Recent asset management regulatory changes in China

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In 2012, the financial regulatory bodies introduced a number of policies that in our view will have a significant impact on the asset management sector. In this issue, we will provide an overview of the important changes introduced by three of the most recent new regulations to be announced.

In late June, the People's Congress of China began to debate a draft of a revised version of the 'Law of the People's Republic of China on Funds for Investment in Securities'. The draft revision is an amendment to the law on the same subject that was introduced in 2003, and which has been used to regulate the fund industry in China since then.

Besides clarifying and amending parts of the existing law, the draft revision, as we see it, introduces the most significant changes in three areas: an expanded definition of securities; an increase in the number of legal forms for funds; and clearer guidance on effective operational controls for fund management companies.

Firstly, with regard to the expanded definition of securities—the draft revision defines 'securities' as including listed and unlisted equities shares, debt instruments, other securities and their derivatives. With this newly-expanded definition, private equity funds, venture capital funds, trusts, variable life insurance plans and broker collective asset management plans would all be covered by this regulatory framework, thus creating some overlap in terms of the regulatory scope of the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), the China Insurance Regulatory Commission (CIRC) and the National Development and Reform Commission (NDRC). Each of the above-mentioned regulatory bodies regulates one or two of the products which are now included in the definition of securities, and would theoretically be regulated by the CSRC if the draft revision is adopted. This would also give fund management companies greater latitude in creating a more diversified product mix to attract investors instead of simple and straightforward listed equities and bonds.

Secondly, concerning the increase in the number of legal forms for funds—in addition to corporations, the draft revision introduces two further legal forms for funds, the 'board fund' and 'unlimited liability fund'. For board funds, members of the board would be responsible for the fund shareholders' general meetings and would oversee the execution of the resolutions passed at those general meetings. The board would also be responsible for supervising the fund's management and custodians.

Proposals for the replacement of fund managers or custodians would also be made by the board. For unlimited liability funds, the fund's manager or institutions which have a control relationship with the fund managers would bear the unlimited liabilities of the fund. In our opinion, the increased number of legal forms gives fund managers and investors more choice in balancing out the rights and obligations of each party when creating a new fund.

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Thirdly, as regards clearer guidance on effective operational controls for fund management companies—a series of provisions have been proposed in relation to the operations of open-ended funds. For example, the majority shareholders of the fund management company cannot interfere with the operations of the fund in an inappropriate manner; and insider trading is strictly prohibited. These provisions also address whether an employee of the fund management company can engage in equity trading. According to the draft revision, with proper pre-clearance, an employee of a fund management company can trade equities on his/her own account, which was strictly prohibited prior to this draft revision.

Between July and October, the CIRC issued: *"Notice on Issues Related to Insurance Companies Investing Equity and Real Estate based on Tentative Measures for Equity Investment of Insurance Companies, Tentative Measures for Insurance Companies Investing Real Estate" and "Implementing Rules for the Tentative Measures on the Administration of Overseas Investment of Insurance Proceeds"* (referred to collectively below as 'the Notice'), and relaxed restrictions on insurance companies investing in private equity funds.

The Notice gives clear implementation guidance on the original rules, which were published in 2007 but rarely followed due to lack of implementation guidance. The Notice relaxes CIRC restrictions on insurance companies investing in private equity funds, which are mainly reflected in the following aspects:

1. **Investment threshold lowered for insurance companies**
   According to the Notice, investment in equities or real estate by insurance companies is no longer subject to regulations on profitability in the previous fiscal year, while the basic requirement for the net assets of the previous fiscal year has been reset at RMB 100 million and the threshold for the solvency adequacy ratio was redefined as a minimum of 120% in the previous quarter, meaning that more insurance companies will qualify for equity and real estate investment and therefore be licensed.

2. **Increased proportion of equity and real property by insurance companies**
   According to the Notice, insurance companies investing in unlisted companies or private equity funds—among other relevant financial products—may determine the investment mode at their own discretion, with a proportion of 10% of the company's total assets in the previous quarter rather than 5%.

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Here, the equity of insurance companies directly invested by the insurance company with its own funds must be excluded from the book value. Insurance companies investing in real estate (except for their own use), infrastructure credit investment plans and financial products related to real estate may determine their investment objective at their sole discretion, while the total book balance must not exceed 20% of the company's total assets in the previous quarter, indicating more financial flexibility for insurance companies in equity and real estate investment.

3. **Better structured capital requirements for GP**
   According to the Notice, for insurance companies investing in private equity funds, the capital requirement for GP is modified to a minimum of RMB 100 million in registered or committed capital. The notion of committed capital is added, with the consideration of the fact that partnerships are generally adopted by private equity firms.

4. **Further clarification on private equity fund types and investment objectives**
   According to the Notice, types of private equity funds invested in by insurance companies include growth capital funds, buyout funds, emerging strategic industry funds and funds of funds, with the above private equity fund as investment objective, where the investment objective of buyout funds may include publicly-traded shares but is limited to non-transaction transfers such as strategic investments, designated placements and block trades, while the scale of investment must not exceed 20% of the asset balance of such fund. The investment objective of emerging strategic industry funds may include financial service companies, senior citizen service companies, medicine and health companies, modern agricultural companies and construction and management companies of public rental or low-rent housing. It is stated in the Notice that buyout funds may invest in the secondary market and that insurance companies are allowed to invest in funds of funds.

5. **Clarification on the qualification of private equity firms**
   According to the Notice, for private equity funds invested in by insurance companies, the baseline requirement for a deal exit for private equity firms refers to the total number of deal exits where professionals of such institutions act as main players in the investment; and the balance of their managed assets refers to the balance of paid-in assets and capital in RMB in China, which means that the '3 billion' threshold has not been lowered this time.

6. **Regulations on overseas investment are further clarified**
   - Article 7—The private equity firms which launch and manage USD private equity funds that insurance companies invest in should meet the following requirements:
     - The paid-in capital or net assets should be no less than USD 15 million or an equivalent amount of other convertible currencies
     - Total private equity assets under management should be no less than USD 1 billion or an equivalent amount of other convertible currencies, with an outstanding track record and good reputation
   - Article 12—The overseas private equity funds that insurance companies invest in should meet the following requirements:

     Private equity funds
     The deals of private equity funds should be at the growth or maturity stage or have high M&A value. They are not limited to the countries and regions listed in Appendix 1. The committed capital should be no less than USD 300 million or an equivalent amount of other convertible currencies, and the paid-in capital should be in place in accordance with the prescribed contribution ratio.

They should have more than ten professionals with experience in private equity investment and relevant fields; at least two of the senior managers should have over eight years of work experience in relevant fields, comprehensive experience in fund-raising, management and exit, and have led at least five projects which have been successfully exited (excl. funds of funds); at least three of the professionals should have worked together for over three years; they should have a sophisticated governance structure, an efficient incentive and retention mechanism and an interest protection mechanism; they should have a Key Man Clause to ensure the exclusivity of the management team.

Insurance companies can also invest in funds of funds which have a portfolio of private equity funds that complies with the provisions of the preceding clause. The funds of funds should have a simple and clear structure and should not invest in other funds of funds.

Financial institutions or their subsidiaries should neither control the management and operation of such private equity funds, nor be the GPs of such private equity funds.

- Article 14—The outstanding balance of the overseas investments of insurance companies should not exceed 15% of the total assets as of the end of the previous year. For the overseas investments in emerging markets listed in Appendix 1, the outstanding balance should not exceed 10% of the total assets as of the end of the previous year.

Even though CIRC might take a more than cautious step towards the actual implementation and practice of the Notice, given the fact that insurance companies in China had approximately RMB 7 trillion in total assets as of Q3 2012, the Notice proved something of a surprise among asset managers in China, and gives foreign fund managers plenty to think about.

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In late October, the Shanghai Finance Administration Office of Shanghai Municipal Government introduced a pilot scheme called RMB Qualified Foreign Limited Partners (RQFLP). The RQFLP means that offshore investment institutions which hold RMB funds can directly establish a legal presence in Shanghai after being granted a QFLP licence.

The RQFLP scheme has several advantages: first, there is no limit on the amount of the investment (no quota); second, RMB cross-border flows under the RQFLP are regarded as foreign capital while there is no need for currency exchange (not subject to the SAFE quota for currency conversion); third, unlike with the RQFII programme, which only allows investments in the equity and bond markets, the RQFLP allows investments in unlisted companies, listed companies, non-publicly-traded equities, convertible bonds and industry funds.

China's finance industry regulatory bodies have been urging the country's financial institutions to transform or grow their asset management businesses for a very long time now. With the rapid introduction of new rules and regulations, which bring more institutional investors to the market, and clearer guidance on the operations and governance of the asset managers, we believe that asset management will become a vibrant sector in the capital markets arena in China.