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Asset Management Law

Analysis of the New PRC Securities Investment Funds Law

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On December 28, 2012, *The Law of the People's Republic of China on Securities Investment Funds (Revised in 2012)* (the "**2012 Securities Investment Funds Law**") was ratified after three rounds of review by the Standing Committee of the National People's Congress, and shall come into effect on June 1, 2013. The revision of *the Law of People's Republic of China on Securities Investment Funds Law* effective on June 1, 2004 (the "**2004 Securities Investment Funds Law**") was finally completed, which lasted for three years and led to intense debates within the industry. The following contains a brief introduction regarding the major revisions made to the 2004 Securities Investment Funds Law:

Deregulate and Standardize Publicly Raised Funds

1) Relax the Regulations and Restrictions on Publicly Raised Funds

The present administrative controls and restrictions on the operation of publicly raised funds have been seriously constraining the competitiveness and vitality of the fund market, thus making its current provisions no longer able to satisfy the rapid growth of fund markets and investors' needs. The 2012 Securities Investment Funds Law was created to moderately loosen the restrictions on the investment and operation of the publicly raised funds through the following points.

First, the "approval system" for public fund raising has been replaced with a "registration system." According to the 2012 Securities Investment Funds Law, a party who intends to publicly raise capital for a fund shall go through registration procedures with the securities regulatory authority under the State Council (the "**SRA**"). Compared to the "approval system," the "registration system" simplifies burdensome administrative application materials and procedures, making the new system more effective. This change reflects the intention of the

regulatory authority to deregulate fund market entry.¹

Second, the scope of investment for publicly raised funds has been expanded. According to the 2012 Securities Investment Funds Law, the scope of investment for fund assets has been expanded to include derivative securities prescribed by the SRA, which signifies the establishment of a legal basis for the funds to invest in currency markets, stock indexes, futures, and any other kind of derivative securities products.

Moreover, the restriction on the investment activities of the funds has been moderately relaxed. The 2004 Securities Investment Funds Law specifies that “the fund assets shall not be used for extending loans or securities to other persons.” However, according to the 2012 Securities Investment Funds Law, extending loans or securities to other persons with fund assets in violation of applicable provisions is prohibited. In other words, loans or securities can be extended to other persons to the extent that the applicable provisions are not violated. In addition, the 2012 Securities Investment Funds Law has removed “using the fund assets to deal in the shares or bonds that are issued by the fund manager or the fund custodian” from the list of prohibited investment activities.

2) Standardize the Supervision over Publicly Raised Funds

Rapid development of the capital market and diversification of the financial products has raised the requirements for fund supervision. The 2012 Securities Investment Funds Law has placed the shareholders and the actual controller of the fund manager under regulatory supervision, and has stipulated the following provisions to regulate the governance structure of the funds.

First, it's specified that fund managers and their practitioners are explicitly prohibited from engaging in insider trading. According to the 2012 Securities Investment Funds Law, fund managers and their practitioners shall not: (1) encroach on or misappropriate fund assets, (2) divulge non-public information obtained by virtue of their positions, (3) engage in trading activities related to such information, or explicitly or implicitly ask others to engage in related trading activities.

Second, it is clarified that the shareholding structure and the governance structure of the fund management company are required to be stable. According to the 2012 Securities Investment Funds Law, on one hand, a fund management company is required to submit an application to

¹ To simplify the report and review process for fund products, the Chinese Securities Regulatory Commission (the “CSRC”) has issued the Notice on Issues concerning the Further Reform of the Fund Approval System to fund companies, specifying that the online operation of the Fund Products Internet-based Reporting and Review System (“FIRST”) shall officially be commenced on January 1, 2013, when applying for fund raising, fund companies shall submit application materials in relation to fund raising through the FIRST system while submitting written materials to relevant department of the CSRC. When adopting the online reporting system for fund products, the review of normal fund products shall be completed within 20 working days under the summary procedure, and the classified supervision mechanism shall be applied to restrain the dishonest behaviors of the fund companies. If a fund company is to be found in the process of materials reporting to have submitted incomplete materials, or have not finished the product preparation work, or have massive misreporting, underreporting or other dishonest behaviors, the common review procedure shall be applied to the review for all fund products that is reported by that company thereafter.

the SRA for approval in the event that it intends to change shareholders who hold more than 5% of its equity or its actual controller. On the other hand, the shareholders or actual controller of a fund management company shall not make false capital contributions or withdraw capital contributions without undergoing required procedures, shall not bypass the shareholders' meeting and the board of directors to directly intervene in the daily operations of a fund manager, and shall not require fund managers to use fund assets to obtain benefits for it or other persons, which could jeopardize the interests of the holders of fund units.

Moreover, it is clarified that the SRA may order the fund manager to replace its directors, supervisors, or senior managers under certain circumstances. According to the 2012 Securities Investment Funds Law, where the directors, supervisors, or senior managers of a fund management company failed to perform their duties diligently and dutefully, and caused the company to commit grave violations of laws or regulations or to have major risks, the SRA may order the fund management company to replace the relevant personnel.

Bring Non-Publicly Raised Funds into Supervision

The development of non-publicly raised funds is significant in promoting economic restructuring, relieving the difficulty of financing faced by small and medium sized enterprises, etc. Notwithstanding, the Securities Fund Investment Law does not provide any regulation on non-publicly raised funds, and due to the absence of an explicit legal basis for and effective supervision over the establishment and operation of non-publicly raised funds, the infringement of investors' interest occurs from time to time. In order to effectively regulate non-publicly raised funds, the 2012 Securities Investment Funds Law has created a chapter discussing the non-publicly raised funds.

1) Establish a Record-Filing System for Non-Publicly Raised Funds

Once the capital raising for a non-publicly raised fund is completed, the fund manager shall report the information to the fund industry association for record-filing. In the event that the total amount of capital raised by a fund reaches the proscribed threshold, or the number of fund unit holders within a fund reaches the proscribed threshold, the fund industry association shall report the relevant information to the SRA. In contrast to the record filing system for private equity investment enterprises that is provided under the Notice of the General Office of the National Development and Reform Commission on Promoting the Standardized Development of Equity Investment Enterprises, the record-filing system under the 2012 Securities Investment Funds Law focuses on fund product record-filing. This means that the fund managers do not need to establish an entity (a company or limited partnership enterprise) for capital raising. However, some practical issues of the fund product record-filing system remain to be dealt with, such as account opening.

2) Establish a Qualified Investors System

Non-publicly raised funds shall only raise capital from qualified investors, and the number of such qualified investors shall not exceed 200 on an accumulative basis. The qualified investors shall refer to the entities and individuals that possess the required asset size or income level, have the appropriate risk identification capabilities as well as risk tolerance, and subscribe for fund units in an amount not lower than the prescribed minimum amount. The specific criteria of qualified investors shall be formulated by the SRA. However, for the purpose of calculating the number of investors, it remains to be clarified whether the ultimate investors of the funds of funds, collective fund trusts, and other institutions without legal person status shall be counted in the total number. Meanwhile, non-publicly raised funds shall not promote the funds to non-specific investors via newspapers, radio, television, Internet, and/or other public media, as well as in the form of lectures, seminars, analysis meetings, etc. It remains to be further clarified whether the aforementioned restrictions shall also apply to promotion via legitimate asset management products, such as trusts.

3) Provide a Mechanism for Fund Unit Holders that Assume Unlimited Joint and Several Liabilities

A non-publicly raised fund may stipulate that part of the fund unit holders can manage the investment activities of the fund as the fund manager, and assume unlimited joint and several liabilities when the fund assets can't repay its debts in the fund contract. With respect to such non-publicly raised fund, the fund contract shall also specify the names and domicile of the fund unit holders that assume unlimited joint and several liability, the conditions for expulsion and procedures for the replacement of fund unit holders that assume unlimited joint and several liability, as well as the conversion procedure between fund unit holders that assume unlimited joint and several liability and other fund unit holders.

4) Specify the Definition of Securities Investment Made with the Assets of Non-Publicly Raised Funds

According to the 2012 Securities Investment Funds Law, securities investments made with the assets of the non-publicly raised funds include dealing in stocks publicly issued by companies limited by shares, bonds, fund units, or other securities and their derivatives as prescribed by the SRA.

Compared to the Securities Investment Funds Law (Revised Draft), the 2012 Securities Investment Funds Law further specifies that "stocks" herein only refers to "stocks publicly issued by a company limited by shares", and doesn't include the equity of companies with limited liability. Thus, private equity investment funds that invest in the equity of companies with limited liability and non-publicly issued stocks of companies limited by shares are not likely to be subject to the regulatory supervisions under the 2012 Securities Investment Funds Law. However, as the SRA is authorized to define the "other securities and their derivatives"

according to the 2012 Securities Investment Funds Law, we can't rule out the possibility that the SRA may expand its regulatory supervision by defining the scope of "other securities and their derivatives".

Strengthen the Protection of Investors

In addition to the above-mentioned investor protection mechanisms, the following measures are also significant in strengthening the protection of investors.

1) Further Specify a Manager Risk Reserves System

A manager risk reserves system is provided in the Notice on Issues Concerning Withdrawing Risk Reserves by Fund Management Companies, and the Decision of the China Securities Regulatory Commission on Revising the "Notice on Issues Concerning Withdrawal of Risk Reserves by Fund Management Companies," but not in Securities Investment Funds Law. Fund management companies shall withdraw risk reserves from fund management fee revenues each month at a rate of no less than 10% of such fund management fee revenues. No more risk reserves need to be withdrawn when the risk reserve balance reaches 1% of the net fund assets. When the balance of the risk reserves is less than 1% of the net fund assets, withdrawal of the risk reserves shall be resumed until the said balance reaches 1% of the net fund assets.

While the 2012 Securities Investment Funds Law specifies that fund managers of publicly raised funds shall withdraw risk reserves from the remuneration from fund management. Where the fund manager is liable for compensating the losses suffered by fund assets or the damage caused to the legitimate rights and interests of the fund units holders due to its violation of laws or rules, breach of fund contracts or for other reason, the fund manager shall assume the liabilities for damage, it may compensate by using the risk reserves on a priority basis. Compared to the aforementioned regulations, the 2012 Securities Investment Funds Law has changed the withdraw base of risk reserves from "fund management fee" to "remuneration from fund management", which actually expands the base for risk reserves withdrawal, and enriches the risk reserves.

2) A System for Convening the Second-time General Meeting of Fund Unit Holders

According to the 2012 Securities Investment Funds Law, no general meeting of fund unit holders may be held unless holders representing at least 50% of the total fund units are present at the meeting. Where the fund units represented by the holders attending the general meeting of the fund unit holders fail to reach the required percentage, the convener may, after three months but within six months of the time when the said general meeting was originally announced to be held, convene a new general meeting of fund unit holders with respect to the matters that were scheduled to be deliberated at the original meeting. The newly convened general meeting of fund unit holders shall not be held unless holders representing at least

one-third of the total fund units are present.

Miscellaneous

1) Specify the Tax Policy on Investments Made with Fund Assets

According to the 2012 Securities Investment Funds Law, taxes on investments made with fund assets shall be paid by the fund unit holders, and shall be withheld and collected by the fund managers or other withholding agents pursuant to the relevant tax collection regulations. Since non-publicly raised funds are not independent legal entities, non-publicly raised funds do not assume any tax liabilities.

2) Specify Restrictions on Investing in Securities by Related Personnel of Fund Managers

According to the 2012 Securities Investment Funds Law, the directors, supervisors, senior managers, and other practitioners of fund managers of publicly raised funds shall report to the fund manager in advance if they themselves, their spouses, or interested parties intend to invest in securities, and shall not cause conflicts of interest to arise with fund unit holders in such investments. The fund manager of publicly raised funds shall establish a management system for the reporting, registration, examination, and handling that relates to securities investments made by the persons specified in the preceding provision, and shall report to the SRA for record-filing.

3) Specify Restrictions on Office Taking by Personnel of the SRA

According to the 2012 Securities Investment Funds Law and the Law of the People's Republic of China on Public Servants, personnel of the SRA shall not take office in fund companies within two years after leaving their posts, and the leaders of the SRA shall not take office in fund companies within three years after leaving their posts. The implementation of this measure shall avail the fund market to operate more fairly, and prevent certain market players from abusing its influence to cause unfair competition.

Overall, the 2012 Securities Investment Funds Law illustrates the idea of “relaxing the controls, strengthening the regulatory supervisions”, and shall avail the unleashing of the dynamism of the fund industry, and further boost the development of the PRC fund industry. However, a large number of specific issues still remain to be clarified by detailed auxiliary rules and regulations.

Important Announcement

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