

## Collective Investment Management Schemes

### **Do Collective Investment Management Schemes Offer a Means for Hedge Fund Managers to Access the Potentially Vast China Market?**

By Cara Griffith

For many hedge fund managers, China represents an enormous investment management opportunity. However, China's extensive capital controls have, to a degree, impeded entry into the potentially sizeable market. To access the opportunity in a manner consistent with relevant capital controls, investment managers recently have been evaluating the potential use of collective investment management schemes (CIMs) as a means of managing assets in China. Although hedge fund managers may not currently manage a Chinese CIM, the CIM industry in China is young and has been compared to the nascent hedge fund industry in the U.S. in the 1960s. CIM industry observers predict that as time passes and the CIM industry matures, Chinese CIMs will increase in number and size. As a result, hedge fund managers active in the China market or considering entering it may benefit from a thorough analysis of the relevant business and regulatory consideration raised by CIMs. This article provides that analysis.

#### *What are CIMs?*

A CIM is a means of pooling money with other investors to enable investors to participate in a wider range of investments than they could individually, and to share the costs and benefits of doing so. Although a CIM may have features of a mutual fund, CIMs are a distinct type of investing strategy. Similar to a mutual fund, a CIM vests nearly

plenary discretion over investment decision-making to the firm or manager that is pooling and investing the money. The target audience for mutual funds and CIMs may also be similar. However, CIM managers, unlike mutual funds managers (at least in the U.S.), can charge performance fees. The minimum investment in a CIM is relatively high, similar to the high investment minimums for hedge funds imposed by regulation (specifically the U.S. rule that only "accredited investors" can invest in domestic hedge funds) and practice. CIMs are typically promoted with a wide range of investment strategies focused either on targeting specific geographic regions, as is the case with China CIMs, or on specific industries, such as technology. In general, there is a bias with CIMs toward the domestic market, although this depends on the specific country.

CIMs have been gaining popularity recently in China. The "buzz" around China CIMs stems from the idea that CIMs represent an up-and-coming investment strategy in China, and that ultimately, China CIMs may be able to invest outside of China. Currently, however, China CIMs are only offered domestically and are, in general, regulated by the China Securities Regulatory Commission (CSRC). CIMs are also not currently permitted to invest outside of China, although that is likely to change in the future.

### *CIMs as Qualified Domestic Institutional Investor Schemes*

CIMs in China may be regulated as a Qualified Domestic Institutional Investor (QDII) schemes for purposes of overseas investments. QDII schemes permit financial institutions to invest in offshore markets. In China, QDII arrangements permit non-bank Chinese residents to access foreign markets through certain funds or other management institutions that have been approved by the CSRC. The Chinese government announced QDII schemes in 2006, after which Chinese institutions and residents were permitted to invest in financial products overseas, via an approved institution. However, such investment was limited to fixed-income and money market products. The Chinese government has since widened the scope of QDII investment. In 2007, the Chinese government announced that an institution can offer stock-related products, provided the net asset value (NAV) of a QDII product invested in stock does not exceed 50 percent of the QDII product's NAV.

### *Types of CIMs*

The terms of a CIM in China depend on the underlying type of investment. Ying White, Senior Counsel with Akin Gump Strauss Hauer & Feld LLP, explained that a CIM investing in publicly traded securities, an open-ended scheme, is regulated by the Securities Investment Fund Law of China (the SIF Law). Issued in 2003, the SIF Law “governs organization, registration, and operation of mutual funds. The SIF Law also governs licensing and the ongoing supervision by the CSRC of fund management companies,” White said.

“During the drafting stage of the SIF Law, there was wide debate as to whether the SIF Law should be an investment

fund law (which would also cover CIM schemes that are designed to invest in unlisted companies/private equity),” White explained. However, at that time, private equity was not a common concept in China. Because incorporation of a novel concept would have required substantial research, study and debate, “legislators eventually compromised on focusing the SIF Law on CIM schemes that engage in investing in publicly traded securities,” White noted. Since the issuance of the SIF Law, White said that “China’s mutual fund industry has taken off and has grown explosively. Both domestic fund managers and Sino-foreign joint venture managers have increased in number and assets under management.”

Investments by CIMs in unlisted securities or private equity (a closed-ended scheme) are largely unregulated because the formation and operation of private equity funds and fund managers in China are largely unregulated. White explained that this has to do with the history of private equity in China. “In a way,” White noted, “it is an extension of venture capital, which came into existence and experienced explosive growth due to the Chinese government’s national policy of supporting national scientific and technology developments.” Venture capital is under the jurisdiction of the Ministry of Science and Technology and the National Development and Reform Commission (NDRC). Private equity is thought of as facilitating industrial and infrastructure developments in certain sectors and therefore is largely under the jurisdiction of the NDRC, White said.

“As more commercial-oriented private equity develops, Chinese regulators are beginning to study the development of a national regulation governing the formation, offering and licensing and operation of private equity and fund

managers, although it is hard to say whether the regulation will come out this year,” predicted White. Mark Barth, a Partner at Akin Gump Strauss Hauer & Feld LLP, noted that participation in CIM schemes investing in unlisted securities or private equity “is generally limited to institutional investors, which may in certain circumstances include non-Chinese investors.”

Barth also noted that there has been a great deal of interest lately “in so-called ‘RMB Funds,’ that is domestic Chinese private equity funds, normally in the form of Chinese limited partnerships, that are denominated in RMB.” The funds may be managed by Chinese managers or in some cases by Sino-foreign joint ventures, and “are sometimes used as vehicles for Chinese investors to invest in parallel with offshore funds in which non-Chinese investors participate,” Barth said.

Other CIMs include trust plans, which are regulated by the China Banking Regulatory Commission (CBRC). White said that “only ‘qualified investors’ as defined in regulation are permitted to invest in trust plans and only trust companies specially licensed by CBRC are qualified to offer such a product.” Additionally, pooled products may be offered by commercial banks. These products are “also regulated by the CBRC under specific regulations that specify investor qualification criteria and bank licensing criteria,” White explained.

### *Who Can Participate in China CIMs?*

Participation in a China CIM is limited. For open-ended CIM schemes, a non-Chinese firm is only permitted to launch or manage a CIM in China “through a joint venture with a local Chinese firm. In closed-ended CIM schemes,

a foreign private equity manager can set up a wholly-owned subsidiary (or a joint venture with a Chinese partner) and raise and manage RMB funds,” White explained. The latter is a new development and one that is worth watching, White said. Trial measures are being tested in Shanghai and Tianjin, and Beijing is expected to follow soon.

While a non-Chinese firm cannot launch or manage a CIM, such firms may be able to invest in a CIM. UBS and Goldman Sachs reportedly are investigating whether and how they can participate in a China CIM. Other companies that might be interested in participating are those with significant amounts of money invested in China that they cannot otherwise expatriate. (IBM, for example, has a significant amount of money tied up in China that it cannot get out because of currency regulations.) Chinese currency is heavily regulated and is not freely convertible into other currencies. If CIMs were permitted to invest outside China, and therefore were able to convert their Chinese currency, the value of the CIM to companies like IBM could increase dramatically.

Hedge fund managers, while not excluded from breaking into the world of CIMs, have generally “focused on trading in H shares [shares of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange] and to some extent A shares [shares in mainland China-based companies that trade on Chinese stock exchanges such as the Shanghai Stock Exchange and the Shenzhen Stock Exchange] through quotas of licensed Qualified Foreign Institutional Investors (QFII),” noted White. The QFII program, launched in 2002, permits licensed investors to trade A shares on China’s stock exchanges. However, at the moment, only big players such as UBS, Goldman Sachs and Deutsche Bank, have formed joint venture management companies with Chinese firms. These firms “manage mutual funds distributed to Chinese residents trading in China’s A shares market. Smaller players generally have not followed this route,” said White.