

Legal Commentary

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Fund Investment Advisory Business Faces New Challenges

Authors: Yin GE | Ellen MAO | Sherry SI

Overview of fund investment advisory business

Securities and fund investment advisory business is a basic capital markets intermediary service. Securities and fund investment advisory business currently comprises securities investment advisory business, fund investment advisory business, and securities research report issuing business. Fund investment advisory business refers to services where (a) clients entrust an advisor to provide them with investment advice as agreed in the contracts regarding mutual funds and other investment products recognized by the China Securities Regulatory Commission (“CSRC”), and (b) an advisor assists clients to make investment decisions or makes transactions on behalf of clients. Fund investment advisory business may be divided into non-discretionary fund investment advisory business and discretionary fund investment advisory business, based on the relevant scopes of authority granted by clients to the advisor. Non-discretionary fund investment advisory business refers to where clients entrust an advisor to provide advice on mutual fund portfolio strategies without making any investment decisions on their behalf. Discretionary fund investment advisory business refers to where an advisor agrees with clients to make decisions on their behalf for specific mutual fund investment types, quantities, and trading opportunities according to portfolio strategies, and to process transaction requests such as subscription, redemption, and conversion of funds. The relevant laws and regulations on fund investment advisory business include the *Notice on Facilitating the Trial Running of Mutual Fund Investment Advisory Business* (《关于做好公募基金证券投资基金投资顾问业务试点工作的通知》), the *Measures for the Administration of Securities and Fund Investment Advisory Business (Draft for Comments)* (《证券投资基金投资咨询业务管理办法(征求意见稿)》), the *Guidelines on the Content and Format of the Mutual Fund Investment Advisory Service Agreement (Draft for Comments)* (《公募基金证券投资基金投资顾问服务协议内容与格式指引(征求意见稿)》), the *Guidelines on the Content and Format of Risk Disclosure Statement for Mutual Fund Investment Advisory Business (Draft for Comments)* (《公募基金证券投资基金投资顾问服务风险揭示书内容与格式指引(征求意见稿)》), and the *Guidelines on Display of the Performance and Clients’ Assets of Mutual Fund Investment Advisory Business (Draft for Comments)* (《公募基金证券投资基金投资顾问服务业绩及客户资产展示指引(征求意见稿)》) (hereinafter collectively referred to as the “**Fund Investment Advisory Regulations**”). It is foreseeable that the supervisions on fund investment advisory institutions will strictly follow the relevant regulatory rules of fund management companies and the compliance management, internal control and risk management of fund investment advisory institutions will face higher standards

in the future. More explicit regulations and requirements will be applied to the business definitions, service models, liabilities, prohibited actions, information disclosure, risk disclosure, promotion etc. of fund investment advisory services. As of December 31, 2021, 58 institutions have obtained the fund investment advisory qualifications, among whom 22 are fund management companies, 29 are securities companies, 3 are fund distribution institutions, and 4 are other financial institutions¹.

The core elements of the fund investment advisory business include products, strategies, investment advice and clients. From global perspective, fund investment advisory business includes four different forms: “intelligent investment advisory”, “intelligent + artificial investment advisory”, “investment advisory” and “financial management”. Under the current regulatory framework, there is no need for a service provider to file or register with CSRC if the fund investment advisory service is ancillary to its fund distribution service, and no separate contract is signed and no separate service fee is charged for the ancillary service. However, the basic legal relationships for fund distribution business shall be followed within the current regulatory framework and distributors are prohibited from engaging in any discretionary fund investment advisory service.

This article mainly analyzes key compliance issues and industry concerns in course of the fund investment advisory business under the Fund Investment Advisory Regulations, including internal decision-making and process control for fund investment advisory strategies, additional requirements for discretionary fund investment advisory services, management of investor suitability and promotion activities, management of conflicts of interest and establishment of effective segregation mechanism, and declaration and information disclosure, etc. for your reference.

Key aspects of compliance and internal control for fund investment advisory business

I Internal decision making and process control of fund investment advisory business

Item	Internal control requirements
Process of adding and removing funds from the product pool	<ul style="list-style-type: none"> ■ Implement standardized and efficient due diligence on fund products, prepare assessment reports, and establish an alternative pool for fund products. ■ Specify the procedure of adding and removing fund products into the alternative pool which shall be subject to the decision of the investment decision-making committee.
Implementation of fund investment portfolio strategies	<ul style="list-style-type: none"> ■ Determine the specific fund product types and quantities in accordance with the unified fund portfolio strategy and within the strict authorization. ■ Determine the available product scope for each type of fund product per risk characteristic of the fund portfolio strategy, the available product scope shall not simply be the same as product pool with all fund products. ■ Generate and adjust the fund portfolio in a centralized and unified manner. The adjustment shall be made according to specific procedures. ■ Reasonably assess and accurately define the risk characteristics of the fund portfolio strategy, and where laws and regulations have special provisions on the scope of qualified investors for specific fund types, the risk characteristics of the fund portfolio strategy shall not be lower than the corresponding provisions.

¹. Sources: <http://www.csisc.cn/zbscbzw/jjtzw/202109/f1e411bef5f64a0595ed9aa09a4f030f.shtml>.

Item	Internal control requirements
	<ul style="list-style-type: none"> ■ Prepare a unified fund portfolio strategy prospectus, which specifies the structure of each fund portfolio strategy, the assessment of alternative fund products, risk characteristics and the scope of qualified investors. ■ Where a third-party fund investment advisor is entrusted to provide fund portfolio strategy advice, due diligence and other management policies shall be established and effectively implemented ■ Track the implementation of the fund portfolio strategy, regularly check the matching degree between the fund portfolio strategy and the client's risk tolerance, and monitor the matching degree between the risk-return characteristics and the investment objectives of the fund portfolio strategy.
Transaction management	<ul style="list-style-type: none"> ■ Clarify the operational process, division of team and authority, and the personnel who execute the investment instructions shall be effectively segregated from those who manage the specific product type and quantity of the fund portfolio strategy. ■ Establish transaction monitoring and recording policies.
Investment diversification	<ul style="list-style-type: none"> ■ The aggregate shares of a single fund held by all clients under a single fund portfolio strategy shall not exceed 20% of total shares of the fund, and the aggregate shares of an index fund shall not exceed 30% of total shares of the fund. ■ Do not recommend to clients' funds with complex structures, including the exchange-traded shares of structured funds or other funds specified by authorities. ■ Formulate special risk management policies along with certain risk disclosure when advising clients to invest into close-ended funds, regular open-ended funds, and other funds with restricted liquidation. ■ Obtain prior consent from non-professional clients when recommending funds with restricted liquidation, and the investment period of such funds shall not conflict with the targeted investment period of clients. ■ Where the aforesaid requirements are passively breached due to market and fund scale fluctuations, adjustments shall be made within 3 months.

II Additional requirements for discretionary investment advisory business

Item	Internal control requirements
Application of the authorized account	<ul style="list-style-type: none"> ■ Agree with clients that fund trading accounts opened by clients are authorized accounts for fund investment advisory business, through which the advisor makes investment decisions on behalf of clients regarding specific fund type, quantities and timing of trading, and enters transactions on behalf of clients, such as subscription, redemption and fund conversion, and fund investment advisory fee may be charged from the authorized account of clients as agreed.
Provisions of fund investment portfolio strategies	<ul style="list-style-type: none"> ■ Specify details of the fund portfolio strategy (including but not limited to investment objectives, investment scope, investment strategy, and risk-return characteristics, etc.).
Risk control measures	<ul style="list-style-type: none"> ■ Specify the terms of investment restrictions and risk control measures. For example, the market value of a single fund (excluding money market funds and index funds) held by a single client shall not be higher than 20% of the net asset value of the client's authorized account, and adjustments shall be made within 3 months where the aforesaid requirements are passively violated due to market and fund scale fluctuations if no exemptions are applicable. ■ When providing non-discretionary fund investment advisory service with the function of simplified confirmation of investment decision-making, the fund portfolio strategy provisions and risk control measures for discretionary fund investment advisory business shall apply accordingly.
Information	<ul style="list-style-type: none"> ■ Account earnings, positions, transaction records, etc. shall be disclosed according to the

Item	Internal control requirements
disclosure requirements	frequency, manner and scope agreed with clients, the net asset value of the account of the previous day shall be disclosed to clients on a daily basis, while account earnings, position details, transaction records, etc. shall be disclosed to clients at least once per quarter.

III Management of investor suitability and promotional activities

Item	Internal control requirements
Suitability and AML management	<ul style="list-style-type: none"> ■ Continuously assess clients' investment needs such as risk identification capability, risk tolerance, investment objective and investment period. ■ Establish a regular review mechanism, re-assess the risk tolerance and investment demanding, and take corresponding measures in time in case of significant changes in the assessment results ■ If conducting fund investment advisory business through a fund distributor, establish mechanism of investor suitability management and data transmission related to anti-money laundering between both parties.
Promotion requirements	<ul style="list-style-type: none"> ■ Except for general business promotion requirements, no direct or indirect reference shall be made to simulated performance or profits generated for some individuals. Where past performance is mentioned, it should be the overall performance of a specific fund investment portfolio strategy over a period of more than one year, and clients shall be specifically advised that the past performance shall not be deemed as a statement of its future performance and the profits generated for other clients do not constitute a guarantee for its performance. ■ Promotion shall be in line with the compliance system and evaluation indicators of fund investment advisory service performance and client asset display: <ol style="list-style-type: none"> (1) Fund investment advisory service performance display means the display of fund investment portfolio strategy performance indicators or fund investment advisory service evaluation indicators during the process of promoting the fund investment advisory service, or through the fund investment portfolio strategy details page etc. The fund investment portfolio strategy performance indicator shall indicate the range of returns of the fund investment portfolio strategy, the rate of returns since its establishment and the maximum decline. (2) When the fund investment portfolio strategy performance indicators are presented, the fund service evaluation indicators shall be presented at the same time and a survey shall be completed in advance of clients' needs regarding fund investment advisory business; the fund investment portfolio strategy performance indicators shall be presented in comparison with the performance of the fund investment portfolio strategy's benchmark for the same period, and the benchmark of the fund investment portfolio strategy performance indicators shall be reviewed and approved by the fund investment advisory business investment decision-making committee; when calculating the fund investment portfolio strategy performance indicators, the after-fee indicator shall be displayed to clients, or in the manner as agreed with clients. (3) The service performance display shall not (a) rank the fund investment portfolio strategy performance and its scale; (b) directly or indirectly refer to the simulated performance (except using probabilistic modeling tools); (c) display profits generated for some individuals; and (d) predict future performance. The service performance display shall also indicate data sources and indicator calculation methods. (4) If the fund investment portfolio strategy follows the fund investment portfolio that has been publicly sold by the fund investment advisory institution before obtaining the fund investment advisory business license, it shall be established and operated after the approval by the investment decision-making committee of the fund investment advisory institution, and the initial date of the fund investment portfolio strategy performance shall not be earlier than the establishment date approved by the investment decision-making committee.

Item	Internal control requirements
	<p>(5) Client asset display means the disclosure of the net asset value and its gains or losses of the authorized account of clients. The fund investment advisory institution shall agree with clients on the frequency, manner and scope of the display.</p> <p>(6) The fund investment advisory institution shall present the previous day's net asset value and its gains or losses to clients on a daily basis, and disclose the compartment and its trading records, market value of assets, gains or losses, accumulated gains or losses, maximum losses, fund investment advisory service fees, fund transaction fees, etc. at least once per quarter.</p> <p>(7) The display of client assets shall indicate the source of the data and the index calculation method.</p> <ul style="list-style-type: none"> ■ Trainings should be provided to personnel who are involved in business process such as promotion, client solicitation, and KYC.
Personnel management	<ul style="list-style-type: none"> ■ Relevant personnel engaging in the fund investment advisory business shall acquire the fund qualification, including personnel who engage in the fund investment advisory business promotion services, personnel who generate, provide, and execute fund investment portfolio strategies, and personnel who design, operate, and maintain algorithmic models related to investment advice. ■ Senior management personnel in charge of fund investment advisory business shall have at least three years of experience in the securities or fund industry or have at least five years of experience in other financial industries and have at least two years of management experience in the business they are responsible for. ■ Personnel who manage the specific product variety and quantity of the fund investment portfolio strategy shall have at least three years of experiences in securities investment, security research and analysis, mutual fund research, evaluation, or analysis, and have been engaged in the above works in the last one year and passed the relevant examination. ■ Having no fewer than ten people who have the business qualifications and having at least three years of relevant business experience for any institution newly engaging in fund investment advisory business.

IV Management of conflicts of interest and establishment of effective segregation

Issues	Internal control requirements
Avoidance of conflicts of interest	<ul style="list-style-type: none"> ■ It is not allowed to compromise the objectivity of the investment advice for the benefit of the fund investment advisory institution itself, or for the affiliated parties, specific clients, and specific product issuers. ■ If a distributor charges client maintenance fee to the fund manager, the client maintenance fee shall be offset against the investment advisory service fee to avoid a conflict of interest. ■ Appraisal and incentives measures for the fund investment advisory personnel shall not be linked to fund sales fees or other arrangements that may present a conflict of interest. Fund investment advisory service fees received in advance shall not be used for staff incentives before being recognized as investment advisory income.
Management of affiliated transactions	<ul style="list-style-type: none"> ■ Strengthen the management of affiliated transactions, accurately identify affiliates, and strictly implement the approval policy for affiliated transactions. ■ It is not allowed to provide clients with investment advisory service that may give rise to conflict of interests, and where clients are advised to invest in products managed by the fund investment advisory institution or the affiliated parties, the potential conflict of interests shall be fully disclosed to clients in advance and written consent shall be obtained. There shall be sufficient evidence to prove that the relevant services are for the benefit of clients.
Information segregation	<ul style="list-style-type: none"> ■ The fund investment advisory business shall be effectively isolated from other businesses that have conflicts of interest and the inappropriate flow and use of sensitive information shall be managed.

Issues	Internal control requirements
	<ul style="list-style-type: none"> ■ Attention shall be given to the implementation of the key client information isolation between the fund investment advisory institution and its shareholders. Policies relating to information transfer and information confidentiality shall be enforced.

V Declaration and information disclosure

Issues	Internal control requirements
Statements of commitment	<ul style="list-style-type: none"> ■ Declare that the investment advisory institution has filed with CSRC and has a trial qualification for engaging in fund investment advisory business. ■ Declare that the fund investment advisory business is different from the fund distribution business. In the course of providing fund investment advisory service, investment advisors may directly or indirectly obtain economic benefits. ■ Declare that the investment advisory company does not guarantee the investment gain or return of principal and disclose the relevant risks.
Disclosure mechanism	<ul style="list-style-type: none"> ■ Provide the “Risk Disclosure Letter” and the “Strategy Statement”. The information disclosure mechanism shall include at least the following: <ol style="list-style-type: none"> (1) in the occurrence of a material event that may affect the rights and interests of clients, disclosures shall be made to clients within two days from the date of the occurrence of the material event in the method agreed in the service agreement. (2) disclose any potential conflicts of interest and inform clients in writing of any advice to invest in products managed by the institution itself or a related party in advance. (3) clients shall be promptly informed of any adjustment to the service rules. ■ Full disclosure of fee items, fee rates, and payment methods: the annualized fund investment advisory service fee shall not be higher than 5% of the net asset value of clients’ account, except where the fee is charged in the form of an annual fee or membership fee and does not exceed 1,000 RMB per year.

VI Other compliance and internal control requirements

Issues	Internal control requirements
Compliance policies	<ul style="list-style-type: none"> ■ Establish a compliance and risk control management system covering the fund investment advisory service model design, fund product research, fund portfolio strategy formulation, business promotion, investment and dealing, dynamic position adjustment, information disclosure, client service and technology platform etc. ■ Establish a sound mechanism for clients protection and resolving clients complaints.
Internal control implementation	<ul style="list-style-type: none"> ■ Information management and retention: trace data and information of each process shall be recorded and kept in written or in electronic files for a period of no less than five years from the date of termination of the service agreement. For services provided to non-professional investors, clients shall be prompted to retain relevant information by means of audio recording, screen loading, etc. before the initial contact to provide the services. Where fund investment advisory service is provided online, the institution shall provide clients with recording, saving, downloading and other trace-keeping functions. ■ Dynamically monitor abnormal trading activities of the client accounts, provide real-time alerts, and conduct quarterly assessment of the effectiveness of the compliance and risk control of fund investment advisory business, fund portfolio strategies and their implementations. ■ Regular regulatory reporting requirements on the fund investment advisory business: to submit monthly reports to CSRC bureau within seven business days from the end of each month; and to submit annual reports to CSRC and CSRC bureau within four months from the end of each fiscal

Issues	Internal control requirements
	<p>year.</p> <ul style="list-style-type: none"> ■ If the person in charge of the fund investment advisory business or the methods for fee collection changes, or there occurs major event such as complaint or litigation etc., it shall be reported to CSRC and local CSRC bureau within three business days; if a significant abnormality or an emergency occurs, an <i>ad hoc</i> report shall be submitted to CSRC and CSRC bureau within 2 business days. ■ The pilot qualification will be terminated if the institution fails to pass the regulatory inspection and assessment or has significant issues at the end of the pilot period.

Note: The implementation of certain key points of above compliance and internal control shall depend on the finalization of relevant draft rules.

The regulatory system for fund investment advisory business continues to improve

In response to the “grey area” in the development of fund investment advisory business, the recently issued Fund Investment Advisory Regulations clarify these issues and would comprehensively regulate the qualification conditions, internal management, service models, risk disclosure, promotion, asset display and service evaluation. The Fund Investment Advisory Regulations aim to establish a multi-dimensional legal and compliance system for the future development of fund investment advisory business, fully reflecting the principles of orderly entry/exit, mutual balance, structural optimization, and risk matching.

We are also paying attention to discussions of certain business models in the market:

Model 1: fund managers list a series of fund portfolios on the fund distributors’ business outlets/websites without charging separate fee or signing separate fund investment advisory agreement, whereas the fund manager will be displayed as the manager of the fund portfolio;

Model 2: fund distributors sell mutual fund products on a commission basis and provide one-click ordering services without a separate fee. Each fund subscription ratio has been configured by default, but the investors may modify the subscription ratio of each fund at their discretion;

Model 3: a key opinion leader in the fund business acts as the portfolio manager and relevant funds remain in the investor’s own account; after the investor has subscribed a fund portfolio, the system will automatically allocate the funds to relevant portfolio per the ratio adopted by such portfolio manager.

We believe the legal application and compliance of above-mentioned business models will be further clarified. According to the Fund Investment Advisory Regulations, institutions with non-compliant business models would not be allowed to conduct new non-compliant activities in providing fund investment portfolio strategy recommendations. This includes not presenting or launching new fund investment portfolio strategies, not adding new clients to existing fund investment portfolio strategies, and not providing additional portfolio strategy investments for existing clients. In addition, clients would be prominently alerted that the institution is in the process of rectifying its fund investment advisory activities and that there is a risk that services cannot be provided uninterrupted in the future.

We will continue to closely monitor the development and implementation of the Fund Investment Advisory Regulations, and how they can be effectively applied to various business scenarios and embedded into

the institutions' internal control frameworks, and work with market participants in connection with legal, compliance, and risk management issues in the development of fund investment advisory business.

Important Announcement

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If you have any questions regarding this publication, please contact:

Yin GE

Tel: +86 21 6080 0966

Email: yin.ge@hankunlaw.com