China And Hong Kong's Regulatory Environment For Foreign Hedge Funds: An Overview

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In recent years, China has been a hot spot for foreign investors that include hedge funds, private equity funds, venture capital funds and corporations, as the Chinese economy has been growing at a breakneck rate. The rapid growth of the Chinese stock market, which includes the high valuation of the listed companies, has attracted the global investors' attention. The expected appreciation of the renminbi provides further impetus to investors' interest in China. To date, only a handful of foreign hedge fund investors have entered the Chinese market. Many are still contemplating the move and have not made it yet, which is perhaps due to unfamiliarity with the Chinese regulatory regime, lack of knowledge or experience of China's foreign investment policies and lack of competent or reliable local agents to implement investment decisions. This article aims to provide a simple overview of the hedge fund regulatory landscape in China and Hong Kong, with a focus on China, as Hong Kong is a distinct jurisdiction and market.

China

For foreign hedge funds that seek opportunities in China, the most favourable targets of investment include the A-share stock market, the real estate market and other fast-growing industries, such as technology, media and telecommunications. So far, foreign hedge funds that choose to directly participate in the Chinese market have mainly entered the market through the qualified foreign institutional investor programme or direct principal investments. In the latter case, hedge funds operate much like a private equity or venture capital investor in China. An indirect approach, which has been the predominant route that foreign hedge funds have taken, entails investing in H-shares in Hong Kong.

A-share investments

A Chinese-listed company may issue three types of shares: the A-share (denominated and traded in RMB in China); the B-share (denominated and traded in US dollars in China); and the H-share (denominated and traded in Hong Kong dollars in Hong Kong). Among the three types of shares or markets, the A-share market is probably the most attractive option for hedge funds, given the recent performance of the market. The Shanghai A-share market surged more than 300 per cent from January 2006 to October 2007, although in recent months the market has dropped as part of the global retrenchment. Generally speaking, however, foreign investors are currently not permitted to directly invest in the A-share market, although they may directly invest in B-shares and H-shares.

To regulate foreign investments in the A-share market, the Chinese government introduced the Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors in 2002, which has been the common passageway for qualified foreign institutional investors in the A-share market. Under the QFII regime, a foreign hedge fund manager may apply for a QFII status if it has been in operation for more than five years and has managed assets of no less than $10bn for the latest accounting year. Such manager may apply for a quota within which it may invest in A-shares. For investors who may not qualify for QFII status, they may invest in A-shares by subscribing to the investment products which QFIIs have made available. An advantage of the subscription method is that such investors, even if they qualify to apply for QFII status, need not complete the often cumbersome and lengthy approval procedures of the Chinese authorities. The disadvantages of the subscription method include:

i. less direct and less efficient transaction execution; and

ii. extra costs that may be incurred as compared to direct participation in the stock market.

The most problematic feature of the QFII scheme, however, is perhaps the quota restriction. Due to China's macroeconomic control and prevention of inflow of "hot money", it is becoming more difficult for QFIIs and their clients to obtain investment quotas, especially if they are hedge funds, as the priority to obtain quotas will be given to pension funds and insurance funds. Another significant impediment to hedge funds' entry to China is the relatively immature state of the Chinese capital market. Financial derivatives and other instruments that often constitute the critical part of hedge funds' strategy are largely unavailable in China. In addition to open-market purchase in the A-share market, another possible route for foreign hedge funds to take is to make strategic investments in China's listed companies. In January 2006, the Chinese authorities began to permit foreign investors to make strategic investments in Chinese-listed companies. Pursuant to the Measures for the Administration of Strategic Investment of Foreign Investors in Listed Companies, however, such strategic investments are subject to regulatory approval and stringent requirements. These include:

i. the actual total value of offshore assets under management shall be no less than $500m;

ii. the first investment amount shall be no less than 10 per cent of the total issued shares of the listed company; and

iii. the A-shares acquired are restricted for sale for three years.

Direct principal investments

In contrast to the restricted manner in which foreign investors may invest in the Chinese stock market, foreign investment is permitted in the vast majority of economic sectors as China has increasingly been opening up its economy in observation of its World Trade Organisation commitments. Investors should, however, be aware that different sets of laws and regulations may apply to different industry sectors. Accordingly, the methods of investment may by necessity differ. Moreover, there may still be restrictions even for permitted sectors. Take the real estate industry for example — the development of ordinary housing units is permitted, while the development of luxury villas is restricted and the development of golf courses is now prohibited. Investment structures that foreign hedge funds have used include:

a. The traditional foreign direct investment.

a. The so-called red-chip model that has, until recently due to regulatory changes, been widely used by foreign private equity/venture capital investors.

The FDI model entails an investment structure that is onshore, i.e., within the purview of the Chinese regulatory landscape, whereas the red-chip model involves an investment structure that is offshore. In a traditional FDI investment structure, after a target company has been identified, the foreign investor would establish, usually through a special purpose vehicle established offshore in a tax-advantaged jurisdiction such as the Cayman Islands or Hong Kong, a wholly foreign owned enterprise or a Sino-foreign joint venture. In the case of a JV, one or more Chinese parties would be involved to carry out the invested business. A WFOE structure would generally give the foreign investors more control, although a JV structure would facilitate the utilisation of the local partner's expertise and relationships. A JV may be an equity joint venture or a cooperative joint venture, depending on the nature of the investment project and the investment objectives of the investors. An EJV and a CJV may differ in such matters as legal status, capital contribution and profit distribution. Selecting the correct investment vehicle can be crucial to achieving one's investment objectives.

A common alternative to setting up a new establishment is an acquisition of a Chinese target. Acquisition as a form of market entry has increasingly become popular for foreign investors. In short, an acquisition may be carried out offshore, if the target company has an offshore holding entity, or onshore, which will result in a Sino-foreign JV or WFOE. The most significant difference between an offshore and onshore transaction is that an onshore transaction is usually subject to the strict approval procedures of the PRC authorities.

This includes a possible anti-trust review and a state security review, which has apparently halted a number of high-profile acquisitions of major state-owned enterprises. Whether an investment adopts an onshore or offshore structure may also have significant implications if the target company has offshore listing plans. Under the current legal regime of the PRC, to design an optimal investment structure is perhaps one of the most important aspects of a China investment.

With respect to the red-chip model, until recent regulatory changes, an offshore structure has been foreign private equity/venture capital investors' predominant method of investment in Chinese target companies. The regulations that Chinese authorities such as the State Administration of Foreign Exchange and the Ministry of Commerce have recently promulgated, however, have made such investment model difficult to implement.

Hong Kong

As Hong Kong adopts the English common law system, fund regulations are, in principle, similar to those under English laws. The regulatory authority for hedge fund activities is the Securities and Futures Commission. Whether a licence from the SFC may be required depends largely on how the relevant activities of a fund are carried out. A licence will be required if the manager of the offshore hedge fund operates in Hong Kong. This may be avoided, however, if an affiliate is established in Hong Kong which provides local investment advice to a fund manager established outside Hong Kong. A licence may also be required if the products or interests of offshore hedge funds are sold or marketed in Hong Kong, with the exceptions of sale to professional institutional investors and private placements. The SFC does not generally regulate purely offshore funds, although they are still subject to the regulations on insider dealing and fraud.

Foreign hedge funds which do not have access to A-shares may look to H-shares and red-chip shares, i.e., Chinese companies reincorporated offshore and listed in Hong Kong, which are freely accessible to foreign hedge funds. Also, foreign hedge funds may choose Hong Kong as the place of incorporation of a special purpose vehicle for investments in China for reasons such as tax benefits.

The economic prospects of China are great, although the Chinese legal regime and regulatory framework for foreign investments are not as developed as other common law jurisdictions which present additional challenges to foreign investors. Hong Kong is a developed yet distinct market that offers different investment opportunities. Given its special political status and close economic ties with China, Hong Kong can be an integral part of a hedge fund's China investment strategy. Investors that seek China investment opportunities should obtain competent professional advice to optimise their investment objectives and avoid unnecessary risks.