

# Mainland-Hong Kong Mutual Recognition of Funds

*by the Financial Infrastructure Department*

The Hong Kong Monetary Authority has recently enhanced the Central Moneymarkets Unit Fund Order Routing and Settlement Service to facilitate cross-border investment fund transactions under the Mainland-Hong Kong Mutual Recognition of Funds programme. This article describes the high-level business and operating model of the enhanced service and how it may help facilitate efficient processing of cross-border investment funds transactions, thereby reinforcing Hong Kong's role as a leading asset management centre in the region. Essentially, the service provided by the Hong Kong Monetary Authority is to facilitate the funds as an investment product to reach the investors across the boundary.

## Introduction

The Hong Kong Monetary Authority (HKMA) plays an important role in developing the financial infrastructure in Hong Kong, which is essential to the stability, integrity and functioning of the monetary and financial systems. Over the years, new components have been developed and added to broaden the scope and increase the depth of the financial infrastructure in response to industry demands and international developments. These include, among others, the Central Moneymarkets Unit (CMU) Fund Order Routing and Settlement Service (the Service) which was initially launched in 2009. The objective of the Service is to provide a standardised and an automated platform for the investment fund industry to streamline the process for handling transactions, and also, to reduce operational risks.

Following the announcement of the implementation of the Mainland-Hong Kong Mutual Recognition of Funds (MRF) by the Securities and Futures Commission (SFC) and the China Securities Regulatory Commission (CSRC) in May this year, the HKMA has further enhanced the Service through the implementation of new cross-border linkages with investment fund processing platforms in Mainland China. Officially launched on 7 August 2015, the enhanced CMU Service provides a standardised and automated platform to facilitate fund distributors, transfer agents (TAs) and fund houses in Mainland China and in Hong Kong to process MRF transactions in a safe and efficient manner. This article describes the high-level business flow of the enhanced Service.

## CMU Fund Order Routing and Settlement Service

Launched in 2009, the Service serves as a processing hub between industry players on the buy-side of the investment fund processing chain (i.e. fund distributors and custodians) and those on the sell-side (i.e. TAs and fund houses). Such processing hub provides a single, automated entry point for industry players to send and receive instruction orders, confirmations, and other information. Compared to the conventional non-standardised, manual and “many-to-many” processing mode (e.g. fax), the Service enables buy-side users to reach multiple TAs for a wide range of investment funds using a single processing standard. Likewise, sell-side users may receive orders from numerous fund distributors in a single automated and standardised message format.

The Service is flexible in terms of communication means. Users may choose to communicate using file transfer (FTS), CMU Member Terminal (CMT) or SWIFT depending on their operational needs. For example, a fund distributor may choose to send order instructions to its TA by means of, say, FTS using a standardised file template provided by CMU. The Service will then convert the file into a standardised format and transmit it to the TA through means preferred by that agent, such as SWIFT. Similarly, the TA may send order acknowledgement and confirmation files to the fund distributor using its preferred means. The Service will then carry out conversion accordingly for onward transmission to the fund distributor using a channel preferred by the distributor.

Fund distributors may choose to use only the order routing part of the Service. In such case, cash settlements will be done outside the Service using other settlement routes preferred by fund distributors. Alternatively, they may subscribe to the full service, which includes both order routing and cash settlement. Settlement instructions will be generated automatically and transmitted to the TAs and the distributors, thereby enhancing the straight-through processing level. Cash settlement can be done in Hong Kong through CMU’s seamless interface with the existing multi-currency RTGS payment platform. Such flexibility in the choice of settlement channels allows service users to reap the benefits of automation and streamlined processing without compromising their preferred post-trade settlement model.

To widen the scope of investment funds’ coverage, the CMU has leveraged on its existing linkages with international central securities depositories (ICSD) to ride on their investment-fund servicing platforms. Through these linkages, local fund distributors can gain access to a wide range of European and international investment funds available in the market. International funds may, through TAs which are already on board for these ICSD platforms, tap into local fund distributors to widen their investor spectrum.

Since its launch in August 2009, the Service has been operating smoothly. To date, more than 20 fund houses and a number of major local bank distributors have participated in the Service with growing transaction volumes. The response from users indicates that the Service has significantly streamlined the investment-fund processing cycle, and the multiple channels of communications have proven beneficial to various operational requirements.

## Mutual Recognition of Funds

To deepen Mainland-Hong Kong financial cooperation and promote joint development of the Mainland and Hong Kong capital markets, the CSRC and the SFC signed a Memorandum of Regulatory Cooperation concerning MRF between Mainland China and Hong Kong on 22 May 2015. The Memorandum provides a framework for mutual recognition of publicly offered funds between the CSRC and the SFC so that these recognised funds could be offered to the public in both markets.

The MRF is an important element in the opening up of the Mainland's capital market. At present, there are approximately 1,500 investment funds approved by the CSRC in Mainland China, and around 450 investment funds approved by the SFC in Hong Kong. MRF sets the milestone in the mutual opening of markets and enhances the mutual capital market access between Mainland China and Hong Kong. It is significant in various ways, as it helps:<sup>1</sup>

- (i) deepen the exchange and cooperation of the Mainland and Hong Kong asset management industries, broaden cross-border investment channels, and enhance the competitiveness of the Mainland and Hong Kong fund markets;
- (ii) lay the foundation for the CSRC and SFC to jointly develop a fund regulatory standard, promote the integration and development of the Asian asset management industry, and encourage the transformation of Asian savings into cross-border investments; and
- (iii) provide more diverse fund investment products to Mainland and Hong Kong investors, and expand the business opportunities and enhance the international competitiveness of Mainland and Hong Kong fund management firms.

At the initial stage, only general equity funds, bond funds, mixed funds, unlisted index funds and physical index-tracking exchange traded funds would be eligible under the MRF. The SFC and the CSRC would consider extending the MRF to include other types of products in future. In terms of funds eligibility, the key requirements are as follows:<sup>2</sup>

- (i) the fund is established and managed at home jurisdiction;
- (ii) the fund is registered/authorised for offering to the public in the home jurisdiction;
- (iii) the fund must be established for more than one year;
- (iv) the fund must have a minimum fund size of not less than RMB200 million or its equivalent in a different currency;
- (v) the fund must not primarily invest in the host jurisdiction; and
- (vi) the value of shares/units in the fund sold to host jurisdiction investors should not be more than 50% of the value of the fund's total assets.

The CSRC and the SFC have begun accepting applications from mutual funds for authorisation under the MRF programme from 2 July 2015. It is understood that major investment funds in Mainland China and in Hong Kong have already submitted applications and are pending approval from the CSRC and the SFC.

<sup>1</sup> Joint announcement on MRF by the CSRC and the SFC on 22 May 2015.

<sup>2</sup> SFC Circular of 22 May 2015 on "Mutual Recognition of Funds (MRF) between the Mainland and Hong Kong".

## Enhanced CMU Fund Order Routing and Settlement Service for MRF

Leveraging on the existing Service, the HKMA worked with platform operators in Mainland China, namely the China Securities Depository and Clearing Corporation Limited (ChinaClear)<sup>3</sup>; the Shenzhen Stock Exchange (SZSE); and the Shenzhen Securities Communication Co. Ltd (SSCC)<sup>4</sup> to enhance the Service by establishing cross-border system linkages between the CMU fund platform and relevant infrastructure in Mainland China to facilitate automated, standardised and efficient service for MRF transactions. The initial scope of the enhanced Service includes:

- (i) routing of subscription and redemption orders instructions between distributors, TAs, and fund houses of MRF eligible funds in Hong Kong and in Mainland China;
- (ii) processing of money settlement instructions in respect of MRF investment transactions where applicable;
- (iii) provision of fund information of MRF eligible funds including Net Asset Value, corporate events, and fund status, etc.;
- (iv) provision of custody operation information; and
- (v) provision of regular reports for reconciliation and internal straight through processing, etc.

The respective roles and functions of the parties in the context of MRF are elaborated below:

- SSCC operates the Financial Data Exchange Platform (FDEP) to which Mainland investment fund players are connected for the purpose information exchange, including transmission of investment fund orders, and regulatory reporting.
- ChinaClear is linked to FDEP and performs the role of TA for Mainland funds recognised for MRF and provide sub-TA services for Hong Kong funds recognised for MRF.
- CMU is connected to FDEP to enable Hong Kong fund distributors, fund houses and TAs to process MRF transactions with their Mainland counterparts via ChinaClear's platform.
- SZSE plays a coordinating and facilitating role during the system development stage. Its system that supports listed open-end fund (LOF) is linked with FDEP and ChinaClear. LOF will provide an innovative new distribution channel for Hong Kong domiciled funds selling in Mainland China at a later stage.

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<sup>3</sup> ChinaClear provides the largest TA platform for open-end funds in Mainland China, covering most of the investment funds with no self-operated TA functions.

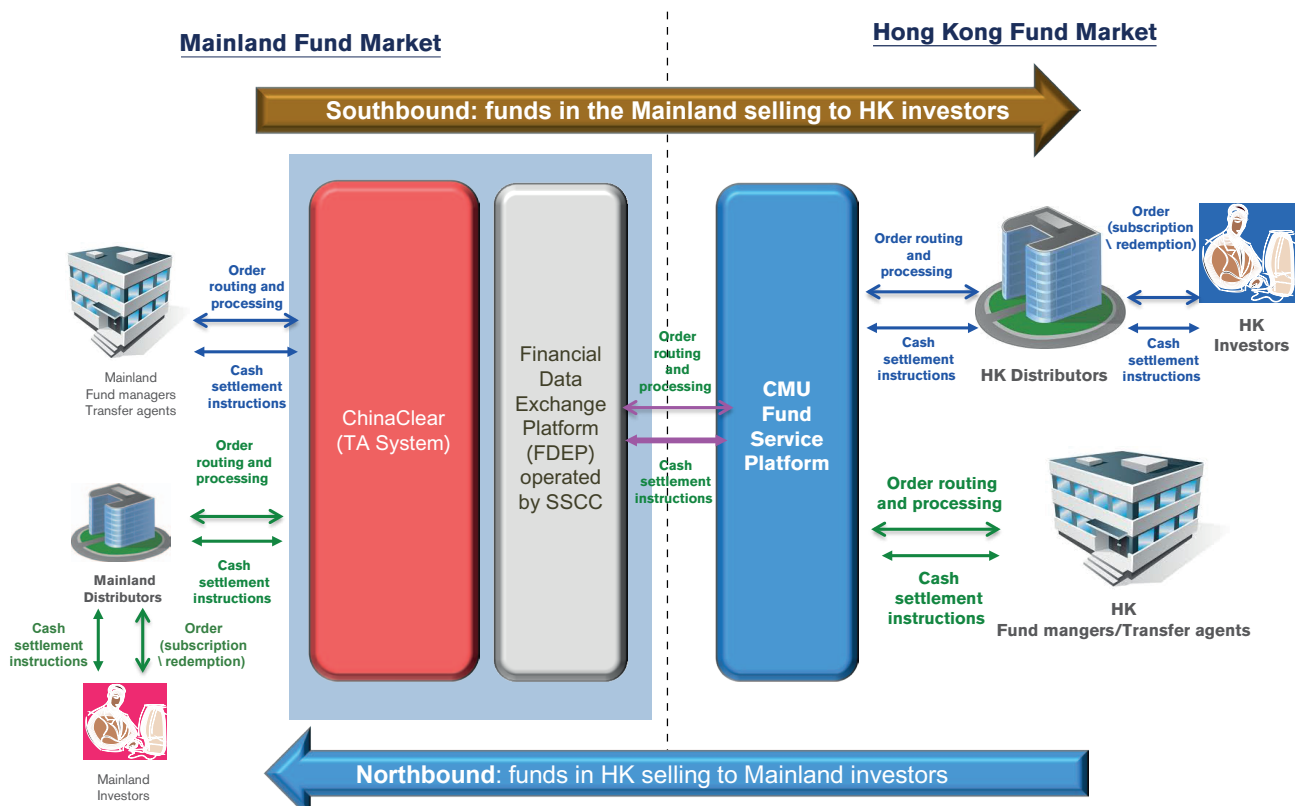
<sup>4</sup> SSCC is a communication service provider and operator jointly owned by ChinaClear, and SZSE (majority shareholders), and the China Academy of Space Technology.

For north-bound transactions, i.e. sale of Hong Kong funds to Mainland investors, ChinaClear will have the investor holdings to individual levels but will only send out consolidated orders to the Hong Kong TAs and fund houses under Mainland distributors' nominee accounts<sup>5</sup>.

For south-bound transactions, i.e. sale of Mainland funds to Hong Kong investors, distributors in Hong Kong will open nominee accounts directly with ChinaClear which acts as the TA of fund houses in Mainland China. A high-level business flow of MRF transactions under the enhanced Service is depicted below:

CHART 1

### High-level Flow



<sup>5</sup> This nominee service is a new service provided by distributors in Mainland China. Before the MRF programme, distributors in Mainland China have no nominee service.

Hong Kong fund managers and distributors may continue to use their communication channels, i.e. FTS, CMT or SWIFT, to communicate with CMU. The enhanced file conversion function of the Service also enables users to minimise the extent of system changes. Specifically, CMU and ChinaClear together with SSCC have developed the capabilities to perform data conversion between the file templates of Hong Kong and Mainland China. As a result, Hong Kong users will be able to continue to use their existing CMU templates for sending orders to and receiving orders from their Mainland counterparts. The data conversion arrangement enables participants of the enhanced Service to avoid significant system changes and development costs. In Mainland China, fund houses and distributors connected to ChinaClear or SSCC may continue to ride on their existing arrangements to send orders via CMU to their Hong Kong counterparts.

At the initial stage, the enhanced Service will enable Hong Kong investors to gain access to more than 150 fund houses and around 250 distributors in Mainland China under ChinaClear's coverage. Going forward, the HKMA will consider expanding the coverage of the enhanced Service by developing direct linkages with fund houses and distributors of MRF recognised funds in Mainland China. According to the SFC, the number of Hong Kong domiciled funds increased by 26.7% year-on-year to 594 as at 31 March 2015<sup>6</sup>, and the increase was partially spurred by the anticipated cross-border opportunities brought about by the MRF programme. Riding on the enhanced Service, the client base of locally domiciled funds can be efficiently expanded to Mainland investors as asset management companies will be able to distribute investment funds in both the Hong Kong and Mainland markets. Mainland fund managers will also be able to reach international investors as

Mainland investment funds gain access to global investors via the distributors in Hong Kong through the MRF programme. Being the largest offshore RMB business centre and in light of the implementation of MRF, it is expected that more fund administration, asset management, distribution and marketing activities and other related functions will take place in Hong Kong. This will further reinforce Hong Kong's status as the leading asset management centre in the region. In addition, the enhanced Service will further enlarge the service coverage and improve the safety and efficiency of Hong Kong's multi-dimensional financial infrastructure, thereby strengthening Hong Kong's role as a regional settlement hub and an international financial centre.

## Way Forward

The enhanced Service is the first and the only automatic and standardised solution for MRF transactions at the initial stage. It helps minimise operational risk, streamline workflow and make the process of MRF transactions between industry players in Hong Kong and their Mainland counterparts more cost efficient. Going forward, the HKMA will continue its dialogue with market participants both in Hong Kong and in Mainland China to explore ways to further improve the functions and operations of the enhanced Service, taking into account the latest market and regulatory developments. Future expansion of CMU services is likely to be in two directions:

- (i) develop new services to serve a greater variety of investment products; and
- (ii) develop more external linkages, especially those with Mainland China.

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<sup>6</sup> SFC Fund Management Activities Survey 2014 (July 2015).