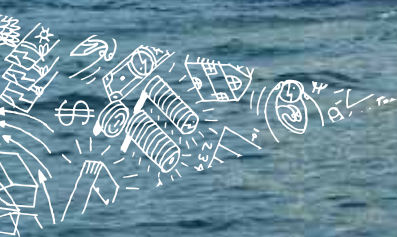


Mutual Recognition of Funds between Mainland China and Hong Kong



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On 22 May 2015, the Securities and Futures Commission of Hong Kong (SFC) and the China Securities Regulatory Commission (CSRC) signed the Memorandum of Regulatory Cooperation on Mainland-Hong Kong Mutual Recognition of Funds (MRF). This memorandum will allow eligible Mainland and Hong Kong funds to be distributed in each other's markets through a streamlined vetting process. The scheme will be implemented on 1 July 2015.

Looking back, the MRF emerged in November 2012 when the SFC submitted a proposal to the Mainland for developing a mutual platform for locally domiciled funds in Hong Kong and Mainland China. Back then, the SFC described this initiative as a substantial breakthrough and the forthcoming MRF would be "Asia's largest and deepest". By December 2013, the SFC and the CSRC jointly disclosed that they were in the final stretch of the MRF.

With the successful launch of the Shanghai-Hong Kong Stock Connect in November 2014, and the positive market response, the recent announcement of the MRF is seen as another breakthrough in the liberalization of the Mainland's financial market. It offers more investment options for both the Mainland and Hong Kong investors to access unparalleled capital markets.

The MRF could potentially introduce around 850 Mainland funds into the Hong Kong market and around 100 Hong Kong funds into the Mainland market. Those 100 Hong Kong funds have around RMB300 billion (US\$48.4 billion) in total assets, and the 850 Mainland funds have around RMB2 trillion (US\$322.7 billion). At initial launch, the initial quota for the MRF is set at RMB300 billion for in and out flows of funds each way, and there is no requirement for quota application as the utilization is on a first-come-first-served basis.

Fund managers on both sides of the border will jump head-on to be first in line with their application on 1 July 2015 while some are still deliberating the fine print contained in the MRF with feasibility studies.

The Mainland has been progressive in its financial liberalization plans and Hong Kong has been benefitting since day 1. The MRF is expected to be exclusive in Hong Kong for a period of time before it is rolled out to other locations. This period of exclusivity could see more global managers shifting its focus to set up in Hong Kong to be closer to the Mainland market and will ultimately strengthen Hong Kong's position as a wealth management center.



What are the criteria?

The following outlines the requirements jointly imposed by the SFC and the CSRC:

General principles:

- ▶ The recognized mutual fund (Fund) in its home jurisdiction should meet the eligibility requirements released by the relevant authority in the host jurisdiction.
- ▶ The Fund should remain authorized by or registered with the relevant regulator in the home jurisdiction and is allowed to be marketed to the public within the home jurisdiction.
- ▶ The Fund should generally operate and be managed in accordance with the relevant laws and regulations in the home jurisdiction and its constitutive documents.
- ▶ The sale and distribution of the Fund in the host jurisdiction should comply with the applicable laws and regulations of the host jurisdiction.
- ▶ The Fund should comply with the additional rules released by the relevant authority in the host jurisdiction governing the authorization or registration, post-authorization and ongoing compliance, and the sale and distribution of the Fund in the host jurisdiction.
- ▶ The management firm of the Fund shall ensure investors of both home and host jurisdiction receive fair and same treatment, including in respect of investor protection, exercise of rights, compensation and disclosure of information.

Eligibility requirements and types of eligible Funds:

- ▶ Only general equity funds, bond funds, mixed funds, unlisted index funds and physical index-tracking exchange traded funds will be eligible under the MRF. At this stage, gold ETFs, listed open-ended funds, fund of funds, structured funds and guaranteed funds are not eligible as MRF
- ▶ The Fund is established, managed and operates in accordance with the respective home jurisdiction laws and regulations and its constitutive documents
- ▶ The Fund is a publicly offered securities investment fund registered with the CSRC under the Securities Investment Fund Law of the People's Republic of China or the SFC under the Securities and Futures Ordinance of Hong Kong
- ▶ The Fund must be established and has been authorised for more than 1 year
- ▶ The Fund must have a minimum fund size of no less than RMB200 million or its equivalent in a different currency on date of application. Step up of fund size before application to meet the minimum fund size requirement is permitted
- ▶ The Fund must not primarily invest in the host jurisdiction; and
- ▶ The value of shares/units in the Fund which are sold to investors in the host jurisdiction shall not be more than 50% of the value of the Fund's total assets

Requirements on management firms:

- ▶ The management firm of a Fund must be registered and operate in the home jurisdiction in accordance with the home jurisdictions laws and regulations. It should be licensed by regulators in its home jurisdiction to manage publicly offered securities investment funds. Delegation of investment advisory functions that are located outside the home jurisdiction is permitted.
- ▶ The management firm of a Fund must not have been the subject of any major regulatory actions by the CSRC or the SFC in the past 3 years or, if it has been established for less than 3 years, since the date of its establishment.



Clarification to Eligibility Requirements

► Definition of “not primarily invest in the host jurisdiction”

One of the eligibility requirements is to “not primarily invest in the host jurisdiction”. This means at least 80% of the Fund’s assets must be invested outside of the host jurisdiction. The market of the investments being traded is the primary factor in determining an investment’s jurisdiction.

This means that Hong Kong Funds can invest into Mainland and Mainland Funds can invest into Hong Kong up to a limit of 20% of the Funds total assets.

► Quota management

The initial quota is set at RMB300 billion and there is no requirement for quota application as this quota will be based on utilization. Investors’ purchase of funds in both Mainland and Hong Kong will be capped at an aggregate net quota of RMB300 billion. Since the subscription and redemption values will be offset, the actual sales volume would be much bigger than RMB300 billion. Fund sales would be registered daily with the China Securities Depository and Clearing (ChinaClear) and reported back to the CSRC.

The quota is utilized on a net basis. The State Administration of Foreign Exchange (SAFE) will monitor the quota through accounts registered with ChinaClear.

► Value of shares/units in the Fund sold to investors in host jurisdiction shall not be more than 50% of the value of the Fund’s total assets

A Fund under MRF is required to monitor the balance of investor mix on an on-going basis. Maintaining 50% or less of host investors at all times will be a challenging task to the Fund. A Fund will generally start off with 100% home investors and the ratio will start to shift once it becomes a MRF. The quantum of shift is not within the control of the Fund or manager, especially when there is significant redemption in the home jurisdiction.

When the 50% threshold is exceeded, the Fund must inform the host jurisdiction’s regulatory body and cease subscription activities of host jurisdiction investors until the balance of home investors’ holdings are restored to the required level. There is no mandatory redemption requirement on existing investors of the Fund.

► Fund of funds

Fund of funds will not be allowed in the first phase of the MRF but will be considered on a case by case basis. Only fund of funds of which both feeder and master are Hong Kong or Mainland domiciled; with its underlying investments being the same vanilla instrument types which MRF permits and meets the requirement of being “not primarily invest in the host jurisdiction” will be considered.



Looking ahead

Participants of the MRF should prepare themselves and consider the following challenges out of the many other challenges ahead:

► Exclusivity to Hong Kong

As with other Mainland financial liberalization schemes (RQFII and stock connect), there is market expectation that the scheme will be expanded in the future once the MRF is proven to be successful. Currently, there is no information on the duration of the exclusivity to Hong Kong. Asset managers may worry that the advantages to Hong Kong will disappear once MRF is expanded to other jurisdictions. But we see this as the beginning of Hong Kong's journey in becoming the asset management hub of Asia as Hong Kong retail funds may be able to ride on the wave of expansion together with Mainland retail funds to other jurisdictions. Asset managers should consider developing their inhouse talents, develop more products in Hong Kong and get ready for future expansion of the MRF to other Asia-Pacific regions or even Europe or the US.

► Cost

To be an MRF in the respective host jurisdiction, there are requirements to appoint representatives or agents in each jurisdiction. The representative or agent in each jurisdiction can function as a distributor or additional distributors can be appointed to expand the product distribution network. Fund managers will need to consider the balance in cost and benefits associated to the appointment of the representative or agent and the establishment of a distribution network in host jurisdiction.

► Conflict in product offering

This is a good problem to have as it demonstrates that the fund manager is a group that has wide product offerings and strong presence in both Hong Kong and the Mainland market. Fund managers operating in Hong Kong have a portfolio of SFC authorised fund with QFII or RQFII strategies and funds in PRC are concentrated to investments in the PRC market.

In the days before MRF, these products worked well as the funds offered in the home jurisdictions caters to investors within its jurisdiction. It is now the right time for fund managers with presence in both Hong Kong and PRC to rationalise their product to avoid cannibalising its own product offering or affiliated product offering within the same jurisdiction.

► Presence in Mainland China

The presence of global managers in the Mainland is currently limited to a representative office, wholly foreign-owned enterprise (WFOE) or as a joint venture. A global manager that has set up in the form of representative office is restricted in carrying out certain business activities. At present a joint venture of global managers with Mainland managers is the more popular mode of operations for global managers in the Mainland. However, with a joint venture, global managers may not be able to fully implement their strategies as the Mainland partner may have different strategies. Some global managers foresee that WFOE will be the best option; however at present, there is no indication from the CSRC that asset management licenses can be granted to WFOE.

The joint announcement made on 22 May 2015 closes one chapter in the Mainland's journey in financial liberalization and Hong Kong's journey in establishing itself as a major fund domicile. It opens up a potential new chapter in developing a fund regulatory standard in Asia as the MRF between Mainland and Hong Kong is expected to be the first of many across Asia.



Tax considerations

Mainland China tax implications of securities investment fund under the current Mainland tax regime

To encourage the development of securities investment funds, Mainland authorities issued various Mainland tax regulations (Mainland Fund Regulations) granting the below preferential tax treatments to securities investment funds and their investors. These Mainland Fund Regulations were issued to address Mainland tax implications of Mainland corporations and individuals investing in securities investment funds, which are established in the Mainland and invest in Mainland securities.

- ▶ Securities investment funds are temporarily exempt from Mainland corporate income tax (CIT) in respect of gains realized from the trading of shares and bonds, dividends and distribution from shares, interest from bonds and other income.
- ▶ Securities investment funds are temporarily exempt from Mainland business tax (BT) in respect of gains realized from the trading of shares and bonds.
- ▶ Corporate investors in securities investment funds are temporarily exempt from CIT with respect to distribution received from securities investment funds.
- ▶ Individual investors are temporarily exempt from Mainland individual income tax (IIT) and Mainland business tax (BT) in respect of distribution and gains realized from the trading of fund units.

It should be noted that Mainland share and corporate bond issuers have withheld IIT at the relevant rate from dividends (5%, 10% or 20%, depending on the holding period) and interests (20%) before their distribution to securities investment funds.

It is unclear whether the above Mainland Fund Regulations would apply to (i) Mainland investors (Mainland Corporate / Individual Investors) investing in Recognized Hong Kong Funds; and (ii) investors in the Hong Kong market (Foreign Corporate / Individual Investors) investing in Recognized Mainland Funds. It is also uncertain whether the Mainland authorities would grant a MRF version of "Caishui [2014] 81", which was issued to address the Mainland tax implications of the Shanghai-Hong Kong Stock Connect. Given the absence of specific guidance, the following Mainland tax issues are pending further clarification from Mainland authorities:

Recognized Mainland Funds

- ▶ Whether the Mainland Fund Regulations would apply to foreign individual investors investing in Recognized Mainland Funds (i.e., IIT exemption with respect to distribution received from Recognized Mainland Funds; and IIT / BT or Mainland value-added tax (VAT) exemption with respect to gains realized from the disposal of units in Recognized Mainland Funds)?
- ▶ Whether the Mainland Fund Regulations would apply to foreign corporate investors investing in Recognized Mainland Funds (i.e., Mainland withholding income tax (WHT) exemption with respect to distribution received from Recognized Mainland Funds)? Or similar to Caishui [2014] 81, whether Mainland authorities would issue a circular granting special WHT / BT or VAT exemption to foreign corporate investors with respect to distribution received from Recognized Mainland Funds and gains realized from the disposal of units in Recognized Mainland Funds?
- ▶ In case foreign investors are subject to Mainland taxes in respect of their investment in Recognized Mainland Funds, which party (e.g., Recognized Mainland Funds) should be the withholding agent for Mainland taxes?



Recognized Hong Kong Funds

- ▶ Whether the Mainland Fund Regulations would apply to Mainland individual investors investing in Recognized Hong Kong Funds (i.e., IIT exemption with respect to distribution received from Recognized Hong Kong Funds; and IIT / BT or VAT exemption with respect to gains realized from the disposal of units in Recognized Hong Kong Funds)?
- ▶ Whether the Mainland Fund Regulations would apply to Mainland corporate investors investing in Recognized Hong Kong Funds (i.e., CIT exemption with respect to distribution received from Recognized Hong Kong Funds)? Or subject to CIT at 25% with respect to distributions received from Recognized Hong Kong Funds and gains realized from the disposal of units in Recognized Hong Kong Funds?
- ▶ In case Mainland investors are subject to Mainland taxes in respect of their investment in Recognized Hong Kong Funds, how the Mainland investors should report the Mainland taxes (e.g., self-reporting by Mainland corporate investors; and withholding at source for Mainland individual investors by Recognized Hong Kong Funds or other designated withholding agents)?
- ▶ Whether the business arrangements between the Hong Kong based-fund managers and their appointed Mainland agent / distributors would give rise to permanent establishment risks of the Recognized Hong Kong Funds and the Hong-Kong based managers in the Mainland?

Certainty in the Mainland tax treatment is critical to the successful launch of the MRF initiative. We hope the Mainland authorities will clarify the Mainland tax treatment in respect of the Recognized Mainland Funds and Recognized Hong Kong Funds before the actual implementation of the MRF initiative.

Hong Kong tax implications of securities investment fund under the current Hong Kong tax regime

Hong Kong adopts a territorial basis of taxation. Only profits arising in or derived from Hong Kong from a trade or business carried on in Hong Kong would be taxable unless there is any specific exemption available. Also, gains of a capital nature are exempted from profits tax. Under the prevailing tax law in Hong Kong, the Hong Kong tax implications of buying and selling securities investment funds are summarized as follows:

- ▶ Hong Kong investors investing into Recognized Mainland Funds: There should be no Hong Kong profits tax on dividends/distributions received. Whether gains derived from disposal of shares/units of Recognized Mainland Funds are subject to Hong Kong profits tax would depend on whether the Hong Kong investor is carrying on a securities trading business in Hong Kong and whether the gains are sourced in Hong Kong.
- ▶ Mainland investors investing into Recognized Hong Kong Funds: There is no withholding tax on dividends/distributions from the Recognized Hong Kong Funds. Whether gains derived from disposal of the shares/units in the Recognized Hong Kong Funds are subject to Hong Kong profits tax would depend on whether the Mainland investor is carrying on a securities trading business in Hong Kong and whether the gains are sourced in Hong Kong.

The transfer of shares/units in the Recognized Hong Kong Funds (other than exchange traded funds) would be subject to Hong Kong stamp duty at 0.1% (a total of 0.2% for a complete transaction) on the value or consideration of the transfer (whichever is higher), if the shares/units constitute Hong Kong stock under the Stamp Duty Ordinance. Effective from 13 February 2015, transfer of shares or units in all Hong Kong-listed ETFs are exempt from stamp duty.



Financial reporting:

A Fund may use its home jurisdiction financial reports as the basis for distribution in the host jurisdiction; however there are dissimilar requirements between Hong Kong and Mainland. The following highlights a sample of such dissimilarity:

Criteria	Hong Kong	Mainland China
Availability of annual report with audited financial statements	4 months after financial period end	90 days after year end
Keeping of records by auditors and legal advisors	7 years	10 years
Language requirement	English	Simplified Chinese
Minimum valuation reporting frequency	Monthly	Weekly
	It is observed from the respective jurisdiction's regulatory guidance that the above were the minimal frequency for valuation reporting. In practice, the market provides valuation reports on a daily basis.	
Financial reporting standards	<ul style="list-style-type: none"> ▶ International Financial Reporting Standards or ▶ Hong Kong Financial Reporting Standards and ▶ Disclosure on investment portfolio as per clauses 1 and 4 of the "Investment Portfolio" Section of Appendix E of the UT Code. This includes: <ul style="list-style-type: none"> ▶ the quantity of each investment holding with description and market value and distinction between listed and unlisted and categorize by country ▶ total investment cost ▶ the value of each holding as a percentage of net asset value ▶ the statement of movements in portfolio holdings 	<ul style="list-style-type: none"> ▶ Mainland Accounting Standards; and ▶ Securities investment fund information disclosure XBRL template no.3



Features of Representatives and Agents in host jurisdictions:

Hong Kong

Each Mainland Fund must appoint a firm in Hong Kong to be its representative who shall comply with Chapter 9 of the Code on Unit Trusts and Mutual Funds (UT Code).

The representative (person or company) must be licensed or registered under the SFO or be a trust company registered under the Trustee Ordinance.

Highlights of the role of the representative in accordance with Chapter 9 of the UT Code include:

- ▶ Receive subscription applications, subscription money and redemption notice units from investors in Hong Kong
- ▶ Provide holders with the Fund's information such as financial reports, offering document, key facts statement, etc.
- ▶ Make available for public inspection in Hong Kong all constitutive documents of the Fund.
- ▶ Represent the Fund and the management company in relation to all matters in which any holder normally resident in Hong Kong has a pecuniary interest or which relate to units sold in Hong Kong.

An application for authorization of a Mainland Fund to the SFC can be made by the Mainland asset manager or the appointed Hong Kong representative.

Distribution in Hong Kong must be conducted by intermediaries who are licensed by or registered with the SFC.

Mainland China

The Mainland will adopt a master-agent distribution model. Under this, the Hong Kong Fund must appoint a CSRC approved firm in The Mainland to be its agent. The appointed agent can be a licensed securities investment fund manager or custodian and shall comply with the Law of the People's Republic of China on Securities Investment Funds.

Highlight of the role of an agent in the Mainland includes:

- ▶ Product registration with CSRC
- ▶ Information disclosure
- ▶ Distribution arrangement
- ▶ Data/information exchange and cash settlement
- ▶ Supervision reporting
- ▶ Communication with investors and regulators
- ▶ Customer service

An application for authorization of an eligible Hong Kong Fund to the CSRC is required to be applied by the appointed Mainland agent and such Funds are also required to provide to the CSRC a legal opinion of their Hong Kong authorization status.

In addition to the agent who can be the Hong Kong Fund's distributor, additional distributors can be appointed.



Operational and ongoing requirements:

a. Home Jurisdiction supervision

The Fund must, on an ongoing basis, remain registered with the home regulators for offering in the host jurisdiction, and be subject to the ongoing regulation and supervision of the host regulators.

b. Pricing error and change/suspension/deferral of dealings

If there is pricing error, change in dealings or suspension or deferral of dealings of the Fund requiring notification to the home regulators, the host regulators should also be notified correspondingly.

c. Jurisdiction

The management firm of a Fund shall make effective and proper arrangement to ensure that, where the constitutive documents provide for dispute resolution by way of litigation, the courts of the host jurisdiction shall not be excluded from entertaining an action concerning the Fund.

d. Languages

Where Chinese documents (including offering documents, product key facts statements, notices and announcements) of a Fund are provided or made available to investors in the home jurisdiction, such documents shall be produced in traditional or simplified Chinese as applicable. Where such documents are originally in simplified Chinese or vice-versa, the traditional or simplified Chinese text shall be a true and accurate reflection of the original text, taking into account market practice and customary use of Chinese language in the host jurisdiction. In any event, there shall be no substantive difference between the traditional Chinese text and the simplified Chinese text registered or filed with the home jurisdiction regulators.

Sale/distribution and offering documents:

The sale and distribution of a Fund in the host jurisdiction must be conducted by intermediaries properly licensed by or registered with the home regulators. The sale and distribution of a Fund in the host jurisdiction should comply with the applicable host jurisdictions' laws and regulations relating to distribution of funds.

A Fund may utilize the offering documents registered with the CSRC or SFC, subject to modification requirements imposed by the respective host jurisdiction.

For Hong Kong distribution, Mainland Fund must provide the following:

- a. Offering documents registered with the CSRC
- b. Product key facts statement
- c. Covering document containing; among others, the following information:
 - ▶ The eligibility requirements that must be met by the Mainland Fund under the MRF, and the detailed arrangements in the event that the fund ceases to meet any of the eligibility requirements
 - ▶ share class(es) offered to Hong Kong investors
 - ▶ applicable tax disclosure (including tax considerations for Hong Kong investors, FATCA disclosure etc.)
 - ▶ circumstance(s) under which the Recognised Mainland Fund may effect compulsory redemption
 - ▶ the contact details of the Hong Kong representative
 - ▶ any substantive differences between the information available to Mainland investors and Hong Kong investors
 - ▶ any other information that may have a material impact on Hong Kong investors

For PRC distribution, SFC registered offering documents must be supplemented with the following:

- ▶ Description and risk disclosure of the fund being an MRF
- ▶ Unitholders rights, obligations and rules and process of unitholders' meeting, contract reason and process of dissolution or termination of Fund contract and dispute resolution
- ▶ Any other information that may have a significant impact on the investors in the Mainland



We would be pleased to assist you in your MRF initiative:

- ▶ Assist in review of financial statement disclosures to comply with the host jurisdiction's financial reporting requirements
- ▶ Assist with evaluation of current product offering to assess which funds would be eligible for MRF
- ▶ Assist with the application process for MRF
- ▶ Assist with the application process for new Hong Kong unit trusts
- ▶ Review current product development/product life cycle controls and processes
- ▶ Review of current oversight processes for delegates/3rd Party Service Providers to assess the framework currently in place and its effectiveness of being able to monitor the Master Agent/distribution agents in Mainland and to consider and deal with relevant regulatory and compliance issues under both Hong Kong and Mainland Chinese laws
- ▶ Assist in evaluating front office controls, regulatory changes process and compliance framework to take into account the cross border business
- ▶ Engage in discussion with the authorities to seek clarity on the tax treatment
- ▶ Assist in reviewing the tax disclosures in the MRF documents from both the Mainland and Hong Kong tax perspectives
- ▶ Advise and review the business arrangements between the fund managers and their appointed representative in the Mainland or Hong Kong to mitigate potential Mainland or Hong Kong permanent establishment and transfer pricing exposures
- ▶ Prepare operational guidelines to mitigate the potential Mainland or Hong Kong permanent establishment risks
- ▶ Explore a sustainable business model (i.e., Mainland presence) to capture the business opportunities arising from the potential relaxation of the scope of the MRF initiative and other business regulations in the future

If you would like to further discuss the MRF initiative, please feel free to contact any member of our FSO team.



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