

## Cross-border ETF Legal Framework and Participating Institutions

By Sandra Lu and Raymond Li

For the asset management industry in the PRC, innovation has been one of the most critical words of 2009. The successive launch of innovative funds – such as detachable traded funds and feeder funds – shows the R&D input of fund management companies (FMCs) and the open-mindedness of the regulators.

Subsequent to the promulgation of state policy building Shanghai into an international financial centre, as well as the execution of CEPA 6 between the Mainland and Hong Kong, cross-border Exchange Traded Funds (ETFs) are now on the agenda.

Over the past three months, leading FMCs – like China AMC, China Southern, Guotai and ICBCCS, together with SSE or SZSE – have actively pushed forward the design and the R&D of cross-border ETFs. Simultaneously, some world-famous index providers, like S&P and FTSE, have also actively participated in the development of cross-border ETFs on the Mainland.

Compared with domestic ETFs – which are based on the legal environment and trading and clearing system of domestic trading markets – cross-border ETFs refer to those whose unit trading and investment involve multiple legal environments and trading and clearing systems of two or more trading markets.

Cross-border ETFs can be classified into three categories: direct development, cross-listing and feeder funds. Direct development refers to an establishment mode under which the ETFs are developed by domestic FMCs to link to certain overseas indices, and are further raised and listed domestically. Cross-listing is where overseas listed ETFs are directly listed and traded on domestic stock exchanges. And feeder funds are where the funds are launched domestically while almost 100% of their assets are invested in the overseas-listed ETFs.

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Considering the circumstances of China's capital markets, at the moment cross-listing is impracticable on the Mainland. And, despite a simpler legal framework and investment management, feeder funds rely too much on the efficiency of master funds. In addition to charging higher fees on investors, they also discord with the policy of improving domestic FMCs' portfolio management capacity through QDII funds.

The direct development mode, however, can fully take advantage of the functions of domestic exchanges, clearing houses and banks, among others. And the ETFs apply to the same legal system and regulatory requirements, as well as helping to cultivate domestic FMCs' international investment capacity. Hence, the regulatory authorities and exchanges are more in favour of this.

Plans submitted by FMCs are almost always under the mode of direct development. Such cross-border ETFs involve various subjects, such as domestic FMCs, domestic custodians, domestic brokers, overseas custodian banks and overseas brokers. The clearing procedures of subscription and redemption are complicated and both investment at front office and clearing at back office are carried out independently by domestic FMCs. This brings challenges to FMCs in terms of talent, capital, technology and international co-operation.

Under the mode of direct development, the fundamental participants refer to fund managers, domestic custodians, domestic brokers, exchanges, clearing houses, overseas custodians and overseas brokers. Though the aforesaid institutions more or less participate in usual QDII funds and domestic ETFs, the role of some of them differs due to time differences and foreign exchange controls.

When referring to cross-border ETFs, the linked indices are all overseas indices. The proposed plans for cross-border ETFs mainly adopt indices from the US, Europe, Hong Kong and Japan. Most of these have no overlap with trading hours in the Mainland, while only a small number – like Hong Kong – have partial overlap. Furthermore, because of foreign exchange controls, Mainland investors cannot directly invest in overseas securities markets while domestic brokers cannot directly accept the brokerage commission of investors for overseas investments.

The units of domestic ETFs are purchased by investors with a basket of stocks held by them or purchased through brokers. They are redeemed to obtain a basket of stocks. Cross-border ETFs can only be subscribed and redeemed in cash. In contrast to the usual QDII funds and open-ended funds – which are also subscribed and redeemed in cash – investors assume the costs of investment in the baskets of stocks by the manager of cross-border ETFs.

With the subscription and redemption of cross-border ETFs, the role of domestic brokers simplifies from a triple nature in domestic ETFs – fund distribution agents, investors' agents and brokers of ETF units – to a double nature of fund distribution agents and brokers of ETF units.

Given the incomplete overlap of trading hours between the domiciled exchanges of the target index and the PRC securities market, the effects of T+0 arbitrage mechanism for domestic ETFs is weakened for cross-border ETFs. On the other hand, the risk of overseas investment – especially settlement risk – will raise the clearing risk of domestic clearing houses. It also brings uncertainty to the continuation of the foundation of T+0 arbitrage mechanism of domestic ETFs, and the provision of guarantee settlement by domestic clearing houses.

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