



# Standards Comparison

SBAI China Working Group

# Agenda

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Objectives

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Standards Comparison and Explanation

# Objectives

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- Help foreign investors to understand the similarities and differences between onshore China and global industry standards, and provide context why those differences exist.
- Help China fund managers who are seeking foreign capital to understand the global best practices.

# Introduction of AMAC and SBAI

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## AMAC

Founded on June 6th 2012, Asset Management Association of China (“AMAC”) is a self-regulatory association of fund management companies in China. It is subjected to the operational guidance, supervision, and administration from the operational competent authority, China Securities Regulatory Commission (“CSRC”), Ministry of Civil Affairs of the People’s Republic of China. The scope of the membership includes funds management companies like mutual funds, private securities investment funds, banks, local equity associations, insurance companies, trusts, QFIs, private equity firms, and etc.

## SBAI

Established in 2008, Standards Board for Alternative Investments (“SBAI”) is a standard-setting body for the alternative investment industry and custodian of the Alternative Investment Standards (the Standards). SBAI and the Standards are supported by managers accounting for over US\$ 1tn in AUM. In addition, SBAI’s Investor Chapter includes over 60 major international investors, including pension and endowment funds, sovereign wealth funds and funds of funds.

# Caveats

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While SBAI mainly covers alternative investment funds, AMAC oversees both mutual funds and private securities investment funds in China and there are different standards and regulations for the two. For comparability reasons, this work focuses on the standards for the private securities investment funds.

Also, due to the different nature of the two entities, comparisons are sometimes drawn between industry standards (from the SBAI) and industry regulations (from the AMAC). Some of the AMAC standards are regulatory standards and some are recommendations of best practices. The AMAC standards are more broad in scope and sometimes more restrictive in nature, compared with the SBAI's.

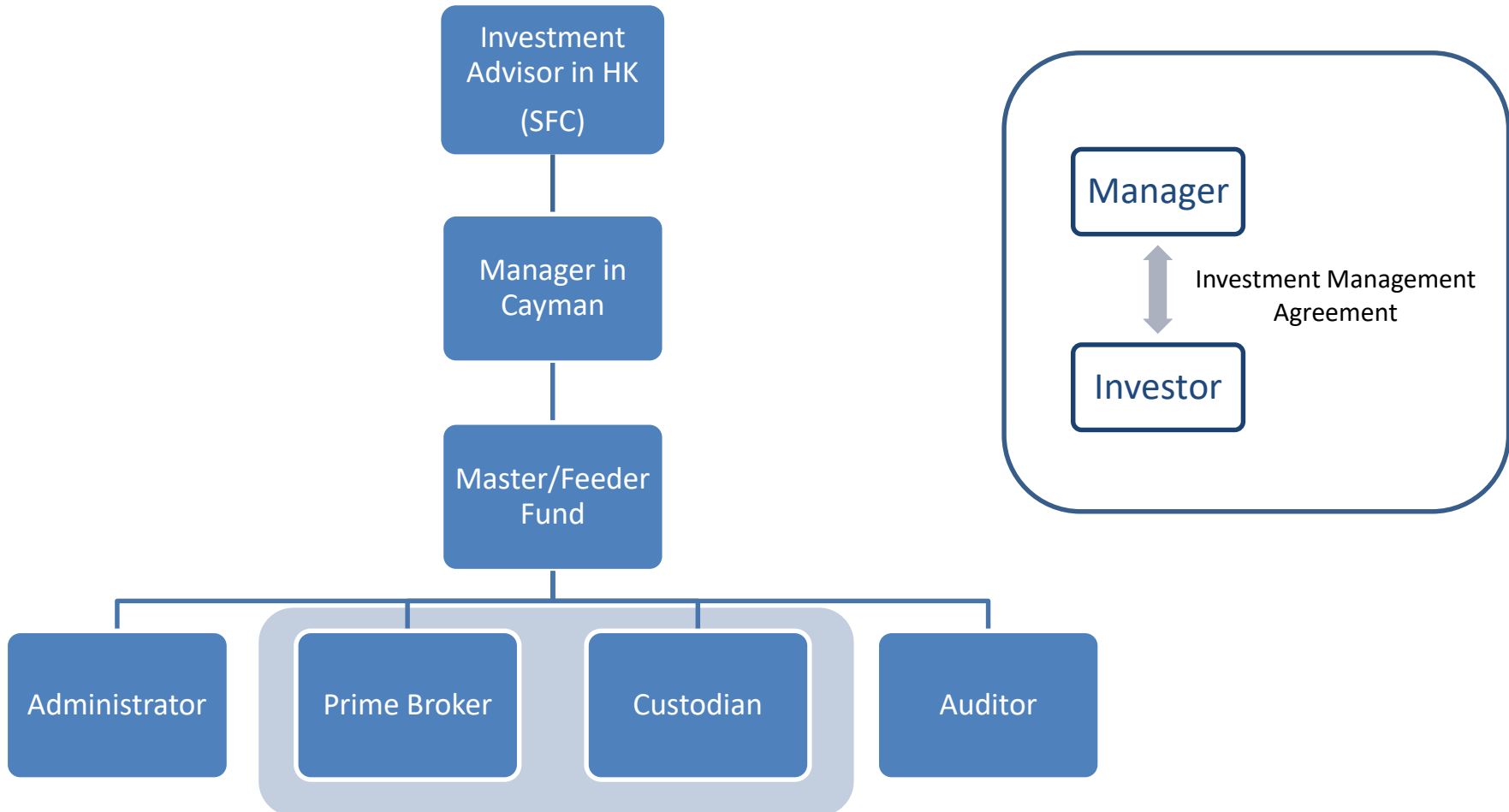
For instance, the followings are required by the AMAC, but are not mentioned by the SBAI:

- Extensive KYC process to ensure investor qualifications
- Qualification certificate by the manager
- Regulatory disclosure

Lastly, due to a dynamic environment in China, AMAC's standards are still evolving. Some information contained in this report may have become obsolete.

# Structure Comparison

## A Typical Offshore<sup>1</sup> Fund Structure



1. Registered outside of mainland China (i.e. in Hong Kong).

# Offshore Service Providers – Segregated

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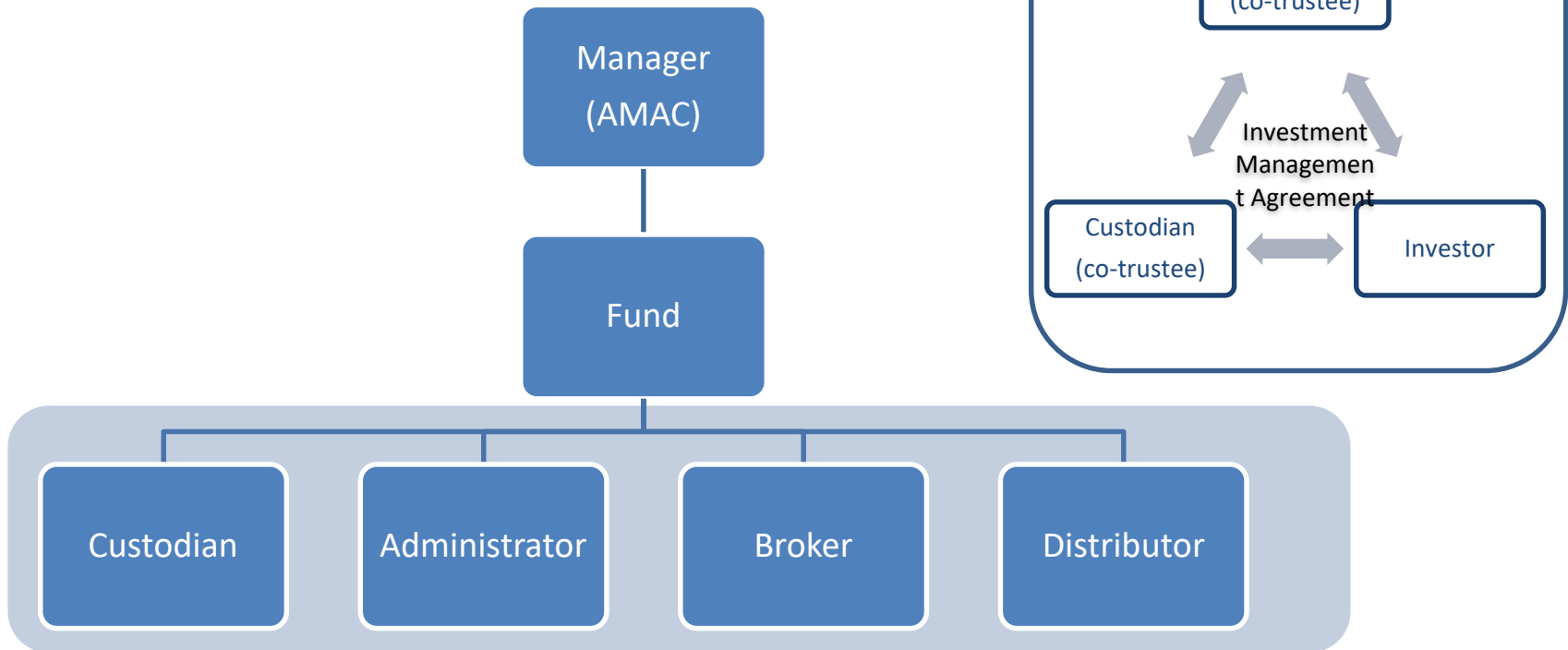
Typical administrator functions:

- Valuation and accounting
- Reconciliation with custodians, prime brokers and counterparties
- Risk and performance measurement applications
- Financial statements
- Tax services
- Subscription and redemption
- Shareholder accounting and reporting
- Anti-Money Laundering due diligence (including FATCA and UN sanctions list)
- Administrator transparency reports
  - Confirmation of existence of assets
  - Independent pricing and breakdown by valuation methods
  - Counterparty exposure breakdown
  - Fair value measurements (ASC 820 level 1/2/3)

# Structure Comparison

## A Typical Onshore Fund Structure

Private securities investment funds were “legalized” and included in the New Funds Law effective on June 1, 2013.



Besides fund structures, another structural reason for the different standards is that China and the Western world operate in two different legal systems – civil law (rules-based) vs. common law (principles-based).



# Onshore Service Providers – All in One

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Administration and custody services are usually provided by different subsidiaries of the same brokerage firm. There are only a handful of brokerage firms in China due to stringent asset and licensing requirements.

- Fund Administration
  - Valuation and accounting
  - Reconciliation
  - Financial statements
  - Tax service
  - Share registration (fund subscription and redemption processing, share registration)
  - Shareholder accounting and reporting
  - Performance fee calculation
  - Account management
- Custody
  - Account opening and management
  - Asset custody
  - Valuation and accounting
  - Settlement and clearing
  - Investment supervision fund services
  - Disclosure and reporting
- Other Value Added Services
  - Risk management
  - Performance assessment
  - Consultation (set up, legal structure, fund registration)
  - Fund and service agreements review and management

# Standards Comparison Overview

Section	Standards	SBAI	AMAC
<b>A</b>	<b>Disclosure</b>		
	- Investment policy and risk disclosure	✓	✓
	- Terms disclosure	✓	Some
	- Performance disclosure	✓	Some
	- Illiquid assets disclosure	✓	✓
<b>B</b>	<b>Valuation</b>		
	- Third-party verification	✓	✓
	- Hard-to-value assets	✓	✓
<b>C</b>	<b>Risk Management</b>		
	- Portfolio risk	✓	Some
	- Operational risk	✓	✓
	- Outsourcing risk	✓	Some
<b>D</b>	<b>Fund Governance</b>		
	- Fund governance	✓	✓
<b>E</b>	<b>Shareholder Conduct</b>		
	- Prevention of market abuse	✓	✓
	- Proxy voting policy and borrowing stock	✓	×
<b>F</b>	<b>Mandatory Company and Manager Registration</b>	×	✓
<b>G</b>	<b>Qualification Certificate</b>	×	✓

# A. Disclosure

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- **Investment policy and risk disclosure**
  - Investment policy is disclosed in the fund agreement
  - Risk disclosure is required by the AMAC and investor consent is required
  - Lawyer’s legal opinions: screen for litigations
  - Managers are required to update investors on monthly, quarterly, and annual basis, according to AMAC’s template.
    - Monthly: NAV
    - Quarterly: Fund development
    - Annually: Fund development and financials (however, external audits are not required)
    - Company/manager registration information
- **Commercial terms disclosure:** AMAC currently does not require managers to disclose the commercial terms of all their similarity funds, while such practice is recommended by the SBAI. China managers often have different product offerings with different terms for different distribution channels due to exclusivity reasons.
- **Performance disclosure:** Although GIPS (Global Investment Performance Standards)-compliant track record is only a recommendation rather than an actual standard, it provides a composite return of all products, preventing the manager from picking the best performing product for marketing purposes.
- **Illiquid assets disclosure:** Both onshore and offshore managers are required to disclose material exposure to illiquid assets. Side pockets are very rare in China so there is no specific mention of it by AMAC.

## A. Disclosure – Cont'd

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Definition of Similarity Funds: Funds that are managed by the same PM/investment team, and have similar investment mandate, strategy and style. They would have 80% or more overlap in the following areas: asset classes traded, target risk and return, time horizon of positions, average liquidity of positions.

Why matters?

- Conflicts of interest can arise between parallel funds in relation to priority of transaction, priority of ideas, resource allocation, etc., in particular in situations where funds pursue similar strategies.
- Conflicts of interest can arise between different fee structures for the same strategy.
- Investors need to understand any potential conflicts of interest by knowing if there are parallel vehicles.

## B. Valuation

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- In China, valuation methods are stated in the fund agreement and guided by AMAC and CSRC.
- Third-party verification: NAV calculations are sometimes outsourced to third party service providers, and reconciled by the custodian.
- Illiquid/Hard-to-value assets
  - AMAC has been constantly updating guidelines on how to value illiquid assets (i.e. PIPE) and suspended stocks.
  - CSRC also published valuation guidelines for suspended stocks.
  - However, some custodian systems do not support new valuation methods (e.g. swing pricing).

## B. Valuation – Cont'd

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- There should be a Valuation Policy that covers all material aspects of the valuation process, including for dealing with illiquid assets.
- Why matters?
  - In situations involving illiquid securities and where valuations are conducted in-house by the manager or where the manager has significant influence on the valuation process, conflicts of interest may arise between the manager and investors (and between different investors). From investors' perspective, it is important that the valuation procedure is robust and consistent to avoid unfair or mis-marking at the expense of investors.

# C. Risk Management

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AMAC outlines risk management in the following guidelines:

- Internal Control Guidelines
- Fund Services Guidelines
- Measures for the Administration of the Fundraising of Privately Offered Investment Funds

For each of the key risk management areas:

- Portfolio Risk
  - SBAI promotes independent risk functions. In China, custodians act as independent risk officers and have risk oversight. If trades fall outside of the investment scope, custodians can block the trades.
  - SBAI promotes extensive back-testing and scenario analysis to assess liquidity risk, market risk and counterparty risk. This is currently not required by AMAC.
- Operational Risk
  - Most of the operation-related risk guidelines are set out by the CSRC. They include but are not limited to: people and governance, trading and execution, fraud and financial crime prevention, disaster recovery, IT security and integrity of systems, legal and regulatory risk, personal account dealing, and trade allocation policy.
  - Also guided by the Internal Control Guidelines and Fund Services Guidelines.
- Outsourcing Risk
  - Guided by the Fund Services Guidelines.
  - Audited financials are not required by AMAC.

## C. Risk Management – Cont’d

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Given the variety of risk issues, it is important that managers have a robust risk framework in place to monitor and manage the risk-taking of the fund, in line with the investment guidelines and restrictions.

- **Portfolio risk** management lies at the heart of the portfolio management process, focusing on investment risk, market risk, currency risk and liquidity risk.
- **Fund liquidity risk** management needs to take into account the risk of investor redemptions, margin calls, and etc.
- **Counterparty risk** management is important in situations where assets are held with counterparties / Prime Brokers, and where downfall of such entities could result in losses for the fund.
- **Operational risks** can lead to financial losses or opportunity costs for investors. This is an area of focus by operational due diligence.



## D. Fund Governance

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- Board of Directors is not needed for onshore funds because of the tri-party trustee structure.
- AMAC requires the set-up of an LP committee. A standing committee, which is a subunit representing the LP committee, is also recommended by AMAC.
- AMAC requires every fund manager to have a dedicated compliance officer.

## D. Fund Governance – Cont’d

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- Potential conflicts of interest may arise between fund managers, the funds which they manage and investors in those funds. To mitigate these potential conflicts, appropriate governance mechanisms and oversight are required.
  - For example, trade allocation policies seek to ensure that investors are treated fairly in situations where different funds invest in the same securities at the same time.
- Benefits of an established oversight function:
  - Increasing remoteness between ultimate investors and fund managers;
  - Increasing institutionalization, with investors looking for a higher degree of comfort; and
  - Increasing “retailization” of the ultimate investor base (for example, entry of retail investors and investment by insurance companies and pensions plans owing ultimate duties to individual investors).

## E. Shareholder Conduct

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### Prevention of market abuse

- Both SBAI and AMAC recommend robust internal compliance arrangements which can identify, detect and prevent market abuse. Managers are encouraged to have:
  - A dedicated compliance officer who is not involved in the investment management process;
  - A compliance manual; and
  - Proper documentation and training.

### Proxy voting

- CSRC defines that whoever makes the investment decisions has the voting rights.
- Onshore managers typically do not exercise their voting rights.
- Aware and being discussed by AMAC.

### Borrowing stock to vote

- Aware and being discussed by AMAC.

## E. Shareholder Conduct – Cont'd

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- Investors want to understand how fund managers engage with portfolio holding companies and whether their managers play an active role in influencing management boards/companies to ensure they act in the best interest of their shareholders.

# Key Conclusions

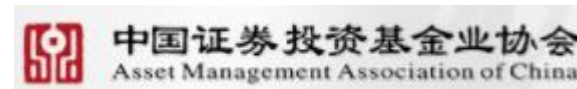
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- Majority of the SBAI standards are covered by AMAC, although some are named differently or placed under different sections/guidelines.
- Many of the differences are caused by the different fund structures between the onshore and offshore funds. In some cases, they are inherent given the two different legal systems that China and the Western world operate in (i.e. civil law vs. common law).
- AMAC is aware of the main differences and discussing them internally.
- AMAC has been receptive and collaborative with our China Working Group on this report.
- AMAC standards have been evolving in the past few years and will continue to evolve.

# The End. Thank You!

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Albourne Partners  
Asset Management Association of China  
China Alpha Fund  
CICC  
CPPIB  
GCM Grosvenor  
Man Group  
Springs Capital  
Topfund Investment Management  
Zhong Lun Law Firm



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