Why do Global Fund Managers need to set up Local Funds in Hong Kong?

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For the whole of the 35+ years I have been working in the Hong Kong fund and asset management business, the local mutual fund industry has been dominated by funds imported from Luxembourg or Dublin, collectively known as Undertakings for Collective Investment in Transferable Securities (UCITS). Although the first UCITS products were simple by comparison to those on offer today, nevertheless they offered retail investors opportunities for investment that could not be matched by other similar but local mutual fund or unit trust vehicles. UCITS are available that can invest into virtually any securities market globally, and the investment manager for the fund is invariably located adjacent to where the assets are invested.

The opening up of the Greater Bay Area (GBA) of Mainland China provides an opportunity for global fund managers to offer their expertise to individual investors and eventually beyond the GBA to the rest of Mainland China. But this is not by using their UCITS products directly, as occurs in Hong Kong.

Why is this attractive? The GBA has a population of around 72 million thus bigger than all European countries except Germany. There is a Gross Domestic Product (GDP) across the region that exceeds that of California, making it equivalent to one of the top 12 economies in the world. The High Net Worth Investor (HNWI) population in the GBA exceeds 280,000 families, i.e. more than 20% of the total in Mainland China, and is one of the fastest growing anywhere in the world, and many of them look to Hong Kong for guidance on where to invest money outside Mainland China.

> On 1 July 2017, witnessed by President Xi Jinping, the National Development and Reform Commission and the governments of Guangdong, Hong Kong and Macao signed the Framework Agreement on Deepening Guangdong-Hong Kong-Macao Cooperation in the Development of the Greater Bay Area.

Until now, many GBA residents have through various means, been able to get some money into bank accounts in Hong Kong, from where they can then invest worldwide. The banks and private banks in Hong Kong have benefited substantially from this flow of money from Chinese customers, and thus so also has the Hong Kong mutual fund industry through which much of the money has been invested. It is estimated that 75%+ of Hong Kong fund sales are into UCITS products.

> Wealth Management Connect (理财通)
> Circular issued on 14 May 2020 by PBoC, CBIRC, CSRC and SAFE lists 26 clauses for consideration and confirms GBA Outline Development Plan issued in February 2019. Announcement 29 June 2020 links HKMA, MAM and PBoC to the launch of Wealth Management Connect which will be rolled out in phases.

With the development of the GBA Wealth Management Connect (WMC) scheme, announced in June 2020, the opportunity to invest via Hong Kong has been widened beyond the HNWI population to include anyone with sufficient assets. People throughout the GBA will be able to go to their local bank and make investments via Hong Kong mutual funds that can be into securities markets worldwide. It is expected that in the initial stages, there will be a quota limit of RMB1m (US$145,000) per person, with an aggregate of around RMB150bn (US$22bn) in each direction.

Clearly, such a development must be considered one of the best opportunities anywhere for the global fund management industry, yet to date very few global fund managers have been preparing their businesses to participate.

Under the terms of the GBA WMC regulations, it is a requirement that only mutual funds that are set up and domiciled in Hong Kong, with investment management carried out in Hong Kong, will be able to participate. This is very similar to the situation that has existed for the last five years with Mutual Recognition of Funds (MRF), which is an "access scheme" allowing the cross-border sale of mutual funds between Hong Kong and Mainland China.

Under MRF, only 29 funds from Hong Kong to date, have succeeded in getting approval for sale in Mainland China, whilst there are 50 Mainland China funds approved for sale in Hong Kong. More importantly, less than 10 Hong Kong fund management firms that have had funds approved on the MRF list, half of which are local Hong Kong businesses.

So what's the problem? Why the hold up?

At issue is that most global fund management firms don't want to set up domestic mutual funds in Hong Kong when they are easily able to sell their UCITS funds in the local market. Quite rightly, most don't see value in duplicating existing fund choices thus causing further proliferation of funds. Although MRF has been around for 5 years, anecdotally, around 70% of the approximate US$1.5bn money going into Hong Kong domiciled funds from Mainland China has been to just one manager, not leaving much to the others to share between them. Further, because of a number of restrictions placed on MRF, it was deemed by many that the scheme would be uneconomic for many to participate in.

But WMC changes all that. It is expected that under the new WMC developments there won't be the restrictions imposed on MRF, there won't be a formal approval process that can take months or years, rather than weeks, and more importantly, funds able to be included can be those that many of the major bank distributors are already familiar with and thus used to using them. Thus expectations for volume sales are much higher than has occurred for MRF.

So how can global fund managers participate?

Put simply, they can make use of their existing licenses from the Hong Kong SFC to also create domestic funds in Hong Kong. These can be set up very simply and easily as either unit trusts or as Open-ended Fund Companies (OFC). The fund needs to be approved under Section 2, Chapter 7 of the Hong Kong Mutual Fund Code, to also be acceptable for use in the WMC development. See here for more details of the requirements from the SFC: https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/section-ii-code-on-unit-trusts-and-mutual-funds/section-ii-code-on-unit-trusts-and-mutual-funds.pdf

These funds should be managed by local licensed personnel in Hong Kong, and for those that invest into global stock markets, they can be sub-advised by specialist teams in London, New York, Tokyo, etc. as appropriate. These funds can include feeder or especially fund-of-fund (FoF) products. Chapter 7.11A (of the Code) identifies:

"A scheme may invest in one or more underlying schemes which are either authorized by the Commission or eligible schemes. The value of a scheme's investment in units or shares in each such underlying scheme may not exceed 30% of its total net asset value, unless the underlying scheme is authorized by the Commission, and the name and key investment information of the underlying scheme are disclosed in the offering document of the scheme."

Thus, a typical fund-of-funds would be required to invest in not less than 4 sub-funds. It is unlikely, at least in the initial stages of the GBA WMC, that pure feeder funds will be acceptable for use, thus focus should be on developing fund-of-funds. Further, in order for this to meet the low- to medium-risk rating requirement, a split between equities, fixed income and cash assets, as often occurs for multi-asset funds is probably best, with investment into global and Asian regional markets.

Fact Sheet of WMC

<table>
<tr><th></th><th>Investment Scope</th><th>Who to invest</th><th>Account Opening</th><th>Quota</th></tr>
<tr><td>Northbound</td><td rowspan="2">PHASE 1
- Deposits, approved by banks
- Mutual funds, SFC-authorized funds that are domiciled in HK and Mainland China with approvals from CSRC and classified as low to medium risk and non-complex by the distributing banks.
- Banks in Hong Kong and/or mainland China cannot repackage or bundle the WMC funds at this stage
- More products to be available by discussing with Mainland China regulators, e.g. individual bonds
PHASE 2 (time TBA)
- ILAS products
- Life insurance
- Private equity/ Credit products
- Investment advisory/ IFA</td><td>- All HK residents holding HK ID card

- Subjective to KYC by Hong Kong banks
- Individual investors only</td><td rowspan="2">- New investment and remittance accounts for WMC in both Hong Kong and Mainland China
- RMB cash transfer
- Closed loop system is applicable
- Required in-person account opening initially.
- Mainland Chinese investors can use their existing remittance accounts in Mainland China for the WMC, provided that funds for the WMC are segregated from funds used for other purposes.</td><td rowspan="2">Same for northbound /southbound.

Total quota:
RMB150bn (US$22.4bn)

Individual quota:
RMB1million (US$150k)

Based on the net remittance amount

Not affected by the capital gains or loss</td></tr>
<tr><td>Southbound</td><td>- Individual investors only
- KYC by Chinese banks</td></tr>
</table>

Restrictions
- Not including ETFs at the stage
- Only HK domiciled products are allowed for northbound
- Initially allows low to medium risk, plain vanilla funds

Whilst most global fund managers will have investment teams in Hong Kong that provide specialist advice on the Greater China and Asian stock markets, now they can use their skills to also set up funds to meet the expected needs of the GBA WMC market. The underlying funds in a fund-of-funds format can be UCITS funds from the same management group, provided they have already been authorized by the SFC in Hong Kong. They may be single strategy or multi-asset funds, they can invest into major stock markets globally, and some that focus on global or specialist bond markets. To qualify for inclusion in the GBA WMC list of funds, it is necessary for a fund to be considered low- to medium-risk by the bank distributor. It should also not use derivatives, leverage or other artificial devices that may enhance performance but also increase risk levels. **It can also be assumed that Mainland Chinese investors won't wish to invest into stocks listed in Mainland** China on the Shanghai or Shenzhen bourses, preferring to be invested in the rest of the world.

Some managers may wish to consider the choice between unit trusts and OFC. Whilst unit trusts have been the traditional legal format for funds in Hong Kong for 40+ years, OFC first became available in 2019. They have almost identical criteria to unit trusts in terms of set up, they can be created in umbrella or single fund format, and have no tax implications. The most compelling issue for their use, is that for Mainland China investors, OFC are very similar to the format of domestic mutual funds, making it far easier to explain them, should it be required. They are also very similar to UCITS, thus ideal for UCITS managers to operate.

In summary, **although global fund managers with UCITS products only can't gain direct access** to Mainland **China's potential 1.4bn population, where over 150m have already invested into mutual funds, they can create local Hong Kong products that can then use their UCITS vehicles. That's the way** of the future!!

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