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Hong Kong-China Mutual Recognition of Funds (MRF) Scheme Nears Implementation

A scheme providing for the mutual recognition of funds authorised in Hong Kong and the Mainland is in its final stages, according to a speech given by Alexa Lam, deputy chief executive officer of Hong Kong's Securities and Futures Commission (**SFC**), on 21 October 2014.[1] Just as the Hong Kong-Shanghai Stock Connect programme, operational since November 2014, allows Hong Kong and Chinese investors to buy Shanghai-listed and Hong Kong-listed stocks, respectively, when implemented, the MRF scheme will allow Hong Kong-domiciled funds authorised by the SFC to be sold in the Mainland, while Mainland funds authorised by the China Securities Regulatory Commission (**CSRC**) will be allowed to be sold in Hong Kong. This will be the first scheme providing for mutual recognition of funds between the Mainland and a foreign market and is consistent with the goals of developing Hong Kong as an offshore RMB centre and an international asset management centre set out in China's 12th Five-Year Plan.

Background

Hong Kong's key strengths in the past have been principally in the areas of fund distribution and sales rather than as a fund domicile or fund management centre, which is borne out by the fact that only about 300 of Hong Kong's 1,800 SFC-authorised funds are domiciled in Hong Kong. The vast majority of funds available in Hong Kong are incorporated in Europe, mainly in Luxembourg and Dublin. That is however beginning to change and at the end of 2012, Hong Kong's fund industry had assets under management of roughly HK$ 12.6 trillion. The number of funds domiciled in Hong Kong has also been growing by an average of about 30% in the last few years. Potential growth areas for Hong Kong's fund industry are expected to be investment portfolio management and fund administration, such as domicile, custodian and administrative services.

Hong Kong hopes to continue to leverage off the Mainland's opening of its capital market to international investment to enhance the status of its fund management industry. The Hong Kong-Shanghai Stock Connect programme has already benefited Hong Kong-based fund managers as they can now invest in Shanghai-listed stocks directly. Previously, international investors could only invest in the Mainland securities markets if they qualified under either the Qualified Foreign Institutional Investor (**QFII**) or RMB Qualified Foreign Institutional Investors (**RQFII**) programmes.

Hong Kong has already established MRF arrangements with Taiwan (for ETFs) and Australia which allow SFC-authorised funds domiciled in Hong Kong which are managed by an SFC-licensed management company to benefit from a streamlined distribution approval process by the host regulator, and comparable arrangements for Taiwanese and Australian funds in Hong Kong. Currently, Chinese investors have no direct access to offshore funds and international investors have no access to Mainland public funds.

1 Alexa Lam, "Mutual Recognition Scheme: Regulatory Developments Global Fund Distribution Asia Conference 2014". 21 October 2014 (at http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Alexa_20141021.pdf)

Recent years have seen tremendous growth in Hong Kong's fund management industry. Decisions made at Mainland China's Third Plenary Meeting in November 2013 made clear that China intends to continue its market reforms.

Proposed MRF Rules

According to Alexa Lam, speaking on the mutual recognition scheme on 21 October, the SFC and CSRC have reached agreement on the following six key areas:

1. Types of Recognised Funds

Initially, the scheme will only cover plain vanilla fund products, although the types of recognised funds may be increased in the future. To qualify for recognition, funds must be established under Hong Kong or Mainland Chinese laws and regulations and must have been authorised for public offering by their home regulators. For Hong Kong funds, this will require that the fund complies with the requirements of the Code on Unit Trusts and Mutual Funds and is authorised by the SFC under section 104 of the Securities and Futures Ordinance.

2. Fund Manager Eligibility

To qualify for recognition under the scheme, funds will be required to be managed by a fund manager which is:

- Established and authorised in accordance with Mainland Chinese or Hong Kong laws and regulations; and
- Licensed by the CSRC or the SFC to manage publicly offered securities investment funds.

In the case of a Hong Kong-based fund manager, this will require it to be licensed for regulated activity Type 9 (asset management). A Hong Kong entity holding a Type 1 (dealing in securities) licence only, will be permitted to be involved in marketing activities only and cannot conduct asset management activities. Firms holding a Type 9 licence subject to a restriction that they may only deal with professional investors, may need to submit a new business and compliance plan to the SFC in order to apply for an extension to permit them to offer funds to retail investors.

3. Approval of Recognised Funds

It is proposed that recognised funds will be subject to a streamlined vetting procedure by the CSRC or SFC.

Due to capital controls on the Mainland, it is expected that a quota system will apply to the scheme.

4. Fund Management Requirements

The laws of a fund's home jurisdiction will apply in relation to the following:

- The eligibility and regulatory requirements for fund managers and the trustee;
- The restrictions on permitted investments; and
- The requirements in relation to dealing, valuation, audits and meetings.

5. Disclosure of Information

It is proposed that the host regulator will be able to impose additional requirements for the offering documents and regular reports of recognised funds in relation to matters such as content, format and frequency of update.

6. Investor Protection

The SFC and CSRC intend strengthening their mutual arrangements for regulatory cooperation and assistance and to provide dispute resolution mechanisms to provide equivalent levels of investor protection in both jurisdictions.

Next Steps

The regulators will publish the detailed arrangements once these have been finalised.

Expected Benefits

The SFC expects the fund mutual recognition scheme to bring substantial benefits to the fund management industry generally and to increase the investment opportunities available in both the Mainland and Hong Kong markets.

For Mainland and Hong Kong fund managers, the scheme should create huge business opportunities. For Hong Kong fund managers, the scheme will mean access to 1.3 billion potential investors including a growing middle class and large numbers of high net worth investors. The Mainland's high savings rate means that there is a large pool of money available for management: in 2013, urban and rural households had savings of RMB 44.7 trillion.

It is also hoped that the MRF scheme will facilitate Hong Kong's transition to a major fund domicile, rather than a fund distribution centre, as is currently the case. The RQFII scheme and the prospective MRF scheme have already resulted in an increase in the number of SFC-authorised funds which are domiciled in Hong Kong. According to the SFC, the number of such funds has increased by over 62% since the RQFII scheme was launched in 2011. Of the 139 funds authorised by the SFC in the first nine months of 2014, 48% (or 67) had a Hong Kong domicile. It is expected that more international funds will be attracted to Hong Kong so that they can benefit from access to the Mainland through the MRF scheme.

From the point of view of Mainland fund managers, the scheme will allow them to distribute their Mainland funds to international investors through Hong Kong.

Steps for Industry Participants

To participate in the MRF scheme, funds must be:

- Domiciled in Hong Kong;
- Authorised by the SFC; and
- Managed by a fund manager which is licensed by the SFC for regulated activity Type 9 (asset management).

It is also suggested that interested parties start to look into the Mainland's distribution networks and work on brand-building in China. The overwhelming majority of investors in China's fund market are retail investors and as a result, funds are distributed principally by China's four principal banks through their branch networks. Fund distribution channels have been expanding in recent years and foreign banks as well as third party independent companies are also able to sell funds. Other channels such as online sales and direct sales are also expected to be used more frequently in future. In the meantime, however, those looking to access the Mainland market once the scheme is implemented should look at partnering with Chinese banks to enable them to take advantage of their distribution channels and client base. Establishing relationships with Chinese regulatory authorities is also advisable.

Other Related Developments

Hong Kong is also taking other initiatives to improve Hong Kong as a potential fund domicile. A key proposal is to allow open-ended fund companies to be incorporated in Hong Kong which will enable fund managers to create funds in the form of a company with variable capital giving them greater structuring flexibility. The proposals were set out in the Financial Services and Treasury Bureau's Open-ended Fund Companies Consultation Paper[2] published in March 2014, but the conclusions reached have yet to be published. For a summary of the proposals, please see our newsletter of 16 April 2014 "FSTB Consults on Open-ended Fund Company Structure"[3].

2 Open-ended Fund Companies Consultation Paper (at http://www.charltonslaw.com/newsletters/hong-kong-law/en/2014/270/open-ended-fund-companies-consultation-paper.pdf)
3 FSTB Consults on Open-ended Fund Company Structure (at http://www.charltonslaw.com/newsletters/hong-kong-law/en/2014/237/FSTB-Consults-on-Open-Ended-Fund-Company-Structure.html)

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