IDC Independent Directors Council
Promoting Excellence in Fund Governance

Comment Letter on Barriers to Entry in Chinese Asset Management Industry, August 2003

Via Email

August 7, 2003

Terry McCartin
Director of Monitoring and Enforcement for China
Office of the United States Trade Representative

Dear Mr. McCartin:

The Investment Company Institute[1] is writing to provide input for US participation in the WTO's second annual Transitional Review Mechanism (TRM) for China. TRM provides for a comprehensive annual review of China's efforts to comply with its World Trade Organization (WTO) commitments.

We applaud the continuing efforts of the United States to secure China's full compliance with its WTO commitments. China is of significant interest to our members, many of whom view China as an important market for the provision of asset management services. We, therefore, appreciate the opportunity to apprise USTR of the issues facing the US asset management industry in China.

China's entry into the WTO was a significant step in opening up the asset management market in China. Under China's accession agreement, foreign firms are permitted to own up to 33 percent of a Chinese asset management firm as of December 11, 2001, and up to 49 percent of an asset manager by December 11, 2004. As an initial matter, we hope that China will go beyond its 49 percent equity ownership commitment and provide a truly open market for asset management firms. In such a truly open market, a foreign asset management firm should be able to choose its form and equity participation levels to best enable it to provide asset management services and compete on the same basis as domestic firms.

More immediately, to implement the commitments in place in the accession agreement, China must make progress in eliminating barriers that prevent US and other foreign firms from obtaining effective

market access to the Chinese market. Removing the barriers discussed below is a necessary prerequisite for China to achieve full compliance with its WTO commitments.

Transparency

In a highly regulated industry such as asset management, it is critical that there is transparency in the eligibility criteria for foreign institutions seeking to participate in the Chinese domestic asset management market.

When the China Securities Regulatory Commission published the draft joint venture rules under which foreign firms could participate in the asset management market (Draft Joint Venture Rules), we recommended that the criteria for regulatory approval be clearly set forth in the regulations. We expressed concern that the Draft Joint Venture Rules did not provide a complete list of objective criteria for approving foreign institutions. Unfortunately, when the CSRC adopted its final rules (Final Joint Venture Rules), it chose not to clarify the criteria that it intended to use in its approval process and instead replaced the unclear text with language providing the CSRC with broad discretion to impose additional requirements for qualification of a foreign firm.[2]

We support the goal of the CSRC in protecting investors and appreciate the need to impose prudential requirements. We believe, however, that those prudential requirements should be clearly delineated to applicants who are seeking regulatory approval. 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 effectively operate as barriers to entry. Transparent regulations and administrative practices, by contrast, 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. We believe this type of regulatory environment would help attract global asset management firms to China.

With respect to transparency in the promulgation of rules, we appreciate the Chinese authorities seeking public comment on the Draft Joint Venture Rules. The proposed rules, however, were issued on December 21, 2001 with a deadline of December 31, 2001. We fully appreciate that holidays vary all over the world and that it would be impossible to be sensitive to such events on a global basis. However, if regulators provide a sufficient period of time—30 to 60 days—for comment, they would afford all interested persons with a meaningful opportunity to provide thoughtful and carefully considered comments. We hope that Chinese authorities will endeavor to establish a uniform minimum time period for comment in promulgating financial services regulatory requirements.

Capital Requirements

The Final Joint Venture Rules require that a foreign institution seeking to enter into a Chinese joint venture have no less than RMB 300 million [$36 million]. This high level of mandated capital for asset

management firms is excessive, is not necessary for protection of investors, and operates 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.

A high regulatory capital requirement disproportionately affects foreign asset managers because their operations in each country will typically not be as significant as their operations in their home country. Therefore, domestic firms will be able to comply with a large capital requirement more easily than foreign firms.

Moreover, in some foreign countries asset management firms tend to be large banks or broker dealers and these firms may not find it difficult to meet high capital requirements. In other countries such as the United States, however, highly successful asset management industries have developed comprised of smaller independent firms. It would be unfortunate if the high capital requirements operated to prevent these US firms from participating in China’s asset management industry. Last year, the Institute published a paper on capital requirements (a copy of which is enclosed) by two distinguished academics that describes the anticompetitive effects capital requirements can have on smaller independent asset management firms.

We strongly urge China to reconsider the high capital requirements it has imposed on fund management companies, which operate as a barrier to meaningful access to the local Chinese asset management market.

A-Share Market

We are pleased that China has taken steps to open the A-share market to foreign investors by adopting rules governing qualified foreign institutional investors (QFIIs). The creation of a deep, liquid equity market can be a powerful engine for economic growth.[3] Dismantling the discriminatory B-share system and allowing foreign investors equal access to China’s A-share market is an important step towards that end.

A number of aspects of the new QFII rules, however, limit their practicality. First, the rules restrict the percentage of an issuer’s securities that may be held by any one QFII and all QFIIs in the aggregate. As well as creating administrative difficulties and introducing a risk of forced divestment, these caps have the potential to distort artificially the A-share market by creating a separate class of shares for foreign investors. This was precisely the problem inherent in the B-share system that the QFII rules were intended to address.

Second, the rules require each QFII to commit total investments of at least US$50 million to a special dedicated QFII account. Given the current limited size of the Chinese market and the percentage limits on investments by QFIIs, this minimum account provision may operate as a practical matter as a

barrier to entry for QFIIs and likely will serve as a disincentive to investment in China.

Third, the amount invested must remain in the QFII account for at least one year for open-end funds and three years for closed-end funds, and any remittances from the account must be approved in advance by the State Administration of Foreign Exchange (SAFE). These lock-up provisions significantly impair the liquidity of investments in the Chinese markets. Given the strict liquidity and valuation standards for mutual funds under US law, these provisions will substantially limit US mutual funds' ability to participate in the A-share market.[1]

Finally, certain elements of the QFII licensing process lack transparency. For example, the licensing rules include a provision that allows the CSRC and SAFE to give priority consideration in granting licenses to "pension, insurance or mutual funds that have a good investment record in other markets." This provision is clearly subjective, lacking any specific criteria to be applied in making priority determinations.

We hope that China eventually will abolish the QFII system and allow foreign investors full and equal access to their domestic securities markets although we understand that this may not be feasible in the absence of a fully convertible currency. In the meantime, however, we urge China to make the QFII system more workable by addressing the concerns discussed above.

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We hope these comments will be helpful to USTR in connection with the TRM discussions with China. 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

Enclosure

ENDNOTES

[1] The Institute's membership includes 8,673 open-end investment companies ("mutual funds"), 588 closed-end investment companies, 106 exchange-traded funds, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.801 trillion, accounting for approximately 95 percent of total US industry assets, and over 90.2 million individual shareholders.

[2] We similarly have found a lack of regulatory transparency in other context. As discussed below, there are certain elements of the Qualified Foreign Institutional Investor licensing process that lack transparency.

[3] See Ross Levine, "Stock Markets, Economic Development, and Capital Control Liberalization," Perspective, Investment Company Institute (December, 1997).

[4] US mutual funds must stand ready to redeem their shares on a daily basis. US mutual funds are required by the federal securities laws to invest substantially in liquid assets and to price their shares daily.

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