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Mutual Recognition of Investment Funds between Mainland China and Hong Kong:

a new chapter of RMB internationalization and cross-border financial cooperation

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Contents

Summary

1. Time is right and tight for the authorities of Mainland China and Hong Kong to conclude a bilateral mutual recognition arrangement (MRA) to allow investment funds and fund management institutions approved by one jurisdiction to enter and operate in the markets of the other jurisdiction.

2. Such an arrangement will not only provide a major and timely boost to financial and economic developments in the Mainland and Hong Kong, and mark a new milestone in cross-border financial cooperation, but will also place the Mainland and Hong Kong in a strong position to participate in, complement or lead regional financial cooperation and integration in Asia, especially regarding the development of regional and multilateral frameworks like the Asia Region Funds Passport (ARFP) under the auspices of Asia Pacific Economic Cooperation (APEC), and the ASEAN and Plus Standards Scheme (APSS).

3. For Hong Kong, such an arrangement will allow Hong Kong fund management institutions to tap on the Mainland's booming multi-trillion (RMB) wealth management market, broaden the city's fund management industry from sales to administration and other key functions, with an impact many folds bigger than that of the Mandatory Provident Fund. It will also provide local and international investors with deeper and broader access to investment opportunities in the Mainland, and boost Hong Kong's RMB transactions by billion dollar terms, which will reinforce Hong Kong's development as a major offshore RMB centre, key International Financial Centre and a Wealth Management Centre compatible with top global centres like London, New York and Luxembourg.

4. For the Mainland, the arrangement can help upgrade China's fund management industry; provide Mainland investors with more investment channels, especially more diversified and efficient access

to investment opportunities overseas; facilitate China's 'going out' strategy; reinforce the internationalization of RMB; advance China's capital account opening; promote integration of the Chinese economy with the global financial system; and support the development and reform of China's domestic capital market, particularly in terms of financial supervision and its alignment with international standards and best practices.

5. Among the major challenges to the establishment of such a bilateral arrangement are the tasks to establish a common set of rules and standards to address issues like investor protection, risk management, dispute resolution, and to safeguard against regulatory arbitrage and hot money flows that may endanger financial stability and security. Hong Kong's experience in concluding similar agreements with other jurisdictions and China's regulatory regime built on QFII/RQFII and QDII should provide a good base to tackle such challenges.

6. To expedite the process of establishing a MRA, authorities could take a two-layer approach similar to APSS, with a first layer of 'Common' standards acceptable to both jurisdictions, and another layer of 'Plus' standards to cater for jurisdiction specific requirements. This may allow time to reconcile differences and test solutions without losing the momentum being built, and ease the way to arrive a final set of common MRA standards and the establishment of a 'passport' regime.

摘要

1. 內地與香港兩地基金產品互認的時機已日漸成熟，兩地監管當局和業界應把握機遇、緊密配合，共同簽訂互認協議，容許經對方監管機構審批認可的投資基金跨境銷售及運作，爲長遠邁向「多邊互認」和「基金通行證」發展打好基礎。

2. 內地與香港兩地基金產品互認將會開啓人民幣跨境流動的另一主要管道，把離岸人民幣業務從現有的貿易與初級債券市場，大幅推廣至包括股票商品等各類投資產品的一二級機構投資市場。此縱深廣闊的市場估計可帶來上千億元的離岸人民幣業務，把人民幣國際化推上新臺階。

3. 通過加強兩地基金流動，兩地基金產品互認將爲香港基金行業開拓一個高達數萬億元、並高速增長的大陸資產管理市場，也將目前只集中於市場推廣銷售功能的香港基金行業，推向管理、托收、交易、研究等多方面發展，與倫敦、紐約、盧森堡等全球頂尖財富管理中心並列，其影響將是本地強積金的數十倍。

4. 內地與香港兩地基金產品互認將會是中國資本帳開放的另一里程碑，它可大幅推動中國民營資本的海外投資，把「走出去」從國營機構直接投資主導的模式中解放出來，減少「走出去」在海外遇到的阻力，讓中國的海外投資更多元化，更有效率。

5. 兩地基金產品互認也可以加強內地與香港在區域和國際金融組織的地位和話語權，扭轉中國大陸當前在區域跨境基金流動協作中，相對滯後的狀態和被動的地位。

6. 內地與香港基金業界加強合作、交流與競爭，將可幫助中國財富管理行業吸納及引進國際先進人材、技術和行業建設管理經驗，讓中國基金業更好地發揮其在社會財富管理、增值、再分配的作用，幫助中國建立完善的養老、退休社會保障體系，應付人口老化和社會分配不均等問題。

7. 透過提高競爭，開放海外投資管道，促進基金行業發展，兩地基金產品互認將推動中國資本市場發展，加速中國金融業從單一的銀行主導結構，邁向多元高效的直接/間接融資並舉的金融體系發展。

8. 基於兩地金融體系的差別，特別是中國資本帳相對封閉，以及人民幣在海外只能有限度流通的現狀，兩地基金產品互認可借鑒東盟 APSS 計畫所採用的「兩層準則」方法，以當前 QDII/QFII/RQFII 有限流動的框架作爲基礎，建立第一層雙方認可的「基本準則」，再在此基礎上各自建立第二層「專門準則」，以滿足兩地不同的監管要求。此舉可讓兩地基金在「基本準則」容許下簡化手續、加強跨境流動，亦讓監管機構有更多空間處理第二層「專門準則」的差別。

Chapter 1 Background

1.1 Cross-border distribution and operation of investment funds has been widely practised among major financial markets and is gaining increasing enthusiasm and support around Asia. This is normally facilitated by two levels of arrangements:

I. Mutual recognition of investment funds which deems funds approved by the home authority to be generally in compliance with regulations of the host jurisdiction. Such arrangements, either bilateral or multilateral, only streamline but not exempt the funds from the process of obtaining host authorization.

II. Passport arrangements which allow funds authorized by any member jurisdiction of the passport arrangement to have automatic entry to other member jurisdictions.

1.2 Europe is at the forefront of such development with its UCITS (Undertakings for Collective Investment in Transferrable Securities) framework established since 1985 to facilitate a single market for fund management services across the European Union. While UCITS takes almost two decades to gain traction, the framework has achieved remarkable success with rapid growth of UCITS compliant funds around Europe and increasing penetration across the globe, with over half of the UCITS funds now being raised outside of Europe. UCITS compliant funds now amounted to EUR6 trillion, or 75% of the European investment funds market. Asia accounts for about 20% of total AUM (Asset Under Management) in UCITS, mainly in Hong Kong, Taiwan and Singapore.

1.3 In Asia, other than some bilateral MRAs, two regional initiatives are under progress: the Asia Region Funds Passport (ARFP) scheme and the ASEAN and Plus Standards Scheme (APSS). ARFP is a multilateral effort initiated by Australia to duplicate the success of UCITS in Asia. It gained support of the APEC Finance Ministers' Forum (FFM) in 2010 and has held six policy and technical workshops by December 2012, with a plan to formulate a pilot scheme later this year among the more developed markets of Australia, Japan, Hong Kong, South Korea, Singapore, and Taiwan.

1.4 The ASEAN and Plus Standards Scheme (APSS) is an initiative developed under the ASEAN Capital Market Forum to facilitate cross-border securities offering among the 10 ASEAN member countries.[1] The Scheme comprises two sets of standards: a set of common ASEAN standards governing disclosures for plain equity/debt offerings based on IOSCO standards, and a set of Plus Standards prescribed by individual ASEAN member jurisdictions based on their specific requirements. Thailand, Malaysia and Singapore have implemented the scheme since 2009, while other members are to opt-in when they are ready.

1.5 While much work remains ahead, both schemes are expected to promote fund management services across the participant economies. But this could also raise pressure on the non-participating economies, especially relatively closed markets like mainland China, to catch up or risk putting their own investment fund industry at a disadvantage as regional integration progresses down the road.

1.6 Hong Kong is the most open regime in Asia in terms of recognizing and allowing the distribution of investment funds authorized by foreign authorities. It already has agreements to mutually recognize investment funds with Australia and Taiwan[2]. It also has a recognized jurisdiction scheme (RJS) that grants funds domiciled in jurisdictions under the RJS – including home jurisdictions of many of the UCITS funds - with streamlined approval process.[3] Although Hong Kong's MRA with Australia made since July

[1] ASEAN's 10 members are: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

[2] There are specific requirements/limitations in Hong Kong's bilateral mutual recognition arrangements. The one with Taiwan (signed in 2009) is limited to Exchange Traded Funds (ETFs), and the one with Australia (2008) excludes hedge funds and real estate investment trusts.

[3] Funds that are established in one of the RJS jurisdictions and are in compliance with similar regulatory requirements as those contemplated in Chapter 7 of the UT Code are deemed to have

2008 has achieved little due to tax and foreign holding impediments, Hong Kong's agreement with Taiwan (May 2009) to mutually recognize exchange traded funds (ETFs) for the purpose of cross listing and offering has made significant impact on both markets.

1.7 While there is no MRA between Mainland China and Hong Kong, cooperation among authorities of both jurisdictions has been facilitated by a number of MOUs (Memorandum of Understanding) and CEPA (Close Economic Partnership Arrangement). Currently, fund management institutions of one jurisdiction are allowed limited cross-border access to investor money and securities markets under the QDII (Qualified Domestic Institutional Investor), QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor) programs.

1.8 As of end-2012, four RQFII ETFs are launched, with a total AUM of Rmb44bn, plus another Rmb12bn managed under 19 unlisted RQFII public funds. Meanwhile, 207 institutions are authorized under the QFII program with a total quota of US$80 billion for investment in Mainland securities, primarily bonds. Conversely, 107 fund management institutions are qualified under the QDII program to invest a total US$85.6 billion outside the Mainland.[4]

1.9 Other than the QDII, QFII and RQFII programs that allowed limited cross-border portfolio investment flows, China has thus far no formal MRA with any overseas jurisdiction. It started to attend the ARFP in the latest policy and technical workshop held in Vietnam, represented by the Shanghai Financial Services Office.

complied in substance with the core investment restrictions, operational and structural requirements (e.g. meeting procedures for investors) imposed under the UT Code. However, the funds must still satisfy the SFC as to the eligibility of the fund manager, trustee/custodian, and that the disclosure and post-authorization obligations under the UT Code have been fulfilled. The list of RJS includes Australia, Taiwan, Malaysia, UK, US, Isle of Man, Guernsey, Jersey, France, Germany, Luxembourg, and Ireland. An updated list of the RJS is published on http://www.sfc.hk/web/EN/regulatoryfunctions/products/product-authorization/list-of-recognised-jurisdiction-schemes-and-inspection-regimes.html

[4] See http://www.csrc.gov.cn/pub/zjhpublic/G00306208/201301/t20130115_220438.htm, http://www.scmp.com/business/money/markets-investing/article/1132555/investors-wary-new-qdii-prospects.

Chapter 2 Benefits of a Mainland-Hong Kong bilateral MRA

Benefits for China

2.1 Three decades of reform and opening has brought huge progress to the Chinese economy, making it the second largest economy in the world and the largest official forex reserve holder worldwide. Yet, a largely-closed and under-developed financial sector has also become an increasing drag on the Chinese economy, especially in allocating capital efficiently to fund domestic growth and overseas expansion. Both the 12th Five Year Plan and the 18th National Party Congress have put great emphasis on the need and urgency to reform the financial system and open the capital account, including internationalization of the RMB.

2.2 Among the various areas of financial reform, development of the Chinese fund management industry is assuming an increasing importance in the policy agenda. With a rapidly ageing population and huge investment needs for industrialization and urbanization, China urgently needs an efficient fund management industry to better mobilize and allocate the country's US$15 trillion in bank deposits and US$4 trillion annual new savings, especially in the development of an effective social security and pension system to safeguard savings of the lower and middle income group and enhance wealth and income distribution.[5] A well-developed wealth management industry also plays an important role in strengthening

[5] At end-2012, there are over 1,100 CSRC-authorized funds, but institutional investors only account for 17.4% of the transaction in the Chinese stock market.

corporate governance of listed companies, and the establishment of a deep and efficient capital market to transform China's bank-dominant financial system.[6] An arrangement to mutually recognize investment funds between the Mainland and Hong Kong could benefit the Mainland in the following aspects:

I. **Promote China's fund management industry** by giving it access to additional pool of overseas savings via Hong Kong, and the experience to invest and operate in an open and highly international capital market in Hong Kong. Increased scale of economy and competition will allow Mainland fund managers reduce distribution and management costs, encourage innovation and drive for higher efficiency and lower fees. Direct access to offshore funds will also cut down intermediary charges and commissions. As of May 2012, Mainland-related companies have set up 168 financial institutions in Hong Kong, including 25 fund management houses with HK$265 billion AUM in 2011, up 13% from 2010.[7]

II. **Give Mainland investors more diversified access to overseas investment opportunities**, and provide them with better protection under a supervisory framework that aligns with international best practices and standards.

III. **Facilitate the Mainland authorities the learning and alignment with international supervisory standards and best practices**.

IV. **Open a new chapter of RMB internationalization and China's capital account liberation** by expanding cross-border flows to basically all classes of assets, especially equity and derivative products which are largely restricted now but could be the most important segments for the development of a deep and liquid RMB offshore capital market in the long run.

V. **Support China's 'going out' policy** by opening a new

[6] 中國證券報‧中證網（2012 年 12 月 2 日）。《第十一屆中國證券投資基金國際論壇：中國證監會基金部主任王林：加快推動境外資金入市》。

[7] HK Securities and Futures Commission, 'Fund Management Activities Survey 2011', July 2012, pp.5-6. See http://www.sfc.hk/web/doc/EN/speeches/public/surveys/12/fmas_201207.pdf

indirect/portfolio investment channel to access global investment opportunities through Hong Kong's open and international capital market. This is particular important as Mainland's Overseas Direct Investments (ODI) face mounting resistance from host country regulators, especially regarding the strategic intent of ODI made by state owned enterprises. While selected Mainland institutions have been increasingly active in making overseas portfolio investment, most of these institutions are government entities like sovereign wealth funds that also face resistance because of their state identity. If a much wider range of Mainland investment institutions, especially non-government entities, are given access to overseas investment channels via the Mainland-HK MRA, it would open a whole new venue for private capital in the Mainland to 'go out' and reduce the resistance of foreign hosts.

Benefits for Hong Kong

2.3 Hong Kong has been highly successful in establishing itself as a premier international financial center, especially in banking and equity business. However, as the Chinese economy grows in size and sophistication, much of Hong Kong's future development in international finance will depend on its success to capture the opportunities presented by the opening of China's capital account, in particular the internationalization of RMB. This requires the buildup of efficient financial infrastructure like clearing and trading systems, as well as competent regulatory framework and platforms, but also vibrant and competitive institutions, especially fund management companies. At end-2011, total fund management business amounted to HK$9 trillion in Hong Kong, including fund management, private banking, REIT, and advisory services in Hong Kong. Hong Kong is the second largest hub of private equity funds in Asia, and hosts the largest pool of hedge funds invested in Asia.[8] These provide a strong base for Hong Kong to benefit from a MRA of investment funds with the Mainland, especially in the following areas:

[8] Data from AsiaHedge and AVCJ according to the HKMA, 'Hong Kong: Asia's Premier Asset Management Centre, Opportunities for the Treasury Market', 8 May 2012.

I. **Access to the Mainland capital market.** While foreign direct investors have invested over US$500 billion in China over the past three decades, foreign access to the Chinese capital market is only limited to the US$80 billion and Rmb270 billion quotas offered respectively under the QFII and RQFII schemes. As of end-2012, a total of US$48 billion of the quotas were being invested (US$37.4 billion under QFII and Rmb67 billion under RQFII). The huge interest of global investors in Mainland investment opportunities can be seen from the large amount of China-bound private equity (PE), totalled US$270 billion at end-2010 and ranked first in Asia. Traditionally, Hong Kong acts as a major hub for global investors seeking access to the Mainland, as reflected by the fact that two-thirds of the funds in Hong Kong were from non-resident investors and about half of the funds were invested in China (including Hong Kong). While a Mainland-HK MRA initially may still subject to different restrictions (e.g. investment quota and/or product/market limits), it could ultimately offer much broader access of the Chinese capital market to Hong Kong investment institutions.

II. **Access to Mainland investors**. A MRA will give Hong Kong investment management institutions much wider access to the huge and rapidly growing financial wealth of Mainland investors. Some private institutes forecast that the number of high net worth individuals in Mainland and Hong Kong will almost double between 2010 and 2020 from 2 million to 3.7 million, while their wealth will more than triple from US$4.2 trillion to US$13.9 trillion.[9]

III. **Broaden and deepen the RMB offshore market, especially equity and derivatives**. While Hong Kong currently has a clear lead in the race of RMB offshore centre, much of the activities are confined to trade settlement and bond market transactions, such as Dim Sum bonds. Given the dominance of equity and derivative products in many Asian and mature capital

[9] Projections made by Deloitte and Oxford Economics according to the HKMA, 'Hong Kong: Asia's Premier Asset Management Centre, Opportunities for the Treasury Market', 8 May 2012.

markets, a MRA that facilitates cross-border flows of RMB equity and derivative products could greatly broaden and deepen Hong Kong's offshore RMB market. Given over HK$11 trillion of asset under management in Hong Kong and the Mainland (HK$9.04 trillion and RMB2.19 trillion respectively)[10], a 10% flow of these assets cross-border triggered by an MRA could mean a flow of HK$1 trillion, well bigger than the size of offshore RMB now deposited in Hong Kong.

IV. **Promote fund management and related industry.** Despite its being a lead fund management hub in Asia, with over US$1 trillion in capital under management, Hong Kong remains lagging far behind London and New York (see Table 1). Also, much of Hong Kong's fund management expertise are confined to sales and distribution, with only limited penetration into other high value-added services like core asset management and administration, custodian, research and audit. A MRA would present a strong incentive for fund management firms to boost their operations or relocate here, especially if they are required to domicile in Hong Kong and have sufficient scale to build their support and core activities. The impact on local fund management industry development could be several times bigger than that brought by the HK$300 billion-plus Mandatory Provident Fund (MPF).

Table 1: Fund management industry compared (US$ billion, 2010)

	Hong Kong	Singapore	UK	US
Asset under management (US$ trillion)	1.3	1.1	7.4	26.2
Domestically sourced	442	220	4,900	n.a.
Mutual funds	71	28	935	10,867
ETF	26	4	67	891
Hedge funds	63	53	343*	799*
PE/VC funds	63	10	173	400

* 2011 London/New York data

Source: HKMA

10 http://www.amac.org.cn/jjgssj/index.jhtml

Chapter 3 Risks

Risks for China

3.1 Every investment opportunity comes with risk, and it is no exception for the establishment of a MRA of investment funds between the Mainland and Hong Kong, but these risks are either necessary evils in the process of development, or more accurately, 'benefits in disguise' as long as they are well managed. Among the major risks are:

I. **Capital flight or hot money flows.** Widened channels of cross-border investment will naturally open holes for unfavorable money flows – commonly branded as capital flight or hot money. Yet, given the small scale of capital flows being allowed and to be expected in the near future, it is unlikely to present any major threat to the stability of China's financial system. More importantly, a MRA does not imply unconditional or automatic market access by foreign institutions. It still requires proper approval or authorization process by the host regulator, though in more streamlined form. Also, we expect the restrictions placed on mutual recognition to be relaxed only in gradual steps, allowing time and experience for regulators of both sides to learn and adapt to unforeseen challenges and risks. In the long run, large and long-term irregular cross-border capital movements can only be stopped by removing or correcting the distorted incentives behind. More open investment channels usually can help to expose such irregular flows and their underlining factors behind.

II. **Investor protection.** Doubtless that protecting investor interest within a confined domestic environment is theoretically easier than across jurisdictions. But a MRA that facilitates exchange and learning of regulatory best practices and more developed international standards can actually improve investor protection in the long run, both for local and overseas investors. Again, this requires careful design and adaptation of prudential regulations by both regulators.

III. **Erosion of supervisory authority.** To the extent that a MRA only facilitates but not exempt foreign funds and fund management institutions from seeking approval and authorization from the host regulator, there should be no erosion of the authority of host regulator. What could make a difference is when the recognition agreement is upgraded to a passport arrangement that offers automatic approval and market access to foreign institutions. However, this next development is likely to be many years away and will only materialize when all member regulators of the passport arrangement are comfortable enough about the approval standards and practices of other members.

Risks for Hong Kong

3.2 In below may be some of the risks for Hong Kong:

I. **Market volatility.** Increased flows naturally come with the possibility of higher market volatility. However, a deeper and more liquid market can also dilute the impact of any move by incidental investors. In any case, there should be sufficient tools like daily price limits and improved disclosures to prevent extreme market movements.

II. **Quality control and investor protection.** Concern about the management standards and professionalism of Mainland institutions is not uncommon. In fact, it is typical for most emerging markets. This can be addressed by tightening disclosure and audit requirements.

Experiences learnt from the QDII/QFII programs should help in this aspect.

III. **Supervisory autonomy.** Again, mutual recognition is different from unconditional authorization of foreign institutions. While closer cooperation between the two regulators is necessary, autonomy of either authority should not be affected.

Chapter 4 Issues and suggestions

4.1 It is encouraging that there appears growing momentum in the negotiation of a MRA between the Mainland and Hong Kong. This also brings forth the issues that need to be addressed in the agreement and their possible impacts. Such are no easy tasks. The way that these issues are addressed will affect the outcome and the steps that may or need to follow.

I. A common regulatory framework: regulators of both jurisdictions need to agree on a common set of regulatory framework for funds that qualify for mutual recognition and distribution across border. Such common framework may not be identical to their domestic rules but need to provide a level of protection to investors acceptable to both regulatory regimes.

II. The common framework should cover such issues like:

- **Eligible asset classes.** Ideally, the arrangement should cover all different asset classes, but it is likely to be a long-term target rather than an initial arrangement. Based on the QDII/QFII programs, the MRA should expand coverage to a wider array of bond and equity products, plus limited use of derivatives. This could then be gradually relaxed to include other asset classes.

- **Custodian arrangements.** Focus should be on the quality of custodian institutions and arrangements to ensure safeguard of investor interest.

- **Offer document conditions**, including information regarding investment strategy, performance, collateral policy, risk management, conflict of interest and other disclosures.

- **Registration requirements for investment funds**: including documentation and disclosure, diversification, leverage, outsourcing, use of derivatives, currency denomination, types of investment funds.

- **Licensing requirements for fund promoters, distributors and managers**, and include such criteria like capital requirements, financial return and reporting, resident responsible officers, foreign/local ownership.

- **Use of leverage and derivatives**

- **Liquidity requirements**

- **Investor protection**

- **Dispute resolution**

III. Other issues that need to be considered by authorities of both jurisdictions include:

- **Capital flow management.** This is especially important given China's relatively closed capital account. It is critical for preventing erratic capital flows from undermining smooth development of the RMB offshore market.

- **Tax considerations for investment fund investors, fund managers, distributors and other related parties**. Including income tax, capital gain tax, withholding tax, access to double taxation arrangements. Hong Kong has a relatively simple and liberal tax regime, including zero withholding tax on dividends, no estate duty, no capital gain tax on sale of private company shares, no profits tax on specific Hong Kong transactions of offshore funds. It also has signed double taxation agreements with 17 countries (as of end-2011). In contrast, the Mainland has a more restrictive tax structure and weak enforcement. A level playing field is needed to reduce regulatory arbitrage.

- **Protection and development of local fund management and related industries**. This will affect decisions on domicile requirements, outsourcing restrictions, and foreign/local ownership requirements.

- **Broader strategic issues regarding financial sector development in both local and regional context**, such as the impact on Mainland's domestic financial reform and China's position in regional and global fund management and other financial platforms like the ARFP.

IV. Given substantial differences between Hong Kong and the Mainland in terms of their existing fund management industry and regulatory regime, but the pressing need and large benefits to have a bilateral MRA between the two jurisdictions, we suggest regulators to consider using the APSS approach to ease and expedite the process by splitting the MRA requirements into two layers: a layer of 'common' standards that forms the basic requirements acceptable to both sides; and a layer of 'additional' standards that outlines remaining jurisdiction-specific requirements. This can help negotiators focus on a minimum set of common standards and leave the more thorny specific issues to a later stage, allowing a basic MRA to be agreed in a shorter period. This approach may allow authorities more time to reconcile differences and test solutions. This bilateral MRA, most likely the Mainland's first in this area, not only will reinforce the momentum built on RMB internationalization, but will also boost Hong Kong and the Mainland's position in the establishment of broader multilateral platforms like ARFP.