Investment funds in China: regulatory overview[1]

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A Q&A guide to investment funds law in China.

This Q&A is part of the PLC multi-jurisdictional guide to investment funds. It provides a high level overview of investment funds in China, looking at both retail funds and hedge funds. Areas covered include a market overview, legislation and regulation, marketing, managers and operators, restrictions and requirements, tax and upcoming reform.

To compare answers across multiple jurisdictions, visit the Investment Funds *Country Q&A tool*.

For a full list of jurisdictional Q&As visit *www.practicallaw.com/investmentfunds-mjg*.

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Retail funds

1. What is the structure of the retail funds market? What have been the main trends over the last year?

The Chinese retail fund market has experienced significant development since last year as a series of new laws and regulations relating to retail funds were promulgated or amended.

Under the Securities Investment Funds Law of the PRC (as amended on 28 December 2012 and effective 1 June 2013) (New Funds Law) securities investment funds (PRC Funds) established in the PRC are categorised into retail funds (publicly offered funds) and non-retail funds (privately placed funds).

Retail funds refer to any fund that is offered to unspecified investors or more than 200 specified investors, and any other funds otherwise classified as retail funds under the applicable Chinese laws.

PRC Funds may take the form of closed-ended funds, open-ended funds, or other forms permitted under the applicable Chinese laws.

Retail funds can only be offered and managed by:

- Fund management companies that are regulated by the China Securities Regulatory Commission (CSRC) (Fund Management Companies).
- Asset management institutions approved by the CSRC (Asset Management Institutions). Only the following entities may qualify as an Asset Management Institution:
  - PRC-incorporated securities companies;
  - PRC-incorporated insurance asset management companies;
  - other PRC-incorporated asset management institutions specialising in the management of non-retail securities investment funds;
  - PRC-incorporated equity investment management institutions;

- PRC-incorporated venture capital investment management institutions.

Retail funds can generally be divided into:

- Equity funds.
- Money market funds.
- Debt funds.
- Hybrid funds.
- Qualified domestic institutional investor (QDII) funds (that is, funds with approved foreign exchange quotas that can make investment in the offshore securities market).

There are also exchange traded funds (ETFs) and listed open-ended funds (LOFs).

Open-ended retail funds

Open-ended retail funds have developed into the most popular form of retail funds in the Chinese market since the first open-ended fund was established in 2001.

Closed-ended retail funds

Under the New Funds Law, retail funds can also be closed-ended. Generally, closed-ended retail funds are subject to the same regulatory regime in China as open-ended retail funds.

Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

Open-ended retail funds

Regulatory framework. The New Funds Law is the principal piece of legislation for PRC Funds, including open-ended funds and closed-ended funds. Within the regulatory framework established by the New Funds Law, the CSRC has promulgated a series of regulations on the operation and management of funds and fund managers, including the following:

- Administrative Measures on the Operation of Securities Investment Funds.
- Administrative Measures on the Marketing of Securities Investment Funds.
- Administrative Measures on the Information Disclosure of Securities Investment Funds.
- Administrative Measures on Securities Investment Fund Management Companies.

- Administrative Measures on the Qualification Requirements for Senior Officers of Securities Investment Fund Management Companies.

Under this regulatory framework, the offering and marketing, registration, trading, day-to-day management, custody, valuation and accounting, taxation, profit distribution, and information disclosure in relation to PRC Funds are heavily regulated.

In addition, the China Insurance Regulatory Commission (CIRC) has promulgated additional regulations to regulate insurance asset management companies engaging in funds management businesses.

Regulatory bodies. The CSRC is the primary PRC authority in charge of supervising and regulating PRC Funds in China. The CSRC responsibility in this respect is discharged by an internal division named the Fund Regulatory Division.

The following actions, among others, require prior registration with or approval from the CSRC:

- Offering of any retail fund.
- Establishment of any Fund Management Company.
- Conducting of retail funds management business by Asset Management Institutions.
- Appointment of senior officers of a Fund Management Company.

The Asset Management Association of China (Funds Association) is a self-regulatory organisation that represents the PRC Funds industry. It is dedicated to enhancing compliance operations and improving industry integrity by exercising industry self-regulation.

The CIRC is responsible for regulating insurance asset management companies engaged in funds management businesses.

Closed-ended retail funds

Regulatory framework. Open-ended retail funds and closed-ended funds are essentially subject to the same regulatory regime in China (*see above, Open-ended retail funds: Regulatory framework*).

Regulatory bodies. See above, *Open-ended retail funds: Regulatory bodies*.

3. Do retail funds themselves have to be authorised or licensed?

Open-ended retail funds

The offering of open-ended retail funds and closed-ended retail funds is subject to approval by the CSRC. For the purpose of registering the offering of a retail fund, the fund manager must submit the following documents to the CSRC for registration:

- Application letter.
- Draft fund contract.
- Draft custodian agreement.
- Draft fund prospectus.
- Legal opinion issued by qualified PRC legal counsel.
- Other documents as may be requested by CSRC.

CSRC will decide whether or not to approve the application within six months. Only after obtaining CSRC approval will the fund manager be permitted to publish the prospectus and offer fund units to investors.

Closed-ended retail funds

See above, *Open-ended retail funds*.

Marketing

4. Who can market retail funds?

Open-ended retail funds

After a retail fund has been duly approved/registered with the CSRC (*see Question 3, Open-ended retail funds*), the units of that fund can be offered to the investors. Only Chinese retail funds that have been registered with the CSRC can be marketed in China. Foreign retail funds cannot be registered with the CSRC and cannot be marketed in China.

The manager of a retail fund (whether open- or closed-ended) and the qualified fund distributors engaged by the fund manager are permitted to market and promote the retail fund. Fund distributors in this context include:

- Commercial banks (including foreign banks having business presence in the PRC).
- Securities companies.
- Futures companies.
- Insurance institutions.
- Securities investment consultancy institutions.
- Independent funds distribution institutions.

- Other institutions that have been approved by the local CSRC to engage in the business of retail fund unit distribution.

Each fund distributor must satisfy the conditions imposed by the CSRC and be pre-approved by the CSRC before marketing and distributing fund units.

The promotion materials of the fund manager must be reviewed and approved in writing by a member of the manager's senior management in charge of fund distribution and the manager's compliance officer. Once approved, the promotion materials must be filed with the local CSRC within five days of their public offering.

The promotion materials of the fund distributors (other than the fund manager) must be reviewed and approved in writing by a member of the senior management of the fund distributor in charge of funds distribution and legal compliance. After being so approved, the promotion materials must be filed with the local CSRC within five days of their public offering.

In addition, the promotion of retail funds is subject to various restrictions. For example, the promotion materials must not include forecast on investment returns, guaranteed return on investments and misleading information.

Closed-ended retail funds

This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

5. To whom can retail funds be marketed?

Open-ended retail funds

After due approval/registration with the CSRC, retail funds (both open-ended retail funds and closed-ended retail funds) can be marketed to the general public in China in writing or through electronic or any other means, such as newspapers, internet, television, and so on. Foreign retail funds cannot be registered with the CSRC and cannot be marketed in China.

Closed-ended retail funds

See above, *Open-ended retail funds*.

Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

Open-ended retail funds

Only PRC-incorporated Fund Management Companies and PRC-incorporated Asset Management Institutions that have been duly approved by the CSRC can serve as the manager of retail funds in China. Foreign fund managers are not permitted to act as the fund manager of any Chinese retail funds.

Conditions for a Fund Management Company to act as the manager of retail funds include the following:

- Articles of association in conformity with the relevant provisions of the New Funds Law and the Company Law of the PRC.
- A minimum paid up capital of CNY100 million.
- Requirements for principal shareholders:
  - good business performance;
  - financial standing and social reputation in the financial business or management of financial institutions;
  - appropriate assets scale;
  - compliance with the applicable regulations.
- Business staff, directors, supervisors and senior management must possess corresponding qualifications.
- Appropriate offices and facilities for engaging in retail fund management businesses.
- Sound and complete internal governance structure, regulations and rules.
- Other conditions stipulated by the CSRC.

Conditions for an Asset Management Institution to act as the manager of retail funds include:

- At least three years of experience in the management of securities assets, provided the managed securities have performed well in the last three years.
- Sound corporate governance, sophisticated internal control system and effective risk management.
- Good state of operation and sound financial performance in the last three years.
- Good faith and legally compliant operation.
- Admitted as a member of the Funds Association.

Securities companies must, in addition:

- Have a total scale of asset management not less than CNY20 billion or have a scale of collective asset management business of no less than CNY2 billion.
- Have all risk control indicators meeting the prescribed standards on an ongoing basis in the last 12 months.

Insurance asset management companies must satisfy the following additional requirements:

- Have asset under management of no less than CNY20 billion.
- Have net assets of no less than CNY500 million at the end of the past quarter.

Private equity securities fund management institutions must satisfy the following additional requirements:

- Have a paid-in capital (in the case of private equity securities fund management institutions in the form of corporations) or actual paid-in contribution (in the case of private equity securities fund management institutions in the form of limited partnerships) of no less than CNY10 million.
- Have securities assets under management of no less than CNY2 billion in the last three years.
- Other conditions as required by the CSRC

Closed-ended retail funds

This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds

The following position applies under the New Funds Law:

- Assets of a PRC Fund must be distinct from and not commingled with the assets of the fund manager and the fund custodian.
- Portfolio of assets of each PRC Fund must be held by the custodian of the fund for and on behalf of that fund. The cash and securities comprising the assets of a fund must be maintained in the cash/securities account opened in the name of that fund.

- Debts and liabilities of a PRC Fund must be repaid from the assets of that fund; unless otherwise provided in the fund contract, the unitholders shall be liable to the fund's debts and liabilities only to the extent of the unitholders' capital contribution to the fund.
- Where the manager or custodian of a PRC Fund is dissolved, liquidated, revoked, or declared bankrupt, the assets of that fund will not constitute part of the manager's/custodian's liquidation assets.

Only the following two categories of institutions satisfying all conditions under the New Funds Law can serve as the custodian of a PRC Fund:

- Commercial banks that have been duly approved by the CSRC and the China Banking Regulatory Commission (CBRC).
- Other financial institutions that have been duly approved by the CSRC.

Closed-ended retail funds

This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

Open-ended retail funds

Legal vehicles. A retail fund is typically set up as a unit trust, under which the fund manager and the custodian bank act as co-trustees of the fund for the benefit of the fund unitholders. The rights and obligations of fund managers, fund trustees and fund unitholders should be provided in the relevant fund contracts. The participants' interests in the retail fund are called units or shares.

Advantages. Retail funds organised in the form of unit trust enjoy many advantages, including tax transparency, better protection of unitholders' interests through contractual arrangements, separation of assets and fiduciary duties for the fund manager and fund custodian.

Disadvantages. As trust is traditionally a legal concept under common law, its adoption in the civil law system of China inevitably gives rise to issues and challenges. Due to the absence of legal tradition and concept of trust in China, the rights and obligations in the governance of unit trusts are not clearly defined. In particular, the custodian is not fully independent from the fund manager, and the functions and powers of the general meeting of the fund may not be completely realised.

Closed-ended retail funds

Legal vehicles. This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

Advantages. This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

Disadvantages. This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

Investment and borrowing restrictions

9. What are the investment and borrowing restrictions on retail funds?

Open-ended retail funds

The retail fund property must be used for the investment in:

- Listed stocks and bonds.
- Investment instruments available in the inter-bank market.
- Stock index futures.
- Other securities and derivatives provided for by the CSRC.

The retail fund property cannot be used to participate in the following activities:

- Underwrite securities.
- Extend loans or provide guarantees to a third party.
- Assume unlimited liability in investment activities.
- Invest in another fund, unless otherwise permitted by the CSRC.
- Invest in the fund manager or the fund trustee.
- Insider dealing, manipulating securities prices or other wrongful securities dealings.
- Other activities prohibited by laws, regulations or the CSRC.

The following requirements apply when trading, using fund assets, in securities that are issued or underwritten by the fund manager, the fund custodian, the controlling shareholder or the actual controlling person of those people, or in relation to other material related-party transactions:

- The fund unitholders' interests must be accorded first priority.
- Any conflict of interest must be avoided.

- Regulations of the CSRC must be complied with.
- Appropriate disclosure must be made.

Other investment restrictions and guidelines may be imposed by the fund contract.

Closed-ended retail funds

This is the same as for open-ended retail funds (*see above, Open-ended retail funds*).

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

The fund contract and prospectus usually provides the conditions and procedures for the issue and redemption of fund interests. The fund manager may require a lock-up period after the establishment of the fund, which must not exceed three months. The manager may reject subscription and/or redemption request in certain circumstances in accordance with the fund contract. In practice, most open-ended retail funds are open for subscription and redemption on each trading day on the local stock exchange, and the fund manager provides a minimum requirement for each issue and redemption.

Closed-ended retail funds

A closed-ended retail fund units can only be traded on a stock exchange. The relevant stock exchange rules apply.

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

Open-ended retail funds

The fund unitholders cannot transfer their fund units to a third party by entering into an agreement with that third party. In certain circumstances, such as death of a natural person, or merger or bankruptcy of a legal person, the fund unit holder's units can be assigned to the relevant parties subject to laws and regulations.

Closed-ended retail funds

Closed-ended retail fund units can only be traded on a stock exchange. The relevant stock exchange rules apply.

Reporting requirements

12. What are the general periodic reporting requirements for retail funds?

Open-ended retail funds

Investors. The fund manager has the obligation to:

- Disclose the net asset value of fund assets and fund units at least once a week before processing purchases or redemptions of fund units.
- Disclose the net value and net accumulated value of fund units on the day following each trading day.
- Publish the net value of fund assets and fund units on the last trading day of each semi-annual period.
- Publish an annual fund report within 90 days after the end of each calendar year.
- Publish a semi-annual fund report within 60 days after the end of each calendar half-year period.
- Publish a quarterly fund report within 15 working days after the end of each calendar quarter.

Regulators. There are no periodic reporting requirements for the regulators.

Closed-ended retail funds

Investors. The requirements are the same as for the open-ended retail funds, except that the fund manager of closed-ended retail funds must publish the net asset value of each share at least once a week.

Regulators. There are no periodic reporting requirements for the regulators.

Tax treatment

13. What is the tax treatment for retail funds?

Open-ended retail funds

Funds. Income derived by securities investment funds from the securities market (including capital gains arising on the sale of stocks and bonds, dividends from equity investment, interest income on bonds) is exempt from enterprise income tax. In addition, raising funds by way of issuing fund shares or units is not subject to business tax.

Resident investors. Individual investors are currently not subject to individual income tax or stamp duty on the purchase and redemption of fund units. However, a 20% individual income tax is withheld on interest income from corporate bonds and stock dividends by the respective listed companies, bond issuers or banks when distributing such income to the fund. There is no further tax withholding when the fund distributes such income to the investors.

On the other hand, institutional investors are liable to both enterprise income tax at the rate of 25% and business tax at the rate of 5% (plus surtaxes that are usually charged at the rate of 12% on the business tax actually paid, amounting to 0.6%) in respect of investment returns derived from the price difference between the subscription and redemption of fund units. Such income is nevertheless exempt from stamp duty.

Non-resident investors. Due to the foreign exchange control system in China, foreign investors are not allowed to directly invest in local retail funds that are denominated in CNY. The following exemptions apply:

- Qualified foreign institutional investors (QFIIs) that have obtained a QFII licence from the CSRC and an investment quota granted by the State Administration of Foreign Exchange can directly invest in retail funds in China.
- Hong Kong subsidiaries of Chinese mutual fund managers, securities companies, commercial banks and insurance companies as well as other financial institutions organised and having its principal place of business in Hong Kong can use offshore CNY to invest in China's securities markets through the Rmb-QFII pilot programme. A licence/quota must be obtained from the CSRC.
- Foreign strategic investors that comply with any applicable regulations.

Non-resident investors (including QFIIs, Rmb-QFIIs and foreign strategic investors) are liable to withholding income tax at the rate of 10% for China-sourced dividend and interest income. Capital gains obtained by QFIIs and Rmb-QFIIs are not subject to business tax, but other non-resident investors should generally be subject to business tax at the rate of 5% (plus surtaxes that are usually charged at 12% on the business tax paid, amounting to 0.6%) for the price difference arising from the purchase and sale of fund units. In addition, although non-resident investors should in principle be liable to a 10% withholding income on capital gains derived from China, the tax treatment of QFIIs and Rmb-QFIIs with respect to China-sourced capital gains remains unclear.

New proposed tax rules are being deliberated by the PRC tax authority that likely will also impose the 10% withholding income tax on the China-sourced capital gains derived by QFIIs.

Non-resident investors (including QFIIs, Rmb-QFIIs and foreign strategic investors) may apply to the relevant PRC tax authorities to benefit from applicable tax treaties if a more preferential withholding income tax arrangement is provided in the tax treaty, but again, whether QFIIs and Rmb-QFIIs may apply for treaty benefits in relation to China-sourced capital gains has yet to be clarified by PRC tax authorities.

Closed-ended retail funds

Funds. This is the same as for open-ended retail funds (*see above, Open-ended retail funds: Funds*).

Resident investors. This is the same as for open-ended retail funds, except that gains arising from the purchase and sale of corporate bonds derived by individual investors from a close-ended fund are subject to individual income tax at the rate of 20%, while those derived by institutional investors are not subject to enterprise income tax.

Non-resident investors. This is the same as for open-ended retail funds (*see above, Open-ended retail funds: Non-resident investors*).

Reform

14. What proposals (if any) are there for the reform of retail fund regulation?

The New Funds Law has resulted in a number of important amendments to retail fund regulation. There are currently no further proposals for significant reform of retail fund regulation.

Hedge funds

15. What is the structure of the hedge funds market? What have been the main trends over the last year?

For the first time, the New Funds Law has officially recognised privately placed funds that invest in public securities and derivatives.

The prototype for these funds is the so-called "Sunshine Private Fund" (SPF), which uses hedge fund strategies. Generally these funds are deemed to be hedge funds with local PRC features. The most popular legal form for an SPF has been the pooled trust plan offered by trust companies, although limited partnerships have also been used at times. Similar hedge fund products have also been offered by securities companies and mutual fund managers in the form of asset management schemes or separate accounts since 2011.

Regulatory framework and bodies

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

Regulatory framework

The key applicable regulation in respect of SPFs that are organised as pooled trust plans, is the Administrative Measures for the Master Trust Schemes of Trust Companies (Order of CBRC [2007] No. 3), as amended by Order of CBRC [2008] No. 1. For SPFs that are organised as limited partnerships, the key legislation is the Partnership Law of the People's Republic of China (Partnership Law), amended by the Standing Committee of the National People's Congress on 27 August 2006 and effective on 1 June 2007.

Regulatory bodies

Pooled trust plans offered by trust companies are subject to the ex-post supervision of the CBRC, while limited partnerships investing in public securities and derivatives must register with and be subject to the supervision of the CSRC.

17. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

Risk

Under the relevant regulations and rules of the stock exchange, principal risk controls of hedge funds should at least cover the following:

- Obtaining the qualification to participate in relevant trading activities (that is, trust companies must obtain approval by the CBRC to participate, directly or indirectly in stock index futures trading activities).
- Engaging in business activities compatible with their risk management capacity.
- Having a specific department and relevant personnel in charge of dealing with legal affairs and ensuring compliance with internal control rules.
- Having a sound management framework for market risk, practice risk, credit risk and other risks.
- Establishing, among others, risk management rules and internal audit rules.

- Any other requirements imposed by the relevant authorities and stock exchanges.

Valuation and pricing

There are no specific laws, regulations or rules in this regard, and common market practices are usually acceptable.

Systems and controls

Except for some general laws and regulations listed below, there are no specific laws, regulations or rules in this regard.

Insider dealing and market abuse

In relation to insider dealing and market abuse, hedge funds are subject to the PRC Securities Law and PRC Criminal Law, under which:

- An insider who has access to inside information on securities trading and any person who has unlawfully obtained any inside information is prohibited from taking advantage of that information by buying or selling securities.
- An insider who has access to any inside information on securities trading or any person who has unlawfully obtained any inside information must not, before that information becomes available in the public domain, buy or sell any of the relevant company's securities, divulge that information to any other person, or advise any other person to buy or sell those securities.
- The following forms of securities market manipulation are prohibited:
    - independently or in concert with others, manipulating the market price or trade volume of securities by jointly or continuously buying or selling securities on the basis of any funding, shareholding or informational advantages;
    - conspiring with others to trade securities based on a pre-arranged plan, thereby affecting the price or volume of securities traded;
    - effecting any securities transaction between accounts controlled by the same party, thereby affecting the price or volume of securities traded; and
    - manipulating the securities market by any other means.

Any company or individual that violates the relevant provisions may be ordered to compensate the losses and even face a criminal charge.

Transparency

Managers of pooled trust plans must comply with Order of CBRC [2007] No. 3 to fulfil their duty of information disclosure and may need to report to beneficiaries in accordance with the trust contract and any other relevant legal documents.

Managers of limited partnerships must report certain information relating to the fund's investment and operation to their partners in accordance with the limited partnership agreement, the management agreement and any other relevant legal documents, typically on a quarterly basis.

Money laundering

The principal regulations concerning money laundering to which hedge funds may be subject are the PRC Anti-Money Laundering Law of the People's Republic of China and Provisions on Anti-Money Laundering by Financial Institutions by the People's Bank of China, under which financial institutions, including trust companies, and branches of those institutions, must:

- Establish an internal anti-money laundering (AML) mechanism, establish or designate an internal organisation responsible for the AML, formulate internal operational procedures and control measures, and provide AML training to employees so as to improve the AML capacity.
- Establish and implement a customer identification system and properly keep customers' identity materials, data, business vouchers and books for each transaction within the stipulated period.
- Report to the China Anti-money Laundering Monitoring and Analysis Centre any CNY and/or large-amount foreign exchange transactions and/or suspicious transactions in accordance with the relevant rules.

Any company or individual that violates relevant provisions may be subject to sanction by the relevant authorities and even face a criminal charge.

Short selling

The principal regulations concerning short selling are the Pilot Administrative Measures for Securities Margin Trading Business of Securities Companies (revised in 2011) by the CSRC and related rules of stock exchanges on securities margin trading. Hedge funds, as investors, which engage in securities margin trading business must comply with these measures and rules, including that:

- The credit securities account of the investor must not be used to:
    - purchase or transfer-in of securities other than those used as collateral; and

    - participate in private placements, subscription and redemption of securities investment fund units, or bond repurchase transactions.
- When the investor trades securities on margins, the minimum margin must be 50% and the margin must not exceed the available balance.
- Encumbered securities cannot be delivered as collateral.
- In the event that the investor fails to fully deliver the collateral on time or fails to repay the debt when due, the securities company may adopt forced closing measures with further recourse to the investor for any outstanding amount.

Marketing

18. Who can market hedge funds?

Hedge funds can be marketed only by managers duly registered with the Funds Association.

19. To whom can hedge funds be marketed?

Privately placed funds must be offered to no more than 200 qualified investors. In addition, the number of natural persons contributing to a single trust fund must not exceed 50 (*Order of CBRC [2007] No. 3*), but any natural person investing at least CNY3 million and any qualified institutional investor do not count towards that 50 person requirement (*Order of CBRC [2009] No. 1*).

Investment restrictions

20. Are there any restrictions on local investors investing in a hedge fund?

The investors of pooled trust plans can include anyone who can identify, assess and bear, the risks inherent in a trust plan and come under one of the following categories (*Order of CBRC [2007] No. 3*):

- Natural persons, legal persons, or other lawfully established organisations intending to invest not less than CNY1 million in the trust plan.
- Natural persons with total household or individual financial assets of not less than CNY1 million at the time of contribution, subject to the provision of evidence of property ownership.
- Natural persons whose individual annual income has been not less than CNY200,000 in each of the last three years, or married couples whose combined annual income has been not less

than CNY300,000 in each of the last three years, subject to the provision of the proof of income.

According to the Circular on Seeking Public Comments on the Interim Administrative Measures for Private Securities Investment Fund Business (Draft for Comments) promulgated by the CSRC on 20 February 2013, qualified investors of non-retail funds must be able to identify and bear the risks for investing in a private fund and satisfy one of the following criteria:

- Total financial assets (personal or household) of no less than CNY2 million.
- Personal average annual income of no less than CNY200,000 for the last three years.
- Household average annual income of no less than CNY300,000 for the last three years.
- In the case of companies, enterprises or other institutions, with net assets of no less than RMB10 million.

In addition, investment products legally established and managed by financial institutions that are subject to the regulation and supervision of the CBRC, the CSRC and the China Insurance Regulatory Commission are deemed as qualified investments.

The amount invested by a qualified investor into a single private fund must be no less than CNY1 million.

Assets portfolio

21. Who holds the portfolio of assets? What regulations are in place for its protection?

In most cases, a trust company holds the portfolio of assets as the legal owner on behalf of the pooled trust plan subscribers, while limited partnerships may hold the portfolio of assets in its own right. There is no clear regulation in place for the portfolio protection.

Requirements

22. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

After a pooled trust plan has been set up, the trust company shall, according to the individual needs of different trust plans, prepare quarterly trust fund management reports as well as tables of trust fund utilisation and investment returns (*Order of CBRC [2007] No. 3*). The trust fund management reports must at least include the following information, where applicable:

- The dedicated account opened for trust property.

- The management, utilisation, disposal, and earnings of the trust fund.
- Change of trust manager.
- Explanation of the material changes to the use of trust funds.
- Litigation or impairment of the trust property or the interests of beneficiaries.
- Other contents as provided in trust plan documents.

In addition, if any of the following events occurs, trust companies must, within three working days after they become aware of the situation, disclose the information to the beneficiaries and, within seven working days of the date of disclosure, provide the beneficiaries with a written explanation of coping measures proposed to be taken by the trust companies:

- The trust property is likely to suffer a substantial loss.
- A substantial deterioration in the financial situation of the manager of the trust funds.
- The guarantor of the trust plan can no longer provide effective guarantee.

23. What are the key requirements that apply to managers or operators of hedge funds?

Hedge fund managers/operators must register with the CSRC and the Funds Association and fulfil certain reporting requirements.

Foreign managers generally cannot act as the manager of an SPF in the form of a pooled trust plan, securities company asset management scheme or mutual fund separate account, or as the general partner or manager of an SPF in the form of a limited partnership. The reason for this incapacity is that it would contravene the PRC regulatory restrictions on trading in China's public securities market by foreign investors unless they:

- Hold a QFII licence/quota.
- Hold a similar licence/quota by investing overseas RMB (R-QFII).
- Invest as a foreign strategic investor in compliance with relevant regulations.

(*See Question 13, Open-ended retail funds: Non-resident investors*.)

Very recently, foreign hedge fund managers have tested waters in China's securities market by trading indirectly in the capacity of a technology sub-advisor to a qualified PRC firm.

Legal fund vehicles and structures

24. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

SPF organised as pooled trust plans

Advantages. The advantages of this structure include:

- More marketing channels and lower sales cost.
- Relatively developed investment and operation mode.
- Relatively mature and flexible regulatory environment.

Disadvantages. The disadvantages are high offering costs and expenses, and unclear tax treatment.

SPF organised as limited partnerships

Advantages. This structure offers the following advantages:

- No income tax at the partnership level.
- Flexible decision-making and an incentive mechanism for the manager and/or the managing team.

Disadvantages. The disadvantages are:

- Relatively strict requirements for the manager.
- Fewer fundraising channels.
- Unclear regulatory framework.

Tax treatment

25. What is the tax treatment for hedge funds?

Funds

SPFs organised as pooled trust plans. No explicit tax laws or regulations require the payment of taxes and in practice, no business tax or enterprise income tax at the fund level applies.

SPF organised as limited partnerships. The gains derived from the purchase and sale of financial products are subject to business tax at the rate of 5% (plus surtaxes that are usually charged at 12% on the business tax paid, amounting to 0.6%). No enterprise income tax is payable at the partnership level.

Resident investors

SPFs organised as pooled trust plans. In respect of the price difference between the purchase and sale of fund units, individual investors are not liable to business tax, whereas institutional investors are liable to business tax at the rate of 5% (plus surtaxes; *see above*).

In relation to income tax payable on the price difference between the purchase price and sale price of fund units, individual investors are not explicitly subject to individual income tax and do not pay such tax in practice, whereas institutional investors are liable to enterprise income tax at the rate of 25%.

SPF organised as limited partnerships. Sale of ownership interests in partnerships does not trigger business tax liability for either individual or institutional investors. In relation to income tax, investors are liable to income tax on their respective share of the partnership's income. Individual income tax is imposed at the progressive rate ranging from 5% to 35% (some local regulations may provide for the application of individual income tax at a flat rate of 20%). Institutional investors must include the accumulated income into their tax base subject to enterprise income tax.

Non-resident investors

Not applicable.

Restrictions

26. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Redemption of interest

The trust contract or the limited partnership agreement, as the case may be, usually provides the requirements for redemption, including a lock-up period that is usually between six months and two years, and post-lock-up redemption on a monthly, quarterly, semi-annual or even annual basis.

Transfer to third parties

Transfer to third parties is usually permitted only with the approval of the manager.

Reform

27. What (if any) proposals are there for the reform of hedge fund regulation?

The New Funds Law will provide, for the first time, a legal framework for non-retail funds (*see* *Question 15*). There are currently no further proposals for the reform of hedge fund regulation.

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Online resources

China Securities Regulatory Commission

http://www.csrc.gov.cn/pub/csrc_en/

Description. Official website of the CRSC, which provides official and up-to-date information regarding securities regulations, public consultations for proposed regulations, as well as explanatory notes to inform investors of the CSRC's latest regulatory moves. English translations should be used for guidance purposes only and the Chinese version is always binding.

China Banking Regulatory Commission

http://www.cbrc.gov.cn/english/index.html

Description. Official website of the CBRC, which provides official and up-to-date information regarding, among other things, banking regulations, public consultations for proposed regulations, explanatory notes, and risk alerts. English translations should be used for guidance purposes only and the Chinese version is always binding.

Invest in China

http://www.fdi.gov.cn/pub/FDI_EN/default.htm

Description. Invest in China is an official website maintained by the Ministry of Finance (MOFCOM). The website provides up-to-date official information regarding foreign investment. English translations should be used for guidance purposes only and the Chinese version is always binding.

Content for table (Tax treatment for open-ended and closed-ended retail funds and hedge funds)

Jurisdiction	What is the tax treatment for	What is the tax treatment for	What is the tax treatment for hedge funds?

	open-ended retail funds?	closed-ended funds?	
China	Not subject to tax.	Not subject to tax.	**Pooled trust plans.** No business tax or enterprise income tax in practice. **Limited partnerships.** 5% business tax on gains derived from the difference between the purchase price and the sale price of financial products. No enterprise income tax.

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Professional qualifications. State of New York, US; Chartered Financial Analyst (CFA) and Chartered Alternative Investment Analyst (CAIA).

Areas of practice. Fund formation; asset management; private equity/venture capital; foreign direct investment; capital markets.

Non-professional qualifications. JD, Columbia Law School; BA in German and LLB, Peking University.

Recent transactions

- Advising leading global asset managers such as BlackRock and Invesco on various QFII matters ranging from offshore QFII fund formation to tax, foreign exchange and other regulatory counselling.

- Acting for a number of global hedge fund managers on applying to set up Qualified Domestic Limited Partner (QDLP) pilot funds in Shanghai in connection with raising capital in China for offshore hedge fund vehicles.
- Advising seven leading international private equity and venture capital firms such as Fidelity Asia, Qiming Ventures and SBI Holdings in setting up Qualified Foreign Limited Partner (QFLP) pilot funds in Shanghai.

Languages. Mandarin (native); English (fluent), German (fluent), Cantonese (fluent)

Professional associations/memberships

- Expert Review Committee of the QFLP and QDLP pilot programmes administered by the Shanghai Financial Services Office.
- Expert Advisor to China Private Equity Association.
- Member, New York State Bar Association
- Member, New York Hedge Fund Roundtable
- Member, CFA Institute
- Member, CAIA Association

Publications

- What You Need to Know When Thinking about Forming a China Fund, forthcoming.
- What You Need to Know When Thinking about Forming a China Hedge Fund, forthcoming.
- Comparative Analysis of Local Rules Regarding Formation of Private Equity and Venture Capital Funds and Their Management Companies in China, Han Kun Asset Management Commentary, January 2011.
- How to Incentivize Your Private Fund Manager, Chinese Venture, May 2012.