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Cross-Border Updates: Quarterly Assessment

June 2015

Promising opportunities

MFR

CSRC and SFC confirmed on May 22 that the long-awaited Mutual Fund Recognition (MFR) program, which will see certain Hong Kong- and mainland-domiciled funds made available for sale in each other's territories, will go ahead, beginning July 1.

Stock Connect

Shenzhen

With an announcement from SZSE and HKEx expected shortly, preparations will begin for the inclusion of Shenzhen into the Connect. The new three-way Connect will create a linked market worth in excess of RMB95tr.

Domestic managers caught off-guard

QDII

As domestic markets rallied, risk-on mainland investors decided to pour money into the Hong Kong market in addition to home bourses. This demand was largely unforeseen and caught a number of domestic managers off-guard. Some funds were forced to close subscriptions due to QDII quota shortages.

Growing in size and aggression

Insurers

Total and investable assets of the insurance industry in China reached RMB11tr and RMB10tr respectively in April 2015. Insurers are continuing to allocate assets more aggressively and capital allocated to funds and stocks increased, reaching 13.2% of allocations in 1Q15.

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Overview of cross border programs

Inbound programs

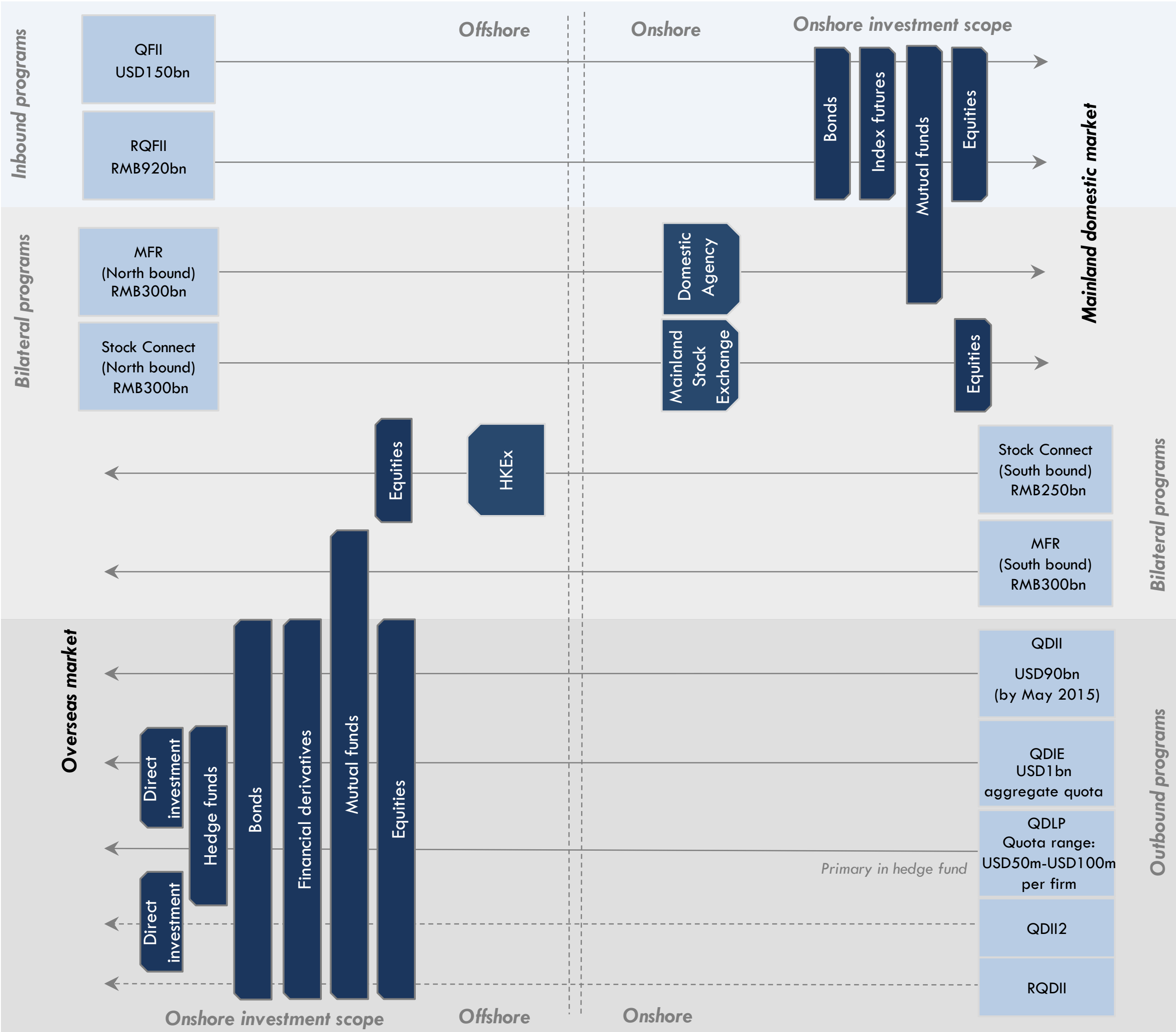
QFII:
QFII suits investors who need large amounts of quota and prefer long-term investments, such as asset owners.

RQFII:
RQFII suits investors who seek direct RMB exposure. The RQFII program has historically been more flexible than QFII.

Bilateral programs (North bound)

Stock Connect (North bound):
Offers global investors direct access to Chinese equities without a license (R/QFII).

MFR (North bound):
850 domestic funds are eligible to sell in HK, offering a wider range of products to global investors.



Bilateral programs (South bound)

Stock Connect (South bound):
Offers Chinese HNWI and mass-affluent investors direct access to HK equities.

MFR (South bound):
Global managers will be able to sell their funds on the Mainland. Approximately 100 HK-domiciled funds are eligible for sale in China.

Outbound programs

QDII:
Allows mainland entities (FMCs, insurers etc.) to invest offshore via approved quota.

QDIE:
A regional outbound investment program in Shenzhen and Qianhai.

QDLP:
A regional outbound investment program in Shanghai and Qingdao. A WFOE and Chinese partners are required.

QDII2:
QDII2 will be launched soon. Six cities are included first batch. Threshold is RMB5m.

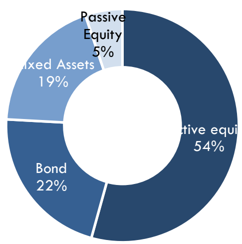
RQDII:
RQDII will be launched as an outbound program targeting RMB-denominated assets

MFR: The first batch of candidates

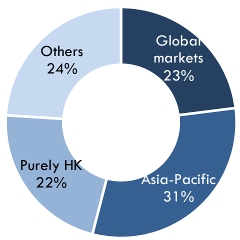
MFR hides many layers of complexity that will need to be assessed by candidates carefully. Having engaged in existing cross-border programs, Z-Ben Advisors believes a handful of firms that currently have a familiarity with the onshore landscape will have accrued experience in penetrating the domestic market and will possess an initial advantage over their rivals. Chinese FMCs will be advantaged if they have a functional and active Hong Kong subsidiary to connect them with global investors.

Estimated asset allocation and geographic focus

Estimated breakdown of MFR eligible funds in Hong Kong by number of products



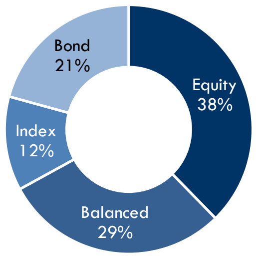
Geographical investment focus in Hong Kong (ex-China)



100 Hong Kong-domiciled funds

850 domestic funds

Estimated breakdown of MFR eligible funds in Mainland by number of products



Source: Z-Ben Advisors, CSRC, SAFE, Lipper

MFR probable winners

Foreign managers

Invesco, Schroders, BEA Union Investment, J.P.Morgan

Winners: Foreign managers that can leverage Mainland relationships for distribution

- A strong Hong Kong-domiciled product suite
- JV experience
- QFII and RQFII experience (knowing how to work with local banks as transfer agents and custodians)
- QDII selling experience (understanding potential partners' distribution strengths and weaknesses.)

Domestic managers

华夏基金 ChinaAMC, 嘉实基金 Harvest Fund, 南方基金

Winners: Domestic managers with Hong Kong familiarity

- Those with Hong Kong subsidiaries and experience navigating local distribution – particularly as it connects with global institutional investors – will be extremely useful
- FMCs that have demonstrated strong performance with QDII
- Mainland firms may offer the same products via MFR and RQFII in order to circumvent the Hong Kong RQFII cap

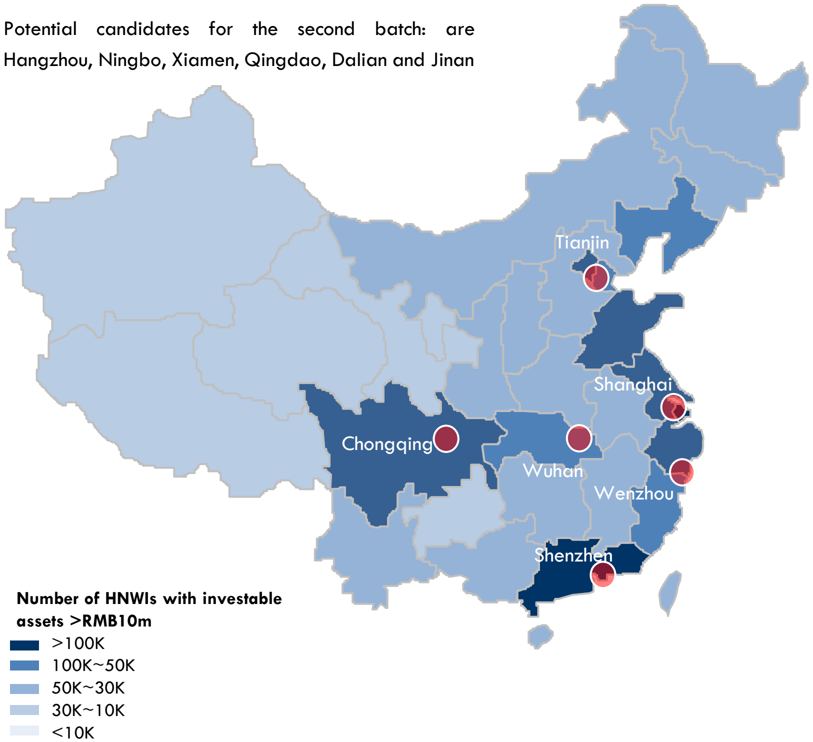
Source: Z-Ben Advisors

QDII2: Pilot program to be launched

Potential first batch of QDII2 pilot cities

The first batch of pilot cities are likely places with a moderate concentration of HNWIs

Potential candidates for the second batch: are Hangzhou, Ningbo, Xiamen, Qingdao, Dalian and Jinan



Source: Z-Ben Advisors, CMB China Private Wealth Report

How QDII2 will likely work

Qualification: It is expected that residents in the pilot cities with minimum net financial assets of RMB1m will be allowed to participate in the program. They will likely apply via a bank and create accounts for investment. Commercial banks are expected to play a key role in the process.

Quota: Individual quota granted is likely to be 50% of an individual's net financial assets. There may also be an aggregate quota.

What QDII2 could offer offshore mangers

Market: By the end of 2014, HNWIs in China (with individual investable assets above RMB10m) amounted to more than 1m, with total investable assets of approximately RMB32tr. Over the past several years, the market has experienced annual growth of 20% on average.

Flexibility: QDII2 could provide more investment flexibility relative to other outbound programs, especially in private equity and real assets. Furthermore, managers may be able to conduct QDII2 business without setting up WFOEs, saving extra time and resources.

Access: Details on accessing QDII2 are currently vague but given the geographic spread of cities it will be available in, it is most likely that each QDII2 area will set its own criteria for access.

- QDII2 is one key step towards China opening up its capital account and pushing forward RMB internationalization. In comparison to QDLP/QDIE/RQDII and other small-scale locally-designed programs that have been tested in many places, QDII2 is more likely to be designed at a higher level and provide more investment flexibility. Domestic banks are expected to play a key role in this business.