



Llinks Asset Management Bulletin

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New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

By Sandra Lu | Tracy Chen

Since the launch of Stock Connect in 2014, a large number of Mainland retail fund management companies (the “FMC”), securities firms, trust companies and private fund managers have issued and managed asset management products that invest in the HK eligible stocks under Stock Connect. Hong Kong institutions have several advantages in such eligible HK stocks. They have a team of experts in investment and research, are familiar with the market and enjoy a high degree of convenience in research. Therefore, in the process of managing HK stock investment products, the Mainland institutions are keen to cooperate with Hong Kong institutions which have rich experience in investing in the HK stock market, so as to provide investment advisory services to the related asset management products in the Mainland, thereby enhancing the investment performance of products and creating better investment returns for investors.

The China Securities Regulatory Commission (“CSRC”) promulgated the Interim Provisions for Securities and Funds Managements Institutions to Use Securities Investment Consulting

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New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

Services from Hong Kong Institutions (“Interim Provisions”) on 29th June 2018, specifying how Mainland securities firms and Mainland FMCs should cooperate with each other under Stock Connect. The Interim Provisions allow the provision of two types of business, namely (1) HK stock research report business; and (2) investment advisory business. For research report business, the Interim Provisions allow Mainland securities companies (including their subsidiaries) to forward securities research report related to eligible stocks issued by eligible HK institutions to their domestic clients in China. While for investment advisory business, the Interim Provisions allow Mainland FMCs to employ eligible HK licensed entity to provide investment advisory service for the Stock Connect securities investment funds managed by them.

This article only aims to introduce and analyze investment advisory business as stipulated in the Interim Provisions, which is provided by HK licensed entity that are employed by Mainland FMCs. But it does not intend to involve relevant content about securities research report business as stipulated in the Interim Provisions.

1. Scope of Application

(1) Applicable to Both Retail Fund Management Products and Segregated Account Management Products

Mainland FMCs manage a vast amount of retail funds that invest in HK stock market. At the same time, they also manage large-scale segregated account management products, which is a kind of private product on private placement basis that invest in HK eligible stocks. According to the Interim Provisions, a HK licensed entity can be the investment advisor for both retail funds and segregated account management products.

(2) Applicable Only to Stock Connect and Different From QDII Regime

Since 2007, along with the promulgation and implementation of QDII regime, many Mainland FMCs with QDII qualification and quota have issued retail funds and segregated account management products that invest in HK eligible stocks. If such product invests in HK stock market through QDII regime using QDII quota, rather than through Stock Connect, there will be a significant difference in laws applicable to the employment of investment advisor. According to the Tentative Administration Measures for Securities Investment Overseas by Qualified Domestic Institutional Investors (“QDII Tentative Measures”), QDII can also hire overseas investment advisors for their retail funds and segregated account management products. However, overseas investment advisors of QDII shall fulfill the requirements stipulated in the QDII Tentative Measures (such as the AUM managed by an overseas investment advisor in the latest fiscal year shall not be less than USD 10 billion).

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

Therefore, in terms of applicable laws, employment of investment advisors for Stock Connect products shall comply with the Interim Provisions. While employment of investment advisors for QDII products shall comply with QDII Tentative Measures and relevant regulations.

(3) Applicable Only to Products of FMCs, but not Products of Private Fund Management Companies

Apart from Mainland FMCs, domestic private fund management companies registered in the Asset Management Association of China (“AMAC”) also manage a large number of private fund products that invest in HK stock market. As private fund management companies cannot apply for QDII license and quota, all their HK stock investment products invest in HK stock market through Stock Connect. However, as the Interim Provisions only regulate the employment of HK investment advisors by Mainland FMCs and do not involve private fund management companies, private fund management companies cannot, by applying the Interim Provisions, employ a HK institution as the investment advisor for their Stock Connect products.

(4) Applicable only to HK institutions, but not non-HK Institutions

According to the Interim Provisions, Mainland FMCs may employ a HK institution, which has registered in HK, obtained a license of “Advising on Securities” (Type 4 License) and a license of “Asset Management” (Type 9 License) as approved by the Securities and Futures Commission in HK (“SFC”), and has experience in and qualification of asset management, as an investment advisor. Therefore, licensees in countries and regions other than HK cannot, according to the Interim Provisions, provide investment advisory services to Mainland FMCs.

2. Eligibilities of HK Licensed Entity to Operate Investment Advisory Business with Mainland FMC

A HK institution intending to provide investment advisory services to Mainland FMCs shall fulfill the following requirements under the Interim Provisions:

- (1) It shall obtain both the license of “Advising on Securities” and the license of “Asset Management” as approved by the SFC;
- (2) It shall have experience in asset management business;

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

- (3) A HK institution refers to any kind of the following institutions:
- a. There is a relationship of control between the HK institution and the Mainland FMC, for example, the HK institution is the subsidiary of the Mainland FMC or the HK institution and the Mainland FMC are under the same control of a financial institution;
 - b. If there is no relationship of control between the HK institution and the Mainland FMC, or they are not under the control of the same financial institution, then the HK institution shall engage in asset management business for 5 years or above, and the AUM shall not be less than HK\$10 billion;
 - c. If a HK institution cannot fulfill the requirements in (a) and (b), it shall illustrate its professional competence, internal control and risk management ability (hereinafter refers to as “Category III Institution”).

3. Legal Relationship between the Mainland FMCs and HK Institutions

Mainland FMCs may entrust a HK institution to be the investment advisor for their retail funds or segregated account management products. Such investment advisor shall not have investment discretion. As always, Mainland FMCs shall perform their duty of active management and make investment decision by themselves. They shall not entrust an investment advisor to execute investment order directly. Liabilities of the Mainland FMC shall not be waived by entrusting an investment advisor.

4. Regulatory Requirements that a HK Institution Shall Fulfill as an Investment Advisor

According to the Interim Provisions, a HK institution shall fulfill the following regulatory requirements in order to be an investment advisor:

- (1) File its basic information with the AMAC. Detailed information to be filed remains to be further clarified by the AMAC;
- (2) Sign a letter of undertaking which undertakes to cooperate with the regulatory work of the CSRC and its local branches, and provide relevant business documents and information upon request;

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

- (3) Sign an Investment Advisory Agreement with Mainland FMCs which includes, at least, rights, obligations and responsibilities of both parties, content and mode of service and prohibitions, etc;
- (4) Within 5 working days AFTER signing the Investment Advisory Agreement referred to in (3), the Mainland FMC shall file such agreement with the CSRC in its place of residence or place of business (such as CSRC Shanghai Bureau, CSRC Beijing Bureau and CSRC Shenzhen Bureau).

5. Special Requirements for “Category III Institutions”

A HK institution which is neither a HK subsidiary of a Mainland FMC nor fulfill the requirements of 5 years + AUM over HK\$10 billion, but still wishes to be an investment advisor of a Mainland FMC, shall act in accordance with the following special procedures:

- (1) File its basic information with the AMAC. Detailed information to be filed remains to be further clarified by the AMAC;
- (2) Sign a letter of undertaking which undertakes to cooperate with the regulatory work of the CSRC and its local branches, and provide relevant business documents and information upon request;
- (3) Sign an Investment Advisory Agreement with Mainland FMCs, which includes, at least, rights, obligations and responsibilities of both parties, content and mode of service and prohibitions, etc;
- (4) Within 5 working days BEFORE signing the Investment Advisory Agreement referred to in (3), the Mainland FMC shall file such agreement with the local branch of the CSRC in its place of residence or place of business (such as CSRC Shanghai Bureau, CSRC Beijing Bureau and CSRC Shenzhen Bureau). At the same time, the following documents shall be provided along with the filing of the Investment Advisory Agreement: a special report on the selection of such Category III Institution by the Mainland FMCs (hereinafter referred to as “Special Report”) and corresponding supporting documents. Such Special Report shall be issued with special review opinions of the chief compliance officer, senior manager responsible for relevant business (such as deputy general manager responsible for international business) and chief executive (such as general manager) of the Mainland FMCs.

The local branch of the CSRC shall, after receiving such Special Report, evaluate prudentially the risk of employing such Category III Institution. If the local branch of the CSRC has any objections, it shall raise such objections in a timely manner. If the local branch of the CSRC has no objections, it shall, within one

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

month after signing the Investment Advisory Agreement, conduct a special on-site inspection on the Mainland FMC, in order to inspect the use of investment advisory services provided by Category III Institutions.

Therefore, Category III Institutions, in order to conduct investment advisory services, have to fulfill more criteria and regulatory requirements than a HK subsidiary of a Mainland FMC and a HK institution which fulfills the requirement of 5 years + AUM over HK\$10 billion.

6. Information of the HK Institution to be Submitted to the CSRC by the Mainland FMC during Registration of Retail Funds

A Mainland FMC, if plans to employ a HK institution as the investment advisor for its retail funds, shall submit the following documents during registration of the retail funds:

- (1) A copy of the Business Registration Certificates, and Type 4 and Type 9 license of the HK institution issued by the SFC;
- (2) Supporting documents which proves that the HK institution has filed with the AMAC;
- (3) Proof of AUM of the HK institution in the last fiscal year issued by a foreign registered accountant;
- (4) Audited financial statements of the HK institution in the latest fiscal year;
- (5) Illustration written by the HK institution on its mechanisms and internal policies of risk control, compliance management and management of investment advisory business;
- (6) Illustration written by the HK institution and its related parties on their existing business in Mainland China;
- (7) The Investment Advisory Agreement signed between the HK institution and the Mainland FMC;
- (8) Relevant documents showing disclosure of information and risks to investors by employing investment advisory services for HK stock investment.

The abovementioned documents shall be prepared and produced (or translated) in Chinese in a true, complete and accurate manner, and in accordance with the practice of the market and use of language in

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

Mainland China. Such documents shall be then submitted.

Furthermore, for existing product, whether a fund unitholders' meeting shall be called upon to discuss the employment of a HK institution as an investment advisor is a question that is often raised. On the premise that there is no conflict between the employment of investment advisor and the fund investment strategy as agreed in the fund contract, and on the basis that a fund manager cannot waive its responsibility of management by employing an investment advisor, we incline to think that, the employment of an investment advisor by a Mainland FMC for existing product will not trigger a fund unitholders' meeting.

7. Information Disclosure to Retail Fund Unitholder in case of Employing HK Investment Advisor

The fund contract and the prospectus are the most important legal documents of a retail fund domiciled in China. Such documents shall truly disclose the use of HK stock investment advisory services, explicitly including but not limited to:

- (1) The name, registered address, office address and time of establishment of the HK institution as an investment advisor;
- (2) The AUM of the HK institution as an investment advisor in the latest fiscal year;
- (3) Key responsible persons and their contact information of the HK institution as an investment advisor;
- (4) Fully explain and disclose the risk that may occur after employing a HK stock investment advisor.

Moreover, according to the Interim Provisions, the Mainland FMCs shall disclose information to retail fund unitholders under the following circumstances:

- (1) Replace the HK investment advisor by the Mainland FMC;
- (2) Change in controlling shareholders or responsible personnel of the HK investment advisor;
- (3) Change encountered by the HK investment advisor which may pose a significant impact on the investment of the retail fund (such as being penalized due to vigorous violations of laws and regulations);

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

- (4) Decision made by the Mainland FMC that it shall terminate the use of HK stock investment advisory service.

8. Special regulations about the Provision of Investment Advisory Business in relation to the CDR Underlying Securities

According to the Administrative Measures for the Issuance and Trading of Depositary Receipts (for Trial Implementation) promulgated by the CSRC on 6th June 2018, retail funds may also invest in the Chinese Depositary Receipt (CDR). If foreign listed companies issue the CDR in China, and provide investment advisory services to Mainland FMCs in relation to underlying securities of the CDR in the future, the Interim Provisions shall be applicable. However, as underlying securities of the CDR are not all issued in HK, institutions that provide investment advisory service in relation to such underlying securities may not be restricted to HK institutions. But details are still remained to be tested through further practice of the market.

New Business for HK Licensed Entity: Providing Investment Advisory Services to Mainland FMC

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