conducting anti-money laundering.

The list of institutions qualified to distribute retail funds as at March 2015 (in Chinese) is available at:

http://www.csrc.gov.cn/pub/zjhpublic/G00306208/201504/t20150414_275012.htm

On the distribution of Recognised HK Funds in the Mainland, Mainland laws and regulations on the distribution of retail funds shall be complied with. Of these, the key ones are the *Funds Law* and the *Measures on Distribution of Securities Investment Funds* (CSRC Decree No. 91). In the aforesaid laws and regulations and other relevant regulatory documents, the CSRC has set out comprehensive and specific requirements on marketing and promotion, handling for dealing applications, settlement and clearance of funds and customer service responsibilities. In the present scope and context, we do not further elaborate

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on the specific requirements on these aspects, but we shall separately write up on the specific requirements from a practical perspective to share with Hong Kong management companies.

On fund distribution, the marketing and promotional materials are among the most important. According to the *Measures on Distribution of Securities Investment Funds*, the marketing and promotional materials of publicly-offered fund refer to information distributed or announced to the public aimed to promote the fund and generally available to the public in the form of writing, electronically or through other media. The *Provisions on Recognised HK Funds* stipulate a series of requirements on Recognised HK Funds’ marketing and promotion in the Mainland:

- (1) Where the Hong Kong management company itself or through appointing another institution produces marketing and promotional materials suitable for the distribution of Recognised HK Fund in the Mainland, it shall first obtain a compliance review and compliance opinion on such materials from the Mainland Agent, and shall within 5 working days of the issue in the Mainland file such materials with the local office of CSRC at the place of principal business activities of the Mainland Agent.
- (2) Where a distributor of Recognised HK Fund itself produces marketing and promotional materials for a Recognised HK Fund, it shall obtain a review and compliance opinion on such materials by a senior management personnel of the said distributor who is in charge of fund distribution business and compliance, and shall within 5 working days of the issue in the Mainland file such materials with the local office of CSRC at the place of business registration of the distributor.
- (3) The marketing and promotional materials of Recognised HK Funds shall be comprehensive, accurate, clear, effective, and shall specifically and expressly indicate that the fund is established according to Hong Kong law, and it shall be regulated by Hong Kong law and the relevant requirements of the SFC such as applicable to its investment operation, information disclosure.
- (4) Where there is reference to appraisals or ratings by offshore institutions in the marketing and promotional materials, it shall specifically indicate that the appraisal methods and results differ from the methods and results adopted by Mainland appraisal institutions.

The mutual recognition of funds is a milestone for establishing new market frontiers for retail funds in both Mainland and Hong Kong, and will no doubt be a key new business for the fund management industry in both Mainland and Hong Kong, where the Hong Kong management companies will face several procedural and specific issues as described above. To the Mainland fund management institutions and custodians, it will also be a new issue with respect to how best the role of Mainland Agent of Recognised HK Funds shall be performed. As always, Links shall be dedicated to in-depth participation in the work of mutual fund recognition in various respects, and with a focus on best market practices, shall seek to provide assistance to institutions in both Mainland and Hong Kong on relevant issues to be addressed and offer solutions.

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Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual Llinks contact.

Authors	
Sandra Lu Tel: (86 21) 3135 8776 Sandra.Lu@llinkslaw.com	Vivien Teu Tel: (852) 2969 5316 Vivien.teu@vteu.co
Shanghai	
Christophe Han Tel: (86 21) 3135 8778 Christophe.Han@llinkslaw.com	Charles Qin Tel: (86 21) 3135 8668 Charles.Qin@llinkslaw.com
David Yu Tel: (86 21) 3135 8686 David.Yu@llinkslaw.com	Sandra Lu Tel: (86 21) 3135 8776 Sandra.Lu@llinkslaw.com
Nicholas Lou Tel: (86 21) 3135 8783 Nicholas.Lou@llinkslaw.com	Tommy Xia Tel: (86 21) 3135 8769 Tomy.Xia@llinkslaw.com
Raymond Li Tel: (86 21) 3135 8663 Raymond.Li@llinkslaw.com	
Beijing	
James Weng Tel: (86 10) 8519 2266 James.Weng@llinkslaw.com	Leo Wang Tel: (86 10) 8519 2266 Leo.Wang@llinkslaw.com
Hong Kong(in Association with Vivien Teu & Co)	
Sandra Lu Tel: (86 21) 3135 8776 Sandra.Lu@llinkslaw.com	Vivien Teu Tel: (852) 2969 5316 Vivien.teu@vteu.co