Hedge funds in China: regulatory overview

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Country Q&A | **Maintained** | China

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

This Q&A is part of the global guide to hedge funds. It provides a high level overview of hedge funds in China. Areas covered include a market overview, legislation and regulation, marketing, managers and operators, restrictions and requirements, tax; private placement rules and upcoming reform.

To compare answers across multiple jurisdictions, visit the hedge funds *Country Q&A tool*. For a full list of jurisdictional Q&As visit *www.practicallaw.com/investmentfunds-guide*.

Hedge funds

Market overview

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

Investment funds are generally divided into three categories in China based on investment targets:

- Securities funds.
- Equity funds.
- Other funds.

Hedge funds, as pools of underlying securities and derivatives, are classified as securities funds. Hedge funds in China are mainly privately raised and available exclusively to sophisticated investors or high net worth investors. Privately raised securities funds were first officially recognised in the amended Securities Investment Fund Laws issued on 28 December 2012, and which has been further amended on 24 April 2015 (Securities Funds Law). The China Securities Regulatory Commission (CSRC) is the main regulator of the securities industry in China. On 21 August 2014 it issued the Provisional Measures on Supervision and Administration of Privately Raised Investment Funds (Private Funds Measures), customising the fundraising and operating compliance requirements of private funds, which applies to privately raised hedge funds. Since then, CSRC and the Asset Management Association of China (AMAC), a self-regulatory organisation backed by CSRC, have issued a series of regulations and rules to strengthen scrutiny on fund management business. Hedge funds in China usually takes the form of pooled trust plans, asset management schemes and contract funds.

China has gradually relaxed the foreign investment restrictions in China's capital markets. Foreign invested enterprises, including wholly foreign-owned enterprises (WFOE), are now permitted to apply for registration with AMAC as private securities investment fund managers. To date several WFOEs established by well-known foreign financial institutions are registered with AMAC as private securities investment fund managers, including:

- Fidelity.
- UBS.
- Man Group.
- Invesco.
- Fullerton.

In December 2017, Man Group announced that they were planning to launch their first onshore quantitative hedge fund in China.

Regulatory framework and bodies

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

Regulatory framework

Securities funds law applies to all securities funds in China. Private funds measures apply to all privately raised securities funds, including privately raised hedge funds, unless superseded by other laws and regulations. Additional specific regulations may apply depending on the legal form of the hedge fund, for example:

- **Pooled trust plans:** the main applicable regulation is the Administrative Measures for the Master Trust Schemes of Trust Companies issued by China Banking Regulatory Commission (CBRC) (Order of CBRC [2007] No. 3), as amended by Order of CBRC [2009] No. 1.
- Asset management schemes: the main applicable regulations are the:
  - Measures for the Administration of the Customer Asset Management Business of Securities Companies (Order of CSRC [2013] No. 93) for asset management schemes managed by securities companies;
  - Pilot Measures for the Asset Management Services of Fund Management Companies for Specific Clients (Order of CSRC [2012] No. 83) for asset management schemes managed by CSRC licensed fund management companies.

Regulatory bodies

Pooled trust plans offered by trust companies are subject to the ex-post supervision of the CBRC, while hedge funds in the form of asset management schemes and contract funds are subject to supervision of the China Securities Regulatory Commission and the Asset Management Association of China.

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

Risk

In relation to hedge funds the main areas of risk control are covered under the relevant regulations and rules of the stock exchange. As a minimum the following is required:

- Obtaining the qualification to participate in relevant trading activities (that is, to participate, directly or indirectly, in stock index futures trading activities) as follows:
    - trust companies must obtain approval from the China Banking Regulatory Commission (CBRC);
    - securities companies and China Securities Regulatory Commission (CSRC) licensed fund management companies must obtain approval from the CSRC;
    - other private companies must be registered with Asset Management Association of China (AMAC), to participate, directly or indirectly, in stock index futures trading activities).
- Engaging in business activities compatible with their risk management capacity.
- Having 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 relation to valuation and pricing. Common market practices are usually acceptable.

Systems and controls

There are no specific laws, regulations or rules in relation to systems and controls. There are some general laws and regulations (*see below*).

Insider dealing and market abuse

In relation to insider dealing and market abuse, hedge funds are subject to the Securities Law and Chinese criminal law.

Insider dealing. 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.
- 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;
    - advise any other person to buy or sell those securities.

Market abuse. 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.
- 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
The following each provides detailed disclosure standards for applicable fund products:

- Order of CBRC [2007] No. 3 (as amended by Order of CBRC [2009] No. 1).
- Order of CSRC [2012] No. 83.
- Order of CSRC [2013] No. 93.

On 4 February 2016, AMAC issued the Notice of the Asset Management Association of China on Issuing the Measures for the Administration of the Disclosure of Information on Privately Raised Investment Funds, which applies to contract funds managed by AMAC registered fund managers. In addition to disclosure to investors under applicable fund contracts and foregoing measures, managers of hedge funds are subject to on-site and off-site inspections by competent authorities which may require disclosure documents for review.

Money laundering
In relation to hedge funds, the principal regulations concerning money laundering is the:

- Anti-Money Laundering Law.
- Provisions on Anti-Money Laundering by Financial Institutions by the People's Bank of China.

Under these regulations, 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.
- 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 sanctions by the relevant authorities and may even face criminal charges.

Short selling

The principal regulations concerning short selling are the Administrative Measures on Margin Financing and Securities Lending by Securities Companies issued on 1 July 2015 by the China Securities Regulatory Commission. 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 securities other than those used as collateral;
    - participate in private placements, subscription and redemption of securities investment fund units, or bond repurchase transactions.
- When the investor purchases securities on margins, the minimum margin must be 100% and when the investor sells securities on margins, the minimum margin must be 50%. This is provided the margin does not exceed the available balance.
- Encumbered securities cannot be delivered as collateral.

If 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

4. Who can market hedge funds?

Onshore hedge funds

For hedge funds organised as pooled trust plans, the funds can be marketed only by trust companies and designated commercial banks. For hedge funds organised as asset management schemes and contract funds, the funds can be marketed only by managers of such products and/or China Securities Regulatory Commission recognised fund distribution agencies.

Offshore hedge funds

Offshore hedge funds are prohibited from marketing into China.

5. To whom can hedge funds be marketed?

Onshore hedge funds

For onshore hedge funds, privately raised funds generally must be offered to no more than 200 qualified investors. However, 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 this 50-person requirement (*Order of CBRC [2009] No. 1*).

Offshore hedge funds

Offshore hedge funds are prohibited from marketing into China.

Investment restrictions

6. 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 that fall 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.

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 (*Private Fund Measures*):

- If the investor is an institution, it must have net assets of not less than CNY10 million.

- If the investor is a natural person, they must have financial assets of not less than CNY3 million or an average income of not less than CNY500,000 per annum for the last three years.

In addition, investment products legally established and managed by financial institutions that are subject to the regulation and supervision of the China Banking Regulatory Commission, the China Securities Regulatory Commission 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

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

For hedge funds, portfolio assets mainly comprise of securities and derivatives. Such assets are held in the name of the investment product itself., The assets of the investment funds must be separated from the assets owned by the manager and the asset custodian, and be separated from the other assets under management of the manager and the other properties held in custody by the custodian under:

- Order of CBRC [2007] No. 3.
- Order of CSRC [2012] No.83.
- Order of CSRC [2013] No. 93.
- Relevant regulations.

Requirements

8. 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 will, 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.

For hedge funds in the form of asset management schemes and contract funds, on the completion of fundraising, the fund manager must submit the relevant fund documents to file the fund with the Asset Management Association of China (AMAC). The filing system of contract funds managed by AMAC registered fund managers is different from that of securities companies and China Securities Regulatory Commission licensed fund management companies. For contract funds managed by an AMAC registered fund, the following documents are required for fund filings:

- Main investment scope and type of funds based on the main investment scope.
- The fund contract and the fund prospectus (if any).
- The custodian agreement (if any).
- Any other documents required by AMAC.

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

Onshore hedge fund managers

Hedge fund managers/operators other than trust companies must register with the China Securities Regulatory Commission and the Asset Management Association of China (AMAC) and fulfil certain reporting requirements. Trust companies are subject to supervision by and registration/filings with the China Banking Regulatory Commission.

Offshore hedge fund managers

Foreign managers generally are prohibited from engaging in hedge fund business in China. This is because it would contravene the regulatory restrictions on trading in China's public securities market by foreign investors unless they:

- Hold a qualified institutional investor (QFII) licence/quota.

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

Very recently, foreign hedge fund managers have tested waters in China's securities market by forming wholly foreign-owned enterprises and applying to AMAC to be registered as a securities fund manager to engage in hedge fund management business.

Legal fund vehicles and structures

10. 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?

Pooled trust plans, asset management schemes and contract funds have a similar legal structure; they are all governed by contractual relationships, and with no legal entity formed. Therefore, participants take interests/units rather than shares in the funds.

Advantages. The main advantages of the structure include the following:

- More marketing channels and lower sales costs.
- Relatively developed investment and operation mode.
- Relatively mature and flexible regulatory environment.
- Low maintenance costs without forming a legal entity.

Disadvantages. The disadvantages are as follows:

- Few have been tested in courts.
- It is unclear how tax is applied.

Tax treatment

11. What is the tax treatment for hedge funds?

Funds

For hedge funds in the form of privately raised pooled trust plans, asset management schemes and contract funds, VAT will be imposed at a rate of 3% on the fund managers with respect to VAT taxable activities during the fund term. However, practice may vary between local tax authorities.

Resident investors

Generally, as the hedge funds are not principle guaranteed, income received on the liquidation of the funds by the investors (including individual and institutional investors) is not subject to VAT.

The income received on the transfer of funds interests is not subject to VAT or individual income tax for individual investors (except for income attributable to the transfer of corporate bonds where individual income tax at the rate of 20% will be levied). However, VAT at a rate of 6% and the corporate income tax at a rate of 25% are imposed on institutional investors for such income.

Tax treatment may vary between local tax authorities, as such legal mechanism is still quite rare in China.

Non-resident investors

Not applicable.

Restrictions

12. 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 fund agreements usually provide 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

Fund interests are generally transferable with the approval of the manager. The transferee must also be a qualified investor.

Private placement

13. Are private placements of hedge funds permitted under national private placement rules in your jurisdiction?

Private placements of hedge funds are permitted in China.

See *Question 2*.

14. What are the requirements for making a private placement of hedge funds?

The regime in China provides that hedge funds are offered privately.

Essential requirements to qualify for the regime
See *Question 2* and *Question 8*.

Registrations/permits/licences
See *Question 3*.

Documents to be filed
See *Question 8*.

Regulatory timescales
This will vary depending on the practice of the competent authority.

Content requirements for offering memorandum
Pooled trust plans. For hedge funds organised as pooled trust plans, the offering memorandum must contain the following:

- The profile of the trust companies and the trust plans.
- The substantial content of the trust contracts.
- The profile of the marketing institutions.
- Legal opinions issued by a law firm.
- Risk prompts.
- Other items stipulated by the China Banking Regulatory Commission.

Asset management schemes. For hedge funds organised as asset management schemes, the offering memorandums must contain the following:

- The profile of the asset management schemes, the asset manager and custodian.
- The substantial content of the asset management contracts.
- Risk prompts of the investment.
- Initial sale periods.
- Other items stipulated by the China Securities Regulatory Commission.

Restrictions on investments/leverage
See *Question 3*.

Requirements for local service providers
The Asset Management Association of China (AMAC) has issued the Administrative Measures on the Private Investment Fund Service Business and the Guidelines Concerning Outsourcing of Fund-related Services, under which services providers to private funds in China are required to be filed with AMAC.

Requirements for non-local service providers
Not applicable.

Requirements for directors
Not applicable.

Ongoing filing/consent requirements
See *Question 8*.

Reform

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

On 17 November 2017, China issued the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (Draft for Soliciting Opinions). This was to unify the rules covering asset management products managed by financial institutions which mainly include:

- Commercial banks.
- Trust companies.
- Securities companies.
- China Securities Regulatory Commission licensed fund management companies.
- Futures companies.

- Insurance companies.

The authors' are of the belief that when the Draft for Soliciting Opinions take effect, they will have a great impact on onshore hedge funds.

Online resources

Asset Management Association of China (AMAC)
W *www.amac.org.cn/cms/site/preview?ID=23*
Description. Official website of AMAC where a copy of privately placed funds related regulations can be accessed. The translation of the website may not be up to date and is for guidance only.

China Securities Regulatory Commission (CSRC)
W www.csrc.gov.cn/pub/csrc_en/
Description. This is the website of the CSRC. The translation of the website may not be up to date and is for guidance only.

China Banking Regulatory Commission (CBRC)
W *www.cbrc.gov.cn/english/index.html*
Description. The CBRC website contains regulations relating to trust plans. The translation of the website may not be up to date and is for guidance only.

Contributor profiles

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Recent transactions

- Acting for SBI in setting up the first RMB QFLP pilot fund in Shanghai.
- Representing global asset managers such as BlackRock, Invesco and Hall Capital in the formation and operation of QFII funds in China.
- Representing international and domestic PE and hedge fund sponsors in setting up QDII funds.

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Publications. Private Equity Review (China Fundraising Chapter), Law Books Review (2014 to 2018 editions)

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