# Year of the WFOE: The Future of Asset Management in China

A flurry of activity and the introduction of a new—and highly dynamic—platform to target China is set to redefine how global asset managers build their future China business

The past seven months have seen more action from China's regulatory community than the previous ten years combined. However, speed isn't the only behavioural change worth noting. Cross-border investment programs have been expanded massively: there is now a common outlook that the working program should receive all the funding it can handle, if not more. Trusts, brokerages and an ever-increasing field of players are encroaching on FMCs' home territory: in the current environment no single platform should define content – anyone who can offer fund-like exposure to assets is welcome to try. A much clearer drive towards inter-regulator cooperation is in evidence, with all of China's supervisory C's (CSRC, CIRC, CBRC) attempting to construct a common playbook: is there now a belief that leisurely inter-agency negotiations are a barrier to progress?

**CSRC has never moved faster, nor to better effect**

Z-Ben Advisors would offer an alternative answer to the last question, one which we feel also gives substantial insight into the causes of current regulatory behaviour. The earliest observable changes in CSRC's behaviour began approximately one month after the most recent Party Congress in October 2011. We feel certain that the new tack is not simply due to the arrival of an energetic reformer at its head. Mr Guo Shuqing, CSRC's chairman, who took up his post last October, has been nothing less than aggressive in his pursuit of change. But Z-Ben Advisors believes he has done so with, if not the outright, at least the tacit support of China's Standing Committee, who are kicking off their Five-Year Plan for the financial industry a year early.

**The new Five-Year Plan for financial services has arrived a year early**

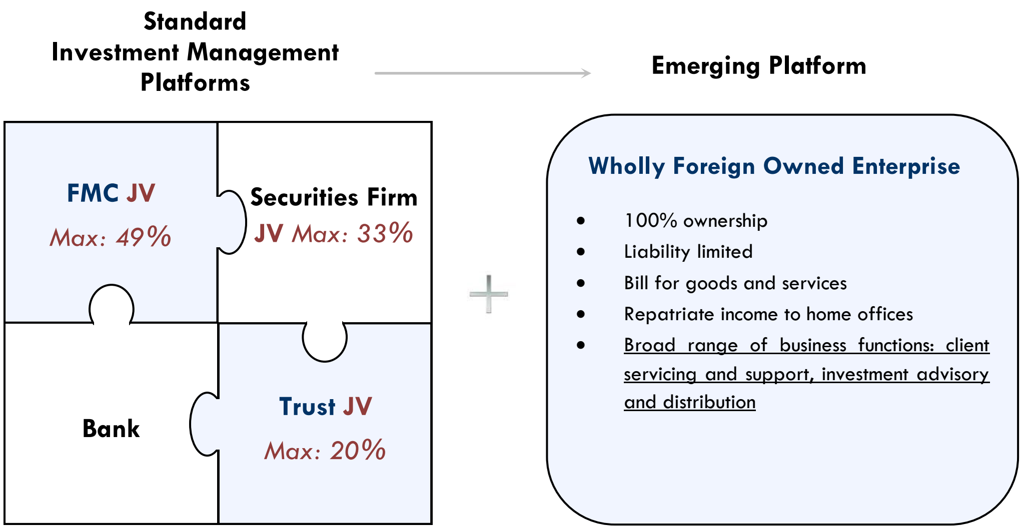
This is nothing short of a seismic event in China's markets, one whose far-reaching effects have not, to the best of our ability to judge, been fully appreciated abroad. Put bluntly, we can arrive at no analytical conclusion from recent events other than this: China's financial regulators are now working to a pre-agreed playbook, fully supported by their superiors, enabling them to work with never-before-seen speed and specificity. Moreover, they are doing so in advance of the upcoming government turnover, with the unambiguous suggestion that China's next government is already committed to this course of action. Put equally bluntly, everything you've come to expect from China's regulators over the past decade needs to be thrown out of the window, with force.

## Here and Now

It's an axiom familiar to anyone who has ever played a team sport that fast execution depends on a well-understood plan of action for its success. All financial regulators are working hard to

## Taking Center Stage

Comparison of different operational platforms




SOURCE: Z-BEN ADVISORS

# Year of the WFOE: The Future of Asset Management in China

Much prep work is being done for the next wave of growth

assist with the plan in play, and we can make a number of safe assumptions from their behaviour so far. A large number of the changes which have been pushed through appear to be preparatory in nature: refinements to the Fund Law, allowing greater competition within the asset management platform, increasing the number of firms able to issue previously restricted financial products and segregated accounts and allowing alternative investments to be held in segregated accounts and traded on secondary markets. These changes have put many more buckets in position to catch a later wave of investments. It's not impossible to believe that these efforts are ground-laying for policy initiatives such as SOE privatizations, reductions in personal income and consumption taxes or other measures which would stimulate investment by retail and institutions alike.

A less contingent view of the overall plan, however, can be derived by examining certain recent actions in light of two little-discussed and imperfectly understood plans that have emerged from Shanghai in the past six months: the first is the NDRC/Shanghai Financial Office (SFO) plan to turn the city into a global financial centre by 2020, the second is the QDLP program. The policy connections between these two programs, and how CSRC – working behind the scenes – has adapted ideas from them for general use, give a clearer picture of the regulator's new priorities and overall approach.

The importance of Shanghai cannot be overstated

Over the past six months, Shanghai has become gigantically important as a means of comprehending regulatory and State Council intent. The NDRC/SFO plan, published on 30 January and given little more than lip service outside China, should now be seen as the starting gun for an audacious attempt to re-establish the city as the most important China-related trading and investment centre in the world. According to the plan, Shanghai will become the locus of efforts to bring market reforms to China's industrial structure, its monetary policy and banking rules. It will also become ground zero for cross-border investment, by establishing itself as the premier hub for interactions between international financial firms and domestic customers.

That bold plan requires support from CSRC, among other bodies, to achieve substantial improvements within the city in two key areas: people and process. Regulators, by any standard, have so far been unsuccessful in their attempts to convince foreign companies operating in China to contribute much of either. Z-Ben Advisors feels certain that CSRC has recognized why those failures were inevitable: they are the key weaknesses of the JV model.

To explain that assertion, we invite readers to consider an important question: what does your head office really want from its Chinese outpost? Put another way, what characteristics of a notional Mainland subsidiary would give your C-suite real comfort that they had established a multi-use, multi-option local base, one that maximises their opportunities for current and future earnings while minimising their external risks? We suspect their list would likely include outright control over budgets, staff and IP; the ability to sign clients, contracts and partnerships – whether in China or abroad; the right to use the firm's hard-earned brand; the right to engage in any form of business open to their Chinese competitors and a thoroughgoing regulatory blessing on their efforts. Those protections and opportunities are likely to form the core of any wish-listed Mainland dream. (A low entry price wouldn't hurt either.)

Why haven't Chinese regulators done more to make these dreams come true? In part, because JVs have been the governing model for regulatory thinking for the past decade. The JV structure offers wide-open doors to foreign entrants, while reserving a far greater degree of control (and less explicitly-controlling engagement with Chinese senior staff) for regulators. In equal part, because the balance of negotiating power has been overwhelmingly on regulators' side for that same decade. Significant constraints on foreign entrants' freedom to act could be imposed when those entrants would accept almost any terms for the right to own something in China, even if that something was a minority stake in a newly-established financial firm. If foreigners' freedom to act was the price regulators paid to attract their skills, capital and global best practices, there was little point overpaying in what once was a buyers' market.

Why will regulators' offering to foreigners improve – to include almost all of the wish list expressed above – faster than most head offices

# Year of the WFOE: The Future of Asset Management in China

expect, or are ready to react to? In Z-Ben Advisors' view, the Shanghai plan requires it as the necessary concession to attract better people and processes. The first example of regulatory willingness to ensure Shanghai gets what it requires can be found in the second little-noticed program to which we referred earlier: the Qualified Domestic Limited Partner (QDLP) scheme.

The QDLP program is the polestar for future reforms

QDLP, an invention of SFO, will mandate offshore hedge funds to open fundraising and servicing offices in China, attracting domestic capital to offshore-operated/domiciled funds. SFO states, in the black letter of the regulations, that participants will be required to open a Shanghai-based Wholly Foreign-Owned Enterprise (WFOE). A WFOE, under Chinese law, is 100% owned by the foreign manager; capable of seeking, signing and billing clients; and able to use the foreign owner's name, brand, trademarks and hard-won-reputation in pursuing those clients. It is the preferred platform which will be used to service domestic clients and report to regulators inside the QDLP program. This marks the first time that the WFOE structure, long promoted as an optimal platform by Z-Ben Advisors, has ever been required from a foreign participant in China's capital markets. We can not stress enough how significant a breakthrough this is for foreign firms.

As we see it, QDLP offers a broad preview of what all foreign assets managers will need if they truly wish to expand their institutional business in China. In assessing all major Asian markets, it is clear that a quid pro quo relationship has developed. Only by making a real commitment to a market – office, talent, best practices – does it remain possible to compete for mandates. China has been the one exception. But will this remain the case in the near term? Z-Ben Advisors emphatically answers "no." We firmly believe that foreign asset managers' future in China (at least on the institutional front) will be contingent on establishing a WFOE.

How to service institutional investors is the key question on regulators' minds

How does QDLP factor into all of this? In Z-Ben Advisors' opinion, the fact that approved participants will be required to establish a WFOE indicates the future requirements for servicing any institutional mandate. Moreover, foreign asset managers will find themselves under increasing pressure to service accounts once the pool of institutional targets deepens.

## What to Expect

Readers of our recent China Alert on this subject – our latest effort to bring the future of the WFOE to a wider audience – may have turned to these pages hoping to find explicit evidence that CSRC has publicly committed itself to a new and clear course. No such evidence exists. We have drawn our conclusions based on what we, with considerable help from groups undergoing the WFOE registration process, have surmised as CSRC's new plans and goals.

Moreover, we know that our disclaimer risks crossing a bold line with many head offices. The express preference of a number of companies is not to make any moves until the regulator's wish has been expressed in the black letter of the law. Our intention here is solely to offer our reading of the regulator's plans in order to help readers to interpret the hints, signs, and changing areas of focus they will encounter in their own dealings with CSRC and its regulated entities in coming weeks.

Those most likely to be asked to read the tea leaves are regional heads and China reps. To them, in the knowledge that we will continue to discuss this evolving opportunity in the coming months, we offer some initial advice. Look for greater distinctions between institutional and retail customers in CSRC's language. WFOE, as we see it, will be the tool needed to target and service institutional clients. For those still intending to target the retail market, the JV fund management platform remains the only route.

Moreover, expect to hear the term "private placement" – a preferred regulatory code word for institutional asset servicing, with the connotation of products and services not offered to mass retail – cropping up with increasing frequency. Insurers, among the key asset owners on whose behalf CSRC is determined to require better servicing, may begin to delay investment discussions with offshore firms in the knowledge that a change in service structure is upcoming. Tax and custody regulations for cross-border investments may receive unexpected and sudden updates. Finally, Z-Ben Advisors strongly suspects that, beginning this year, the optimal approach to Chinese institutional clients will include two offices: a commercial office (WFOE) to serve customers and a rep office to coordinate with regulators.