

Investment funds wake the sleeping dragon

Fund management is an ideal vehicle to direct billions of domestic savings towards Chinese companies, and China is adjusting its regulatory framework towards this end. Raphaël Chantelot and David Boitout of Gide Loyrette Nouel explain

With barely a decade of legal existence, fund management is a young industry in the People's Republic of China, yet it is one of the fastest growing businesses in the world. In 2006, China is due to overhaul its stock exchanges and to further open its financial sector to foreign investors, in line with its WTO commitments. In that context, the demand for capital prompted by China's growth, and the estimated \$1.5 trillion of domestic savings, promise tremendous growth for fund management.

The Securities Investment Funds Law (the Funds Law), adopted in 2003, is the first permanent and comprehensive set of rules aimed at regulating the fund management industry in China. However, the scope of the Funds Law is limited to funds investing in listed securities, and it does not encompass funds such as private equity or venture capital funds.

Background

China's fund management industry began with the establishment of the Shenzhen and Shanghai stock exchanges in the early 1990s. The first securities investment fund was formed in 1991, and the first company dedicated to fund management was established in 1992. Although evolving in an unregulated environment, this industry prospered. A number of closed-ended funds were set up, and more than Rmb6 billion (\$750 million) in assets were under management at the end of 1997.

1997 Interim Measures

Faced with the strong development of this new industry, the Chinese government recognized both the opportunity for development of the securities markets and the risks associated with a situation where no regulatory framework or oversight existed. As a

result, in November 1997, the Chinese authorities promulgated the first set of unified rules designed to regulate the fund management industry: the Interim Measures for the Administration of Securities Investment Funds. These provisional measures formed the basis for the current regulatory framework, as they organized the structure of funds and funds management companies, detailed the obligations on their managers and custodians, and made the China Securities Regulatory Commission (the CSRC) the main approval and regulatory authority, as well as the industry watchdog. On these stronger foundations, fund management in China began a booming expansion that is continuing today.

The following years saw the establishment of new, regulated fund management companies, the restructuring of the existing unregulated funds, and the establishment in 2001 of the first open-ended fund. This was a breakthrough in China's fund management industry, and since

then few new closed-ended funds have been created, as open-ended funds quickly became investors' first choice. The establishment of a number of open-ended funds was followed in 2002 and 2003 by a stream of innovations, notably the introduction of fixed income and index funds, umbrella funds, and the first monetary market fund. In 2002 the first Sino-foreign joint venture fund management

company was set up.

2003 Funds Law

By 2003, it had become apparent that the development of capital markets would be an essential tool for funding China's strong growth and the capital needs of its companies. At the same time, the Chinese government realized that the fund management industry could be a crucial element in the restructuring of the securities market, and that foreign players should be encouraged to contribute their financial expertise in joint-venture fund management companies. A permanent and more comprehensive regulatory regime was needed to prepare for strong future growth. As a result, the Funds Law was adopted on October 28 2003 by the highest legislative body in China, the Standing Committee of the National People's Congress, emphasizing the importance of the new law. It came into force on June 1 2004.

On December 31 2005, there were 218 funds in China (compared with 110 at end-2003), among which 54 were closed-ended funds and 164 were open-ended funds. These funds were managed by 52 management companies (compared to 34 at end 2003). The aggregate net assets value of the assets

under management was Rmb470 billion, representing about a quarter of the total market capitalization on the Shanghai and Shenzhen stock exchanges, a figure to be compared with the Rmb170 billion recorded at end-2003 and Rmb6 billion at the end of 1997. Since 2002 and

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the approval of the first Sino-foreign joint venture fund management company, foreign institutions have rushed in the industry. There were 20 joint venture fund management companies in China at the end of 2005 (compared to 13 at end-2004). Although the largest fund management companies so far remain purely domestic companies, the Sino-foreign joint venture companies are catching up,

Author biographies

**David Boitout**

Gide Loyrette Nouel

The partner managing the firm's Shanghai office since January 2004, David Boitout was a member of the mergers and acquisitions department in GLN's Paris office from 1996 to 2000 before joining the Shanghai office, where he has been based since the end of 2000. Boitout's practice focuses on international mergers and acquisitions, including cross-border acquisitions, joint ventures and corporate restructurings. He has been involved in foreign direct investments and acquisitions in China by prominent European groups from several industries including: catering services, automotive, distribution, manufacturing and chemicals. His experience within the firm in Paris and in Shanghai has enabled him to develop specific expertise in all matters relating to acquisitions by either share deals or asset deals, in the context of China's rapidly changing regulatory environment. Boitout is recommended by the *Asia Pacific Legal 500*.

David Boitout has advised and assisted:

- an international industrial group in relation to strategic investment projects in China (2005);
- an international truck manufacturer on establishing a manufacturing joint venture (2005);
- an international industrial group, which was already present in China through foreign direct investment, to make its first acquisition of assets in China, for existing and strategic production units (2004);
- a large group to restructure its existing subsidiaries in China through the incorporation of a holding company under Chinese law (2003/2004);
- several groups involved in the distribution sectors to set up their distribution networks (2002/2003);
- a German industrial group in the steel sector with a disinvestment project and the simultaneous acquisition of two domestic companies in the north of China (2002/2003); and
- a French group to finance and acquire a majority stake in a holding company in Hong Kong and to obtain ownership of several subsidiaries involved in the aviation maintenance business in China (200/2001).

He was admitted to the Paris Bar in 1998. He holds a postgraduate degree (DEA) in private law (1996) and an honours degree (*Maîtrise*) in business law (1995). He speaks French, English, Spanish and Chinese.

**Raphaël Chantelot**

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A senior associate based in Shanghai, Raphaël Chantelot joined Gide Loyrette Nouel in 2005, after working for five years in the M&A and capital markets departments of a leading US firm in Paris. Raphaël Chantelot started practising law in 1998 and is a member of the New York Bar and the Paris Bar. He received an LL.M. degree from Georgetown University (Washington DC), a postgraduate degree in business law from the University of Paris (Sorbonne), and he graduated from the Institute for Political Studies in Paris.

Raphaël Chantelot's practice focuses on corporate and financial matters, including capital market transactions, joint ventures, and international mergers and acquisitions. Recent transactions in which he was involved include: the €150 million acquisition of the electrical appliances division of a Chinese group; the merger between two French telecom companies to create the second-largest provider of fixed-line internet and telephone services in France; the €300 million acquisition of pharmaceutical assets by a US laboratory; the €300 million leveraged acquisition of a French services company by a US fund; a €500 million rights issue by a global French advertising company; and the €200 million refinancing of the real estate arm of a financial institution. In the past, he also participated in the preparation of a number of tender offers, rights issues and bonds issues, as well as in the negotiation of a number of joint ventures and acquisitions, and several financing projects.

bringing their expertise to an industry that lacks skilled and experienced fund managers.

The Funds Law is a pragmatic codification of the practices and solutions adopted under the previous regulatory framework of the 1997 Provisional Measures, and of the traditional patterns of securities investment funds. Regulated fund management companies establish contractual funds with approved custodians. These funds can be either closed-ended or open-ended, and may invest in the securities products authorized by the CSRC (so far, stocks, bonds, and monetary market products). An approved fund manager administers each fund, making investment decisions according to the fund's contract. The assets are held by a commercial bank acting as custodian and implementing the fund manager's decisions. Investors have the rights provided for in the funds contract. They also enjoy certain specific rights provided for in the Funds Law. The enforcement of the rules relating to fund management remains in the hands of the CSRC, which has broad approval and oversight powers.

Funds and fund management companies

Under the Funds Law, funds are structured as contractual arrangements between a fund management company, a custodian and investors, without the creation of a separate legal entity. It is likely that the CSRC will soon also authorize funds structured as corporate funds, because the revised PRC Company Law (which came into force on January 1 2006) has removed the traditional prohibition pursuant to which investments by a PRC company in other companies should not represent more than 50% of its net assets.

Only fund management companies approved by the CSRC may establish and manage funds. In 2004, the CSRC adopted a specific set of procedures further detailing the rules applying to the setting up, approval and regulation of fund management companies, the Administration of Securities Investment Fund Management Companies Procedures (the FMC Procedures), which became effective on October 1 2004.

Fund management companies

A fund management company must have

a registered capital of at least Rmb100 million. It must have a staff engaging in research investment, valuation and marketing, with at least 15 senior management personnel who have qualifications in the fund management industry. Any fund management company must have a *main shareholder*, who must hold at least 25% of its registered capital. This main shareholder must have at least Rmb300 million of registered capital and must have operated in the securities and assets management industry for three full years, with sound corporate governance and internal control systems. In addition, it must show “good business results” (meaning it made profits over a three-year period), and it must have no record of violating laws or regulations in the past three years.

The other shareholders in a fund management company need only have Rmb100 million of registered capital and three years of operation. Overall, these are quite high capital requirements, by which Chinese authorities are probably aiming to make the young fund management industry safer by limiting its access to fairly large investors. The FMC Procedures provide that the same shareholder (and its corporate group) may not invest in more than two fund management companies, only one of which they may control.

The FMC Procedures also set out specific requirements applying to foreign shareholders in joint venture fund management companies. The foreign shareholder must be a financial institution with financial assets management experience, its registered capital must be at least equivalent to Rmb300 million, and its country of incorporation must have a sound securities regulation framework and have established channels of cooperation with the CSRC. The maximum ownership allowed to foreign shareholders in fund management companies is limited to 49% of the registered capital of the company. The application procedure for setting up a fund management company (and for the approval of any subsequent big changes) is handled by the CSRC.

The CSRC assumes a pivotal role: it combines the powers to approve the players, to make regulations, to control their enforcement and to impose sanctions

Authorized investments

The Funds Law initially limited funds in their investments to shares and bonds. However, making use of the powers granted to it by the Funds Law, in 2004 the CSRC approved the establishment of money market funds, and in 2005 issued several circulars regarding investments in short-term financial instruments. More innovations are expected, although funds so far remain prohibited from investing in other funds, making it impossible to establish funds of funds. Also in terms of innovation, in 2004 a listed open-ended fund was created, providing enhanced liquidity for investors by offering the choice to either ask for the redemption of their shares or to sell them in the market.

The Chinese authorities have also recently taken several steps to further develop the funds sector. In February 2005, for instance, the CSRC authorized Chinese commercial banks to establish separate fund management companies, although so far these companies are not authorized to invest in shares but rather into a limited number of money market instruments. The CSRC adopted a circular that authorized funds to invest in the warrants issued in connection with the reform of the A-shares, which could potentially be an important market if the A-shares reform goes through and expands in 2006. Pension funds are another promising development, as the Chinese authorities are now encouraging companies to set up corporate pension funds and open up their management to fund management companies.

The Funds Law does not allow funds to borrow money to finance redemptions when requested by investors in the fund. This could be an issue for certain funds in China, given the level of redemptions in the months after a fund is set up, and more generally if there is a sharp downturn in the market. Fund management companies are also prohibited from using the assets of their funds to extend loans, underwrite securities, or invest in

other funds, the fund management company, the custodian, or their controlling shareholders or related parties, or buying shares underwritten by them.

Fund managers and custodians

The CSRC has set out detailed rules regulating the qualifications, duties and responsibilities of senior management in fund management companies and custodian companies (the Administration of Appointment of Senior Management Personnel of the Securities Investment Fund Industry Procedures, which took effect on October 1 2004).

Under these rules, the chairman and general manager of a fund management company or a custodian company, as well as the head of compliance and the persons in charge of the operations and investments in a fund management company, must have at least three years of experience in the financial industry and must have passed an examination administered by the CSRC regarding the Funds Law and related regulations.

These persons must also have obtained “qualifications to engage in the funds business”. These qualifications are assessed by the CSRC according to a series of criteria that also apply to non-Chinese persons appointed to such positions. Among the main criteria, candidates are screened to see if they: (i) have the relevant overseas licence; (ii) have been engaged in the relevant financial industry over the past five years; and (iii) have passed a specific examination administered by the CSRC.

Investors' rights and CSRC control

A clear concern on the part of the Chinese authorities when adopting the Funds Law and later regulations was to design a sound securities investment industry and to ensure investors were protected. This concern led to some innovation with respect to investors' rights, and granting increased powers to the CSRC.

Investors' rights

One of the innovations of the CSRC in the field of investors' rights is to provide that holders of units constituting more than 10% of the fund's total units may convene a general meeting of unit holders to decide a particular issue.

However, the quorum for the general meetings of the unit holders is 50%, which will make this new right difficult in practice for investors to exercise. In addition, a two-third majority vote of the unit holders represented at the meeting is required for taking actions such as the removal of the fund manager, the early termination of the fund or the conversion from a closed-ended fund to an open-ended one. This might be an interesting exit possibility for holders of units in underperforming closed-ended funds trading at discounts.

Aside from the general enforcement powers granted to the CSRC, the Funds Law grants private enforcement rights to investors. It authorizes them to bring an action against any person who is involved in the fund's management (the fund management company, fund managers and custodians) or interacts at some point in the life of the fund (lawyers, accountants, sales persons) when they have contravened the regulations applying to funds. However, similar private enforcement provisions were introduced in the 1998 PRC Securities Law but proved to be inefficient in practice, as courts rejected the suits brought by individual investors. Enforcement of the provisions of the Funds Law will therefore remain primarily, if not exclusively, the responsibility of the CSRC.

The Funds Law also marks an effort to increase the accuracy of the information disclosed about funds. This is particularly welcome in light of the abuses that tarnished the nascent funds industry in the past. The Funds Law expressly prohibits misleading statements and omissions, which sets the basis for a civil action by investors for breach of fiduciary duties. It also provides for various disclosure obligations, including the publication of the net asset value of the funds, the purchase and redemption price, quarterly interim reports, change in

management team, and annual reports. Furthermore, fund managers are prohibited from issuing forecasts regarding the future performances of their funds.

The CSRC's role

The CSRC assumes a pivotal role in the regulation of the fund management industry: it combines the powers to approve the players in the industry, to make regulations, to control their enforcement and to impose sanctions for their violation. The CSRC is in charge of numerous approvals, from the approval of fund management companies and of the funds themselves, to issuing business licences to fund managers and other industry professionals. The CSRC also has an important rule-making function, as it is granted the power to issue additional rules to regulate funds, fund management companies and their personnel, or to expand the scope of certain provisions of the Funds Law (for example, types of authorized investments).

Lastly, the CSRC oversees fund management companies and the practices of fund managers. To that effect, the CSRC may conduct on-site inspections of fund management companies to check that they have maintained sound operating systems (which are to be separated from those of their shareholders), as required by the FMC Procedures. If the Funds Law and the related regulations have been violated, the CSRC may issue orders or suspend the fund management company's activities and impose disciplinary sanctions. The CSRC also holds the power to levy administrative fines or, when a criminal offence is suspected, transfer the case for criminal prosecution. The CSRC's reach extends beyond fund management companies, fund managers and custodians. Other persons such as law firms and accounting firms and other "directly

responsible individuals" (which appears to be a broad catch-all provision) could face sanctions for breaching the regulations applicable to fund management or causing prejudice to investors.

The way forward

Recent years have witnessed a tremendous growth in the fund management industry in China, and investment funds have become one of the most widely used investment tools in the Chinese securities markets. This strong growth is poised to continue, as Chinese authorities are hastening the pace for their stock exchange reform by addressing the problem of non-tradable shares and opening the A-shares market to strategic foreign investors.

Chinese authorities are willing to restructure and develop the securities markets to make them a main element in financing the Chinese economy, in contrast to bank lending which remains rather inefficient and scarce. From this perspective, they will certainly continue to promote the development of the fund management industry, as they view it as a safe and controlled way to direct billions of domestic savings towards Chinese companies. Foreign investors and international financial firms are now ready to play in this game and their efforts to enter such an enormous market will certainly redouble in 2006.

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