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China's Commitment to Open Up Its Private Securities Investment Fund Management Industry to Foreign-Owned Entities: Opportunity and Uncertainty

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I. Introduction

On 30 June 2016, the Asset Management Association of China ("**AMAC**"), a self-regulatory organization supervised by the China Securities Regulatory Commission ("**CSRC**"), promulgated the "Q&A regarding the Registration and Filing of Private Funds (No. 10)" (私募基金登记备案相关问题解答(十)) ("**Q&A No.10**"), which provides that a private securities investment fund management company ("**Private Securities FMC**") established in the form of a wholly foreign-owned enterprise or a Sino-foreign equity joint-venture may register with the AMAC and operate as a private securities investment fund manager ("**Private Securities Fund Manager**"). In a press conference on the same day, the CSRC confirmed Q&A No.10. If effected, this would be ground-breaking as it reverses the prohibition against any entity with more than 49% foreign ownership from engaging in the "securities investment fund management" [sic] business in the People's Republic of China ("**PRC**"). However, Q&A No.10 is silent on, and therefore does not apply to, public "securities investment fund management" businesses.

II. Background

Currently, foreign investors are restricted from entry into the PRC's securities investment fund management industry. Pursuant to the "Catalogue of Industries for Guiding Foreign Investment (2015 revision)" ("**Foreign Investment Catalogue 2015**"), a foreign investment guide promulgated jointly by the National Development and Reform Commission and the Ministry of Commerce ("**MOFCOM**"), the "securities investment fund management" business is categorized as one of the "restricted foreign investment industries", and the maximum percentage of foreign investments permitted in a "securities investment fund management" business is 49%. This position remains the same even in free trade zones in the PRC.

In addition to other requirements applicable to the establishment of businesses, under Article 89 of the Securities Investment Funds Law of the PRC (2015 Revision), and the "Measures for the Registrations of Private Investment Fund Managers and Record Filings of Funds (Trial Implementation)" (私募投资基金管理人登记和基金备案办法(试行)) effective February 7, 2014, private fund management companies (which include Private Securities FMCs) are required to register with the AMAC before carrying out any fund raising and investment activities in the PRC. Prior to Q&A No.10, only those Private Securities FMCs with foreign ownership of 49% or less can register with the AMAC. It appears from Q&A No.10 that the AMAC now accepts registration of all Private Securities FMCs, irrespective of

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the level of foreign ownership, as Private Securities Fund Manager, which appears to contradict the Foreign Investment Catalogue 2015.

As previously stated, it should be noted that Q&A No.10 does not apply to public "securities investment fund management" businesses, which remain subject to the foreign investment restrictions under the Foreign Investment Catalogue 2015.

III. Summary of Q&A No.10

Q&A No.10 sets out the requirements and registration procedures for a Private Securities FMC to register as a Private Securities Fund Manager with the AMAC.

The key points of Q&A No.10 are set out briefly below:

1. Registration requirement

A Private Securities FMC has to satisfy the following conditions in order to register as a Private Securities Fund Manager with the AMAC:

- (i) the Private Securities FMC must be a company incorporated in the PRC;
- (ii) the foreign shareholder of the Private Securities FMC must be a financial institution approved or licensed in its home jurisdiction, and the securities regulatory authority of that jurisdiction has entered into a memorandum of understanding relating to securities regulatory corporation ("**MOU**") with the CSRC or with such other authority approved by the CSRC (for example, United States, United Kingdom, Japan, Hong Kong and Singapore); and
- (iii) the Private Securities FMC and its foreign shareholder have not been subject to any material punishment imposed by any regulatory or judicial authority in the preceding three years.

Where there is a *de facto* (or actual) (实际) foreign controller of the Private Securities FMC, such controller must also satisfy conditions (ii) and (iii) above.

2. Applicable laws, regulations and operating requirements

The registered Private Securities FMC is expected to comply with the same laws and regulations that are applicable to local PRC private securities fund management companies. In addition:

- (i) any use of proceeds received from capital inflow and the Renminbi so exchanged must comply with the relevant regulations of the State Administration of Foreign Exchange; and
- (ii) the registered Private Securities FMC shall make independent investment decisions when engaging in securities and futures trading in the PRC, and shall not place any trading orders through foreign institutions or systems.

3. Registration procedures

A Private Securities FMC shall register as a Private Securities Fund Manager through the AMAC's online portal and submit the following information and documents to the AMAC:

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- (i) all information required under the "Measures for the Registration of Private Equity Fund Managers and the Record-filing of Funds (for Trial Implementation)" (私募投资基金管理人登记和基金备案办法(试行)) effective as of February 7, 2014 and the relevant rules promulgated by the AMAC;
 - (ii) a letter of undertaking confirming that all information submitted by the Private Securities FMC are true, accurate and complete, and do not contain any false statement, misleading representation or material omission, and that the Private Securities FMC agrees to comply with the law and regulations of the PRC as well as the relevant self-regulatory rules of private funds; and
 - (iii) a legal opinion issued by a PRC law firm and its lawyer confirming that the Private Securities FMC has satisfied all the registration requirements.
4. Approval process and ongoing obligation

Upon receipt of the application materials, the AMAC will process the application and notify the applicant within 20 working days.

After registration, a Private Securities FMC shall commence its investment fund management business. As soon as fund raising has been completed, the Private Securities FMC must complete the relevant record-filing procedures. In particular, the Private Securities FMC and its fund must update the AMAC quarterly and annually, and notify the AMAC of any other material information.

IV. Uncertainty

There are certain issues arising from Q&A No.10 which require clarification, some of which are discussed below:

1. *De facto* controller?

As mentioned in section (III)(1) above, if there is a *de facto* foreign shareholder for a Private Securities FMC, such shareholder must also fulfil conditions (ii) and (iii). However, Q&A No.10 has not provided a definition for the term "*de facto*", which may cause confusion because of the different and conflicting interpretations.

On one hand, Article 216 of the Company Law of the PRC defines a *de facto* controller as any person who is not a shareholder but is in a position to exercise actual control over the actions of the company by way of investment relationships, agreements, or any other arrangements.

On the other hand, the AMAC published the "Explanation on Registration and Information Update of Fund Manager", which states that a *de facto* controller means a holding shareholder or a natural person, legal person, or other organization who can exercise actual control. In order to confirm the status of the *de facto* controller, it is necessary to trace back the ultimate natural person, state-owned holding enterprise or collective enterprise, or foreign institution that is subject to supervision by the financial regulatory authorities in its jurisdiction.

As the interpretation of the aforementioned legislations and rules may differ, in the event that the AMAC considers the *de facto* controller of a Private Securities FMC is domiciled in a country which has not entered into a MOU, such Private Securities

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FMC will fail to satisfy condition 1(ii) and will therefore not be eligible to register with the AMAC. The implication of differing interpretations can be very significant.

2. Material punishment or sanction?

Q&A No.10 has not provided a definition of "material punishment" (重大处罚), as specified in condition (iii) in section (III)(1) above. Different jurisdictions and regulatory authorities may have different definitions of the seriousness of an offence or punishment and what exactly constitutes "material".

3. Inconsistency with existing legislation

It remains unclear as to how Q&A No.10 can be reconciled with the Foreign Investment Catalogue 2015. On one hand, the Foreign Investment Catalogue 2015 has specified a restriction on the percentage of foreign investment permissible in a "securities investment fund management" business in the PRC. On the other hand, Q&A No.10 appears to have removed this barrier of entry with respect to private "securities investment fund management" businesses. However, the Foreign Investment Catalogue 2015 remains in effect and has not been amended. Given that the Foreign Investment Catalogue 2015 derives its authority from a different branch of power (i.e. the National Development and Reform Commission and the MOFCOM), than Q&A No.10, which is issued by the AMAC and endorsed by the CSRC, the position with respect to whether a majority foreign-owned Private Securities FMC can actually carry on a private "securities investment fund management" business in the PRC is unclear, notwithstanding the fact that a Private Securities FMC may have registered as a Private Securities Fund Manager with the AMAC. It is likely that further regulations will be enforced to clarify this point. In the meantime, whilst there are reported cases of successfully including "asset management" or "investment management" in the business licenses of foreign-owned Private Securities FMCs, it remains unclear as to whether the AMAC has indeed accepted or granted any application from a foreign-owned Private Securities FMC for registration as a Private Securities Fund Manager. Given the preliminary nature of Q&A No.10, we do not expect the AMAC to grant any such registration until the CSRC has issued further regulations on this point.

4. Confusing "business scope" requirements

According to the "Q&A regarding the Registration and Filing of Private Funds (No. 7)" (私募投资基金登记备案的问题解答 (七)) issued by the AMAC on November 23, 2015, in order to register with the AMAC, Private Securities FMCs must include wordings such as "fund management", "investment management", "asset management", "equity investment" or "venture capital", in their business scope in the business license. However, there are no clear guidelines or definitions provided by the authorities to distinguish these different business scopes in terms of their respective permissible activities.

Conclusion

Q&A No.10, to an extent, represents a significant change in the permissible foreign ownership structures of investment fund management companies in the PRC. The new rule indicates the willingness of the PRC to open up its investment fund management industry to

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foreign participation. It also suggests the possibility of extending the same to the public investment fund management industry in the future. However, Q&A No. 10 currently has minimal effect when read together with existing applicable laws and regulations. Further rules and regulations will need to be amended and/or issued to enable Q&A No. 10 to have any teeth and to consolidate and make consistent, the regulatory regime in this area.

Foreign investors must remain vigilant of market developments. When Q&A No. 10 has been given full effect, foreign investors can set up and operate as Private Securities Fund Managers without being subject to restrictions on foreign ownership that were previously in place.

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