The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
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Letter on Proposal to Allow Joint Ventures with Chinese Companies, January 2002

Via E-mail and Facsimile

January 11, 2002

Mr. Jianping Liu
China Securities Regulatory Commission

Dr. Liu:

The Investment Company Institute[1] appreciates the opportunity to comment on the draft Interim Provisions on the Purchase of Shares of Fund Management Companies and the Joint Establishment of Fund Management Companies by Overseas Institutions ("Draft Interim Provisions") issued by the China Securities Regulatory Commission (CSRC) on December 21, 2001. We are submitting this letter after the close of the official comment period because we did not learn of the proposal before the Christmas holidays in the United States. We understand from the US Department of Treasury that the CSRC will accept submissions after the comment deadline of December 31, 2001.

The Institute was pleased to learn of the Draft Interim Provisions, which would permit foreign institutions, including US firms, to enter into joint ventures with Chinese companies to provide asset management services in China.[2] We applaud the CSRC in seeking public comment on these rules, which we view as an important step in opening and strengthening the asset management market in China.

These rules are of significant interest to our members, several of which already engage in limited asset management-related activities in China (such as providing technical assistance to Chinese firms that are establishing open-end mutual funds) and many of which view China as an important market for the provision of asset management services. Because the proposed rules will apply to foreign institutions such as our members, we seek in this letter to provide helpful and constructive comments on the proposed rules. Our comments are based on two English translations of the Draft Interim Provisions; we have attached these translations to this letter for your reference so that you can understand the basis for our views and concerns.

A. Criteria for Approval

Regulatory Transparency

Article 4 of the Draft Interim Provisions describes the eligibility criteria for foreign institutions seeking to purchase shares of or to participate in the establishment of domestic fund management companies. To qualify, a foreign institution must be a legal person with no less than RMB 300 million in paid-in capital. The foreign institution also: (1) must be established in accordance with the laws of the country or region in which it is located; (2) must not have committed any material illegal activities in the past three years; and (3) must hold a permit to provide securities investment or securities asset management activities if it is an institution that is equivalent to a Chinese securities company or a trust and investment company.[3] Article 7 also states that the CSRC will examine and approve the applications of foreign institutions to enter into a joint venture, and Article 8 describes the information that foreign institutions must provide with their applications.

As an initial matter, we request clarification whether an application for a joint venture by a foreign institution would be approved by the CSRC solely on the basis that the foreign institution satisfies the qualification requirements described in Article 4 and provides the documents as required by Article 8. If the CSRC intends to base its approval on criteria other than those described in Article 4 (such as based on information requested under Article 8), we respectfully recommend that the criteria to be used be clearly set forth in the regulations.[4] We note that Article 7 provides that the CSRC will examine and approve applications in accordance not only with CSRC regulations but also with "internationally recognized principles of prudential supervision." This article suggests that the CSRC will or

may consider other factors in approving applications. If that is the case, we request that the Interim Provisions specify the principles that will be applied.

Regulations that lack transparency or provide broad discretion to officials in approving applications create uncertainty for foreign firms that wish to enter foreign markets and thus operate as barriers to entry. On the other hand, transparent regulations and administrative practices ensure that foreign firms will not be treated in an arbitrary manner and that approvals of applications will be based on objective and fair criteria and on rules to protect investors. For these reasons, we suggest that the joint venture regulations clearly set forth the criteria that the CSRC will use to approve or disapprove an application for a joint venture with a Chinese domestic asset management firm.

Capital Requirements

In Article 4, the Draft Interim Provisions would require that a foreign institution seeking to enter into a Chinese joint venture have no less than RMB 300 million [$36 million]. As an initial matter, it is unclear to us whether this reference to "paid-in capital" is meant to require RMB 300 million in initial shareholder contributions or regulatory capital. In either case, the prescribed dollar amount, in our view, is excessive.

If the Draft Interim Provisions intend to require RMB 300 million in initial shareholder contributions, we are not clear as to the purpose for such a requirement. Especially for institutions that have been in existence for a number of years, the initial shareholder contributions may have no relation to the strength, size, or financial condition of the institution.

On the other hand, if the Draft Interim Provisions intend to require foreign institutions to hold a certain level of regulatory capital, we believe the high level of mandated capital is not necessary for investor protection purposes and will operate as a barrier to entry. In contrast to the business of a bank or broker-dealer, the business of managing assets does not require large amounts of capital to protect investors. The business of asset management is not capital intensive, and client assets typically are not in the custody of the asset manager and are not at risk if the asset manager experiences financial reverses.

In some foreign countries asset management firms tend to be large banks or broker dealers and these firms would not find it difficult to meet high capital requirements. In other foreign countries, however, highly successful asset management industries have developed comprised of smaller independent firms. It would be unfortunate if a high capital requirement operated to prevent these firms from participating in China's asset management industry.

We urge the CSRC both to clarify the capital requirement and to impose a less excessive capital requirement on foreign institutions because a high capital requirement is not necessary to advance legitimate investor protection goals.[5] We also suggest that foreign institutions be permitted to take their affiliate's capital into consideration in meeting the capital requirements if the foreign institutions are relying on their affiliate to qualify under the Interim Provisions.

B. Information to be Submitted to the CSRC

As discussed above, it is unclear whether the CSRC will approve an application based exclusively on the articulated criteria set forth in Article 4 of the Draft Interim Provisions or whether the CSRC also will consider other information, such as that submitted under Article 8. We request that if the information in Article 8 will be considered by the CSRC in approving an application for a joint venture, the criteria for approval be clearly delineated in the Interim Provisions. In addition, we have the following specific comments on the information requested.

1. Certification by Home Country Regulator

Under Article 8(3) of the Draft Interim Provisions, a foreign institution submitting a joint-venture application must provide a certificate issued by its home country regulator stating whether that institution has committed any material illegal activities in the past three years. We appreciate the CSRC's concerns about an institution's home country record and its need to have procedures in place to deny approval to foreign applicants that have been guilty of breach of their clients' trust in their home countries.

To achieve this objective, the Interim Provisions should be written and applied to take into account differences in the legal systems around the world. Any determinations to grant, deny, or revoke a foreign institution's right to participate in the Chinese asset management market based on a foreign disciplinary matter should not be automatic but considered under all the facts and circumstances.

In addition, the rule should distinguish between major and minor infractions. Some jurisdictions may impose disciplinary measures for relatively minor infractions that do not implicate a firm's integrity. Examples of minor infractions could include inadvertent recordkeeping violations or a short delay in making a required filing. We respectfully suggest that minor disciplinary matters that do not implicate or compromise a firm's integrity or jeopardize investor protection not bar a foreign firm from participating in the Chinese

asset management market. Of course, a repeated pattern of minor infractions may be a legitimate basis for disapproving a foreign firm.

Finally, the CSRC may wish to reexamine the scope of the certification requested of home country regulators or at least recognize that the type of certification that regulators may be willing to provide may vary from jurisdiction to jurisdiction. The US Securities and Exchange Commission, for example, will likely certify only to public enforcement actions taken against a firm and will not comment broadly on "illegal activities" of a regulated firm. The CSRC rule should not be administered in a way that precludes firms from a jurisdiction that provides a certification limited to public actions from qualifying to participate in a joint venture.

2. Fund Performance

Article 8(5) requests information for the prior three years on the performance of funds that are managed by the foreign applicant. It is unclear how CSRC would use this information but we respectfully suggest that the CSRC not use performance records of foreign institutions as a criterion for approving a foreign institution's application to enter into a Chinese joint venture. It is well recognized that past performance is not an indicator of future success. Moreover, performance records could be of little use in ascertaining the ability of an asset manager to fulfill its fiduciary duties to its clients because performance may vary based on a number of factors, including the investment objectives of funds, the investment style of the manager, and market conditions wholly outside the manager's control.

Finally, we think it would be unwise for the CSRC to suggest that it is screening foreign managers based on performance. To the extent that the past performance of a foreign institution is relevant, it should be considered by the domestic participants that are proposing the joint venture with the foreign institution or the Chinese investors considering the products or services of the joint venture. Regulatory approval of the foreign institution by the CSRC should be based solely on whether the applicant has met the objective standards for qualification set out in the rules.

Prior Activities in the B Share Market

In Article 8(6) of the Draft Interim Provisions, a foreign institution that has participated, or has an affiliate that has participated, in the domestic B share market prior to the application must submit a report to the CSRC on the possible influence of its investments and transactions on the business operations of the domestic fund management company upon entering into the joint venture. We do not understand the policy purpose for such a report. Although US asset managers may invest in the B share market for their US mutual fund or other non-Chinese clients, these investments should not affect the activities of any joint venture management company in which the US firms participate.

If the requirement stems from a concern that a foreign manager trading in the B share market with respect to its non-Chinese activities and in the A share market with respect to the joint venture could manipulate the A or B share markets, we believe that such abuse by asset managers would be highly unlikely. Asset managers typically make portfolio investments (i.e., trade in the domestic B share market) for the accounts of their clients (e.g., mutual funds and other clients), not for their own account. In addition, asset managers are under a fiduciary obligation to act in the best interests of their clients. As a result, it would be a breach of fiduciary duty for an asset manager to manipulate the market (using investments of a select group of its clients) to benefit another group of its clients.

We recognize that regulators have an interest in making sure that procedures are in place to deal with conflicts of interest and to protect investors. We respectfully submit that participation in the B share market should not be a basis for disqualifying a foreign institution from participating in a joint venture under the rules. Any conflicts that may arise from investments in the B share market and participation in the domestic asset management industry could be dealt with by eliminating separate markets for domestic and foreign investors or by disclosure.

Confidential Treatment of Certain Information

The Draft Interim Provisions require foreign institutions to submit a variety of information, including financial information and research reports prepared on the development of the fund market in China. We request that these materials be given confidential treatment (limiting access to the information to CSRC officials) if such treatment is requested by the applicant. We regard such confidential treatment as important for two reasons. First, a foreign investment management company that is not a public company may not wish to disclose publicly its financial information. Second, applicants likely would not want their competitors or other persons to obtain access to their proprietary research reports or other similar information.

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We hope these comments will be helpful to the CSRC in drafting the final regulations. We would be pleased to answer any questions or discuss any of these issues further. You may contact me at (202) 326-5826 or at podesta@ici.org or Jennifer S. Choi at (202) 326-5810 or at jchoi@ici.org.

Very truly yours,

Mary S. Podesta
Senior Counsel

Enclosures

ENDNOTES

[1] The Investment Company Institute is the national association of the US investment company industry. Its membership includes 9,063 open-end investment companies ("mutual funds"), 485 closed-end investment companies, and 6 sponsors of unit investment trusts. Its mutual fund members have assets in excess of $6.5 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] Under the World Trade Organization (WTO) accession agreement, foreign firms will be able to own up to 33% of a Chinese asset management firm upon China's accession into the WTO and up to 49% of an asset manager within three years thereafter. China acceded to the WTO on December 11, 2001. We respectfully request that Article 6 of the Interim Provisions specify the percentages of a Chinese asset management firm that foreign firms are permitted to purchase that are no lower than the WTO agreement.

[3] One of the translations states that an institution that is equivalent to a Chinese securities company or a trust and investment company must hold a "qualification license" in its home country. Some jurisdictions such as the US Securities and Exchange Commission do not pass on a company's qualifications but require registration with the regulator for an institution to engage in asset management activities. Accordingly, we request that the Interim Provisions be drafted to allow firms from these jurisdictions to satisfy this condition.

[4] The Institute also seeks clarification whether a foreign institution must be in a business equivalent to that of a Chinese securities company or a trust investment company (i.e., be a regulated entity) and must provide certain documentation from its home country regulator to qualify to participate in the Chinese asset management market. In some cases, a foreign institution may want to enter the Chinese market by establishing an affiliate, which may not have a foreign home country regulator. If a foreign institution must be a regulated entity to participate, we suggest that the foreign institution seeking to enter into a joint venture be permitted to satisfy the requirements under the Interim Provision through its regulated affiliate.

[5] Recently, the International Investment Funds Association, which represents the major investment fund industries around the world, issued a statement regarding the need to tailor capital requirements to the asset management industry. A copy of the statement is attached for your information.
