



# Opalesque Roundtable Series '16

# CHINA

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# Editor's Note

Among China's strategical focus in the 21st century are the built out of financial services and big data (TMT). The opening of the Chinese private securities funds sector has already started, and allows different styles of fund management using liquid instruments such as stocks, bonds and commodities. Apart from the RMB 8 trillion mutual funds industry, a strong RMB 1.8 trillion private funds industry has grown to now about 20,000 private securities funds. An estimated **15% of those follow a typical hedge fund, quant or CTA investment style**. The broader 80% of private funds are still long only.

Insiders see this opening up of the private security licenses as very encouraging, and expect **other sectors like investment consultancy and risk management consultancy will benefit from a further potential opening as well**. 300 major banks, insurance and financial companies are operating from Pudong alone. Considering the potential size of the countries' different markets, the opportunities are simply humongous.

## Shanghai Hedge Fund Park: The astounding success many other Chinese provinces aim to copy

The launch of the Shanghai Hedge Fund Park was an astounding success and a mark of legalization of the hedge fund industry (see page 15 and following). Financial services veteran Kenny Li, who was involved in helping the Shanghai Government setting up the first hedge fund park in the Hongkou District of Shanghai, says he has been approached by **four different provinces** to become a hedge fund development zone consultant. The officials understand hedge funds can grow AUM quickly in China, and that it is relatively inexpensive to give incentives to support them.

The inaugural Opalesque China Roundtable was sponsored by Eurex and WTS and took place end of 2016 in Shanghai with:

1. Martin Ng, [WTS](#)
2. Sophia Sung, [Eurex](#)
3. Dr. Martin Lockstrom, [QuantCore Capital Management](#)
4. Kenny Li, [Quattro Quant](#)
5. Sun Suzhi, [CITIC Futures](#)
6. Robert Welzel, [WTS](#)

The group also discussed:

- How leverage burst the China bubble (page 9 and following)
- How many trillion RMB of bad leverage are in the Chinese system? (page 9)
- Where regulations may be heading in China? (page 8 and following)
- Why the Chinese PE market is a lot more mature than what many think (page 18)
- How FinTech can change the wealth management landscape in China in a way that most other countries can never imagine (page 20)
- Tax: What you should know about certain high-risk areas in China (page 20)
- Why the Shanghai Futures Exchange, the Dalian Futures Exchange and the Zhengzhou Futures Exchange have been experiencing significant increases in trading volumes (page 4)
- What is the first international exchange JV the Chinese have entered, and where is that based? (page 10)
- How have Chinese funds dealt with the volatility and market interruptions during the summer 2015 (page 11)?
- How can foreign managers set their foot into China (page 13 and following)?
- Update on Shanghai and other Chinese hedge fund parks (page 15 and following)
- Will there be a London-Hong Kong stock connect? (page 8)

Enjoy!

Matthias Knab  
Knab@Opalesque.com

# Participant Profiles



(LEFT TO RIGHT)

Sun Suzhi, Dr. Martin Lockstrom, Kenny Li, Sophia Sung, Martin Ng, Robert Welzel, Matthias Knab.

Cover photo: The View From the Bund - Shanghai, China  
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# Introduction

**Sophia Sung**  
Eurex

I represent Eurex, the international derivatives exchange of Deutsche Boerse Group, which is headquartered in Frankfurt, Germany. Our team, Business Development Asia and Middle East Team, focuses on market development and product introductions in Asia. I cover both buy side and sell side clients within the Greater China region, sharing and promoting Eurex and our group initiatives in Asia. Our team also maintains multiple cooperation projects with regional exchange partners – such as the Eurex/KRX Link and the Eurex/TAIFEX Link implemented in 2010 and 2014 respectively – to give Eurex participants direct access to two of the most liquid Asian contracts in the world.

Prior to joining Eurex, I was with the UHNW wealth management team at UBS Hong Kong and subsequently with the prime brokerage capital introduction team at Credit Suisse Hong Kong. As a result of my previous experience, my personal connections to the buy-side segment are valuable, as currently Deutsche Boerse is also actively engaging the buy side community across Asia.

**Kenny Li**  
Quattro Quant

I am Kenny Li, CEO of Quattro Quant, a Sino-Foreign joint venture company with a China FOF management firm that oversees RMB 2billion in AUM. Prior to Quattro Quant, I came to China and started up my own firm KKM Capital and was involved in helping the Shanghai Government setting up the first hedge fund park in HongKou District of Shanghai, making us a pioneer and well-known figures in the markets. I have also worked in investment banking for almost 20 years for JPMorgan, Credit Suisse and Barclays, where I ran the equity derivatives and convertibles units, primarily from Hong Kong, specializing in the Asian Pacific markets.

Quattro Quant is a financial consultant to China FOF portfolio construction. We are also building a Roboadvisor APP to cater for retail investors to select funds and FOF's.

We invest in China hedge funds and mutual funds for our funds of funds portfolios. We have devised a scientific fund investment selection for China and work closely with institutions for their need of scientific ranking & rating systems. There is no such ranking for mutual funds or private securities fund (defined as privately raised securities fund) in China at present.

And besides that, we are attempting to help foreign management firms to localize and build their China business under a partnership program.

**Sun Suzhi**  
CITIC Futures

CITIC Futures is basically a 100% owned subsidiary of CITIC Securities. It is ranked number one by trading volume and also by margin deposits in China. CITIC Futures focuses on institutional clients, especially the professional investors such as the quantitative traders or firms, and also on end clients, for example from the commodities industries. CITIC Futures has also recently launched a quant trading system. It is ranked number one by volume and is regarded as the best quant trading system in the market. However, the futures volumes have dropped significantly after the regulations were put in place by CSRC.

What's so good about this system is the fact that aside from equity futures, it also caters for commodity exchanges such as the Shanghai Futures Exchange, the Dalian Futures Exchange and also the Zhengzhou Futures Exchange. These are the three main commodity exchanges. And it also should be noted the fact that there has been a great shift into these markets since the regulations on the equity futures has been in place. This is why I believe the system is going to be pretty useful especially to professional investors, such as the quant funds.

Probably at some point in 2016, I reckon that most of the trading restrictions would be lifted and CITIC Futures will re-establish substantial trading volume again.

**Robert Welzel**  
WTS

My name is Robert Welzel, I am a qualified German lawyer and a tax adviser focusing on tax and regulatory issues relating to the financial services industry since 25 years. I am representing WTS, a tax, legal and consulting firm based in Germany. WTS started in 2000 with six colleagues. We now grew in Germany alone to more than 500 colleagues. In Germany and other European jurisdictions, we have experienced teams advising the asset management industry covering a broad range of tax, regulatory and legal topics. My team advises numerous hedge funds and other alternative investment funds (AIFs) and mutual funds with regard to German and European tax and regulatory structuring and compliance issues.

WTS also assists international fund managers or other financial intermediaries in approaching the German and European market, especially with regard to institutional and regulated investors such as insurance companies and pension funds. This consulting approach is the reason why WTS is employing financial services teams in Asia - Hong Kong and Shanghai. My colleague, Martin Ng, will further talk about this topic in addition, too. Furthermore, WTS assists institutional German and European clients in investing in Asian domiciled private equity or hedge funds.

**Dr. Martin Lockstrom**  
QuantCore Capital Management

I'm Dr. Martin Lockstrom. I'm originally from Sweden, but I have been in China for nine years in total. I have my roots in the academic world, actually. I have a PhD in Operations Research and at some point I have started to put my statistics and software development knowledge to better use than writing academic papers that few people would read anyway. So I set off on a journey and started up QuantCore Capital Management which is a registered investment adviser based out of the US targeting a large client base from retail investors to high net worth individuals, family offices and to an increasing extent, also institutional investors.

So we're fairly young and a small company, but I think we have done a lot of interesting stuff so far and can offer a quite interesting performance, to say the least.

Here in China we cooperate with various asset managers as financial consultant. So here we develop trading systems on their behalf that they are operating, and also implement systems on their existing platforms. In a way, in China we have moved one step backward in the value chain because we don't pool any capital ourselves.

So our core competency is the development and management of fully automated quantitative trading systems. That's really the core of our business. The reason why I'm in China is not really because of the business per se. I just happened to have been here for a long time, so nowadays I call China home. When people ask, "How long you are going to stay?", I really can't say... For me, it's in a way also a fortunate coincidence to have the pleasure and joy of being based in Shanghai and experience the ups but also the downs of the market having an onshore China perspective. I am sure we will talk about risks in the market or on the regulatory side later on. China is a very exciting environment.

Our trading is 100% quantitative. We are actually quite agnostic what we invest in as long as we can generate returns. What can hinder are things like legal or regulatory barriers that sometimes exist as barriers of entry. In US markets we have primarily traded futures and in recent times also equities. We currently also operate long-short equity strategies for the S&P 500 Index components. To be more precise, we have one strategy which trades ETFs, it's a very simple strategy in that sense, and then we have the long-short equity strategy which trades each and every of the individual S&P 500 components. These are like two ends of the spectrum, so to say. This means our long-short equity strategy has basically one model per index component, that's 500 models working in parallel.

From a conceptual point of view, our systems are designed in order to operate perpetually without human intervention to the lowest extent possible, we just have the on switch. Well, of course, there are circuit breakers and we can interrupt things and so forth. We also sometimes fine-tune and tweak the systems, but by and large they are designed to operate indefinitely. That's one of the design principles that we apply in every strategy basically.

In terms of holding period, we don't do high frequency trading according to my definition, which is when you go sub-second in your trading frequencies. I would say we do more medium to low frequency trading. So it can be anywhere from one minute and up.

Our S&P 500 long-short equity strategy actually makes a trading decision once per day. So the system goes through all 500 S&P components and makes a decision whether it be long-short or stay on the sideline. For the futures strategy, we tend to have a shorter holding period and typically don't hold any overnight position in order to avoid the overnight risk. Our trade frequency in this strategy can be anywhere from zero – on some days we don't do any trades – to 10 to 20 trades per instrument. We always try to take both long and short positions in order to benefit from market direction regardless of whether markets move up or down. Our overall goal is to generate long term steady returns.

**Martin Ng**  
WTS

This is Martin Ng. Maybe a little more information about WTS as my colleague, Robert, just explained. He's from Germany and I'm from Hong Kong but we have a very strong German blood because the core team of WTS used to be part of Siemens. Globally we were carved out from Siemens and became independent, and that's the origin of WTS.

WTS China has a history of 10 years. Today WTS covers over 100 counties. This has been achieved in the last decade while it took the Big Four accounting firms a century to achieve that. WTS does almost similar jobs of what the Big Four is doing except that we don't do audit.

So in general, we do tax consulting and finance consulting business except audit. In China, WTS does not serve in legal areas but in any other parts of the world especially in Germany, we do have legal practice.

Many of us are from Big Four accounting firms and renowned companies. Personally, I retired from KPMG before joining WTS. I have my whole career all in tax consultancy for 26 years. WTS is serving not only finance sectors but many others, of course, including manufacturing, high-tech, venture capital, banking, and insurance, et cetera.

Among others, I served venture capitalists, JPMorgan, Carlyle Group and HSBC, etc. in China in the tax / finance consultancy area. On the project level, we help them to handle tax issues, negotiate for preferential tax treatment or refund or set up cash pooling, etc.

And maybe a thought for our discussions as well: the Chinese government is promoting aggressively some special zones, especially Shanghai pilot free-trade zone and Qianhai zone targeting at the financial sector in particular. Investors should study carefully how they are doing in opening up any opportunity.

For example, we help one group in setting up cross-border RMB cash-pooling in Shanghai, involving China and a number of Asian and European countries. That's what we consider quite a pioneer, but I'm more anxious to see how this is replicated across the country.

# 70

percent of the world's surface is covered by water.



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Sun said an interesting point about the regulation, that hopefully during 2016 at some point all will be back to normal trading. Could you please share with us more insights where regulations may be heading in China?

**Sun Suzhi:** First of all, I want to express that the following are my personal views that are based on my own personal observations.

Obviously, what's been happening to the stock market together with the mark of regulations has been pretty unpredictable. Also, the crash of the stock markets in China during the summer 2015 has been a relatively large one, its impact has been bigger than the 2008's crash.

The recent news flow has also been pretty severe. There was an incident involving one of the biggest and best performing private funds, Zexi, that reported returns of like 200% to 300% per year. The chairman of the company has actually been taken into custody and questioned. I think we now have to analyze how the cat is catching the mouse, with the mouse being the guys who haven't really obeyed the regulations, and that may include some of the larger financial institutions and major security houses as well.

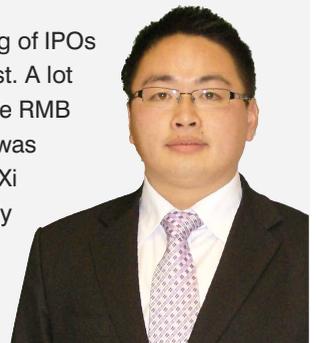
Chairman Xi Jinping has formed new groups to restructure the economy in order to foster more stability and further growth. Also the inclusion of the RMB into the Special Drawing Rights are welcomed and are a major signal for the ongoing RMB Internationalization. I believe that the opening of the economy should be a non-stop process from hereon.

Going back to the crash for a moment, there have been a lot of opposing views in the West about how the risk is being managed in China. But since this was such a big shock to the system, I believe that the authorities here are doing everything they can and in a way that they think is right to stabilize the market.

**What people need to realize now is the fact that the investor base in China is a lot different now to what it was just a few years ago.** One major development has been around the extent how private bank and wealth management products are now participating in the equity markets. Another major impact is coming from the leaders or the main shareholders of listed entities who are using financing to potentially participate in the market as well, or they use their shares to borrow money for other projects.

So in a relatively loose regulatory environment it is further questionable how much bank leverage is actually in the system, which can cause systemic risk. This is an aspect that both international markets and investors but also the domestic markets need to realize, there has been a huge structural change in the investor base.

I expect the cleanup that is happening now in China after the crash to be very positive. The re-opening of IPOs was a fairly positive step, and looking ahead, the further internationalization of RMB is definitely a must. A lot more asset classes that are opening up, and we will also see a large number of new directives. So, the RMB bond market will be opened up to international investors. The International Energy Exchange Center was supposed to open in 2015, but it should certainly open in 2016. I am also very positive that chairman Xi Jinping is also going to open up the London-Hong Kong connect. So from my perspective, I certainly feel that the RMB Internationalization is on track and that will basically be a good signal for the further opening of the financial markets.



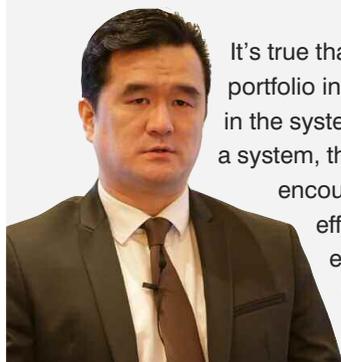
**Kenny Li:** Mr. Su mentioned a very important point that the structure of the Chinese investor base has changed substantially over the last two to three years because share financing has grown so much. Major shareholders of listed companies have done a lot of share financing to obtain loans, and there is also a lot of leverage in private bank wealth products and private funds.

**The private funds market is probably at 1.6 trillion RMB, and easily around 30% of the total AUM is through leverage.** The more mature funds can probably finance themselves through their fees, but **all of the newer funds – over the last 1.5 years or so about 10,000-20,000 new funds were formed – and the way they launched was typically by putting down an equity tranche and then leverage through bank funding in order to reach a decent AUM to kick off.**

Nobody wants to start with AUM of RMB10 million, but in order to build track record with a higher AUM, managers can put down RMB10 million as the first loss for the fund and obtain a loan of RMB30 million to leverage up AUM. With the manager taking a large first loss, banks get decent good principal protection for their loans. This type of leverage for new private securities fund managers is quite substantial, probably in the areas of RMB300-400 billion.

**But apart from that, the amount of the unregulated financial leverage is so big that you probably won't even believe me.** This is the leverage in the accounts of basically hundreds of thousands of investors who are on a certain segregated management account system or umbrella structure like the Hang Seng Trading System. There, one main account can hold like thousands of accounts and what investors tend to do was borrowing money to put the initial margin into the account. That in turn gets leveraged by the security houses. This means the **total leverage could be something like 10 times or 15 or 20 times. That excess leverage has been the major cause of the crash.** People here are in a way sentimental or accessible to what the Government says, and in a way the Government did encourage them by signaling that the stock market should be good, Chinese stocks are underrepresented globally, and hopefully, everyone can make money from it.

But the problem is that a lot of retail speculators in China just don't go in and invest in a logical or prudent way. They may leverage 5-10 times to trade stocks during the bull market period.



It's true that China is the second biggest economy, but global funds only hold on average about 2% of their portfolio in Chinese stocks. So while there is a lot of room to grow, but the way the investors were leveraging in the system was just too big. When the Government identified that there was a lot of unregulated leverage in a system, they decided to put a stop to it. That was probably around May 2015. They said, "Look, we do not encourage this, this is illegal, it's the wrong thing to do." But when you have that knock-on domino effect, and then when you have banks who have potentially financed the leverage.... so that knock-on effect was huge and it affected these kind of segregated accounts, which then affected private funds and in turn all shareholders who have the shares under financing.

**Matthias Knab**

So is this de-leveraging completed or is it still going on? Or are there still big risks in the system?

**Kenny Li:** Through sources and our calculations, we estimated **there's probably about four trillion RMB of bad leverage in the system.** Even after the 1.5 trillion RMB central bank intervention in July 2015, we felt there is roughly 1 trillion of bad leverage that is still in the system. Hence, even after the Government intervened, we felt that the market is still somewhat fragile and the only way that could have actually prevented another leg down was hopefully a vast improvement in confidence.

The intervention was not exactly smooth as government initially bought only big cap stocks, and neglected the fact that most retail investors were stuck with small caps. Government had later intervened the small cap market by investing through mutual funds and intervened in the futures market to stabilize the entire market.

The second leg down in 2015 was due to poor international market sentiment, and government was also blaming what they called malicious short-selling that was driving markets down in an already fairly weak environment.

The market was still vulnerable. You can argue that there was some malicious selling, especially high frequency traders who were order spoofing, but a lot of people doubted that was the major contributor in driving the market the second leg down. The whole market was very weak, and Government spending about 1.4 to 1.6 trillion RMB wasn't enough to stem the entire issue. The initial rebound was good, but then the leg down caught the government and a lot of retail investors by surprise.

So what the government and regulators imposed were more restrictions that was literally freezing the market, causing a huge decrease in liquidity. In light of what we know and what we have discussed here as well about the changes in the investor structure, the number of new accounts and the ginormous leverage in the system, I can't say whether that decision to freeze the market was bad or good. But by stopping all liquidity is not a healthy sign. What initially was a liquidity crisis then became more a confidence crisis in the second leg. To be fair, it's always easy to criticize any government interventions.

Hong Kong intervened during the Asian Crisis, and everyone was against it, but considering what options are left on the table, it was probably a right thing to do in hindsight. It is hard to understand the structure of the China stock markets, the freezing of the market liquidity is shocking but as long as the market is somewhat stable, it would only seem the market can recover over time. There is no clear cut right or wrong in the new regulation decisions.

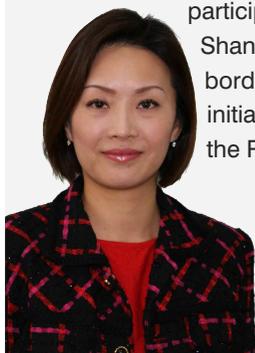
But I believe China is on a right track for recovery. Based on a lot of conversations I have with people in the market now, I believe the tail risk is actually decreasing. Although quite a bumpy road ahead, but there could even be some decent performance to follow in the later part of 2016.



**Sophia Sung:** From an exchange perspective, the recent increase of market volatility has driven investors to look for alternative hedging instruments. Since 2009, Eurex has established its presence in Asia, with offices in Hong Kong, Singapore and Japan. Since then, we have entered into solid cooperation with other regional exchanges; these have all deepened our commitment to jointly develop the Asian markets with our partners.

Recently, Deutsche Boerse announced the establishment of a joint venture with our Chinese partners, the China Financial Futures Exchange and the Shanghai Stock Exchange. This new joint venture, the China Europe International Exchange or CEINEX, was officially established on 18 November 2015 in Frankfurt to offer international investors investment products based on Chinese underlyings. Initial product focus will be on cash market products, including China A-share ETFs, money market ETFs, depository receipts and RMB-denominated bonds. Product development and offerings of Chinese derivatives will be considered at a later stage.

We see strong interest coming from large Chinese brokers and asset managers as well as European investors to trade China-related products on offshore platforms. China has been gradually opening up and allowing overseas investors to participate in its financial markets through certain investment channels, such as the QFII/RQFII schemes and the Shanghai-Hong Kong Stock Connect. Investors, however, have been consistently looking for more cross-border trading opportunities in different asset classes to diversify and hedge their exposure to China. This joint initiative, CEINEX, is expected to offer distribution of offshore RMB products, and more importantly, to support the RMB in becoming one of the international investment currencies.



Therefore, given the size of its economy and growth rates, China continues to provide major opportunities to the international investment community. In my view, the recent market volatility helped the Chinese financial markets accelerate its reform to a more solid market infrastructure.

**Dr. Martin Lockstrom:** My take is obviously more from a trader's point of view. Well, if you would have asked me six months ago, I would have said, it's wonderful, the markets were still climbing. If you would have asked me three months ago, when markets were in free fall, I would have said I love the market here. Now, I would say it's miserable and it's not so much to do with the market itself but with the tightened regulations basically.

So many of those strategies that we have been operating, especially in futures, are impossible to operate currently. First of all because margin requirements had been increased to like 41% right now for the index futures, and they have increased the minimum brokerage commission as well. But this of course affects you more if you do intraday trading. If you have longer holding periods, you're not exposed to that, but as explained, this is primarily not how we trade futures. Therefore, we currently cannot operate most of our strategies, also because the transaction cost would be astronomical.

So if you ask me, I think **the biggest risk is not in the market itself but in the regulatory environment** simply. To be precise, we can't even call it risk, rather uncertainty. When I talk about risk, that's typically something that you can assess. You can quantify it, you can manage it, you can develop tactics and strategies to cope with it, but with uncertainty, you have no clue what's going to happen. A lot of those regulations that have been implemented have just happened over night.

So in autumn 2015 I could come to the office in the morning and my colleague told me, "Hey, now they have increased this or that margin of requirement, so today, we cannot trade, let's see what the situation is like tomorrow." That was happening over-and-over again.

From a market point of view, I would say it's wonderful. I heard it over-and-over again, people telling me, "Well, you know, China is different", and my standard reply is always, "I know, and that's why I like it: because it is different." Markets here are less efficient than in the western economies and "developed" securities markets. So there are fantastic trading opportunities here, no doubt about it.

Looking forward, I believe everyone is pretty much in a wait-and-hold mode, waiting for regulators to revert to the previous long-term development path which I think was very positive with the liberalization of markets, the internationalization of the RMB and all these kind of things, so I think it's a pity it has come to a still-stand. I mean, the CSI 300 index futures contract was at its peak one of the most widely traded futures contracts in the world actually, with a fantastic trading volume.

So I think the Government may have essentially shot themselves in the foot. First of all, by stoking the market in the first place; secondly, by trying to prop-up the market when it was falling, and when that didn't work either, it eventually becomes a credibility problem when investors see that Government interventions have no effect. And tightening the regulation as well, which was the third step, essentially strangled the market.

We could see in the past that also other authorities, other regulators and other markets have taken similar steps. You could see that France and I believe Germany as well were at times prohibiting short selling and so on and so forth. There is always this kind of scapegoating, trying to pinpoint someone or something. You can see it in the US, in every market, often the short sellers are victimized. But what happens, and we have seen it before, is that you get rid of the speculators. There is sometimes the view that if you post liquidity, then you are a benevolent market actor, so to say. If you take liquidity, you are sort of a bad guy. If you go long and you have a positive view on the future, you are a good guy. If you are a pessimist, you are a bad guy.

Most people have a long-term interest in seeing markets go up, so to say. A few benefit. It's like shadow fighting basically. Like these Russian traders, two Russian guys who made astronomic profits here in Chinese markets. They did it in an illegal or semi legal ways, so to say. They were setting up like 31 futures trading accounts and using high frequency trading strategies.



But I haven't seen any facts on the table whether those strategies per se were illegal, but they probably did this kind of flipping strategy like this Indian guy in London did who later got accused of causing the flash crash in 2010.

I believe there is a very well-known German guy as well; his name is Paul Rotter who back I think in 1990 did something similar, no one has ever complained about him, but in trading circles he is hailed as a hero basically for his fantastic returns.

So these guys are always allowed to operate, and nobody complains, as long as everyone else is also making money from the market. But as soon as the market is starting to go down and a lot of people are starting to lose money, everyone gets upset. People then always start trying to find such kinds of scapegoats.

To put a long story short, the futures market was initially created for hedging purposes, but we should not forget that the speculators in the market are equally important in order to provide liquidity and make sure that the markets are operating smoothly, that there is enough liquidity in the market. Now the liquidity is not there, the trading volumes have gone down dramatically and are only a tiny fraction, a few percent of what it used to be. You no longer have a functioning market.

It's important to realize that **when trading volumes go down, it's also easier to manipulate the price**, even accidentally. You're trying to do one thing, but you get the opposite effect. That's a big pity, because the Chinese trading markets were on such a good development in the past. Back in July 2015 there were discussions about including the Shanghai Stock Index into the MSCI World Index, which eventually didn't happen. I think in retrospect I think they are happy that they didn't include it, but they were on the verge of really stepping up and becoming a truly global marketplace.

So my fear is that with what has happened over this summer that China has essentially moved back a few years in time. I think by now the markets have recovered decently. It looks like the market has found a bottom, or let me put it this way, I do think that this summer's low was the lowest low that we will see in the foreseeable future. It's a plausible scenario that at some point we may see a decline back to that lowest low that we had seen during the autumn, but I don't think that markets would fall much further than that.

The greater challenge is the retail character of the Chinese investor base, more institutional investors are needed. As often in retail driven markets, you can see a certain herd mentality – for example, if you walk around anywhere in the neighborhood, outside of the Lujiazui financial district, you see these **small mom and pop brokerages**, where the aunties and uncles sit on plastic chairs and play with their pension savings basically.

Some of these people will have already burnt their fingers in the past, in the last global financial crisis. And, if history repeats itself, when there is such a sharp decline after a historic peak, it often levels out, and the markets can remain pretty much flat. Often people go from a panic mode to accepting the loss, but many are not going to touch the stock market for years.

Therefore, in my view I believe it's highly likely that we will see a repetition of what we saw after the global financial crisis in 2009. Hopefully, there will be a stronger linkage between the real economy and the financial market at some point. When the Chinese economy was doing pretty well, 10 plus percent GDP growth per year, so around the global financial crisis and also in the years right after as well, not much happened in the stock market in those years of 2010, 2011 and so on.

And then suddenly, when the GDP growth declined and China shifted toward a more consumption-, service-, and innovation-driven economy, suddenly stocks started to take off. So much of what's happening is actually market psychology. Overall, there is a strong need to allocate capital in the markets more professionally.

From a long-term perspective, I believe the vision, the willingness and also the awareness is here. Nobody is talking about deluding anyone or anything like that, everyone here in China is very aware about the path they are taking. The events of 2015 were simply an overreaction by everyone, from grassroots level basically to the top. Also, hopefully in 2016 we will see some positive news again so that capital can find its way back into the market here.

**Robert Welzel:** Every market downturn may provide for new or enhanced opportunities to trace good and solid investments at bargain prices. There may be attractive opportunities for international institutional investors to invest into these markets.

We learned and it had been already mentioned that in order to increase market liquidity, you have to attract more institutional investors. But institutional investors will not establish their investment decisions only upon performance, they intend to evaluate and get to be confident with further additional requirements such as investor reporting, compliance, operations, governance, etc.



We recognize the Chinese government favors Chinese asset managers to prepare for further internationalization. The current price levels might help to attract more institutional investors to evaluate a direct investment into Chinese equity and debt markets. Probably within a midterm timing perspective, additional interest and investments could be increased. However, as already mentioned, other relevant prerequisites to satisfy foreign institutional investors have to be taken into account, too. With an upgrading of the Chinese asset management industry, more institutional investors are more likely to invest, providing additional liquidity and hence add further stability to the markets.

**Kenny Li:** We as a firm are a big believer to introduce foreign expertise to professionalize the domestic hedge fund management industry, especially on quant funds, Quant is the global trend. There is a real need for quant and automation technologies in China.

Most importantly, how do you bring international money to China? One key goal is the international regulatory standards China will have to adopt in the future. There has already been talks that the AMAC registration in China will be on par with HK's SFC registration in a few years.

I see Hong Kong regulator already putting in efforts to encourage cross-border amalgamation of all of the regulators. It's more like a "one world regulation" kind of idea.

I think in the case of Hong Kong, US and UK, and Japan, any bad practice can be caught and be reinforced, because the regulators are connected. It will be at least several years China regulations to catch up. This is the major barrier for international money investment in China private securities funds.

QFII, cross-connect, are the only channels for investments in China stocks and bonds. With further opening to what foreign institutions can buy in the future, there will also be good demand for local experienced managers with expertise in CSI 500, ChiNext and even the New Third Board for more diversified and perhaps more lucrative returns. I think sub-advisory is a growing trend to leverage the expertise of local managers, for it will be years before international institutions would be able to invest directly into private securities funds. We have had good success in recommending QFII sub-advisors to foreign investors. As a fund of funds manager, we are open to provide international investors our fund analytics and due diligence on Chinese managers.

When China opens the door for alternatives to foreign investors, then that sub-advisory role could expand into derivatives.

We plan to bring in international quant and hedge fund experts to fill the gap of managing foreign institutional money for alternatives in the future. International investors are more likely to invest in products that are managed by fund management firms that have already built a previous track record with them.

We have a plan to partner with foreign hedge fund as sub-advisors on the ground in China. We help to localize these hedge funds to capture a piece of the China market. At present, we work with a few quant funds as we can advise on the fine tuning of their strategies to work in China.



We are very focused to build a platform to localize international expertise as QuattroQuant key members have extensive international fund management and banking experience, but at the same time we have spent a great deal of time to understand the local markets.

We have seen a lot of Chinese hedge fund managers returning China and built successful hedge funds over the past 2 years.

But like what Martin said about the regulations, I agree that this is a huge risk or uncertainty. Funnily enough at a conference panel, Robert Lloyd George was sitting next to me, he said China is a wild market, but even when US first started it was pretty wild, wild west as well. Give it enough time, China will develop and progress over the course of time.

The Chinese stock market is still quite young. The pace of development has been so rapid, therefore a bumpy road is always expected. There has been a lot of news about foreign managers being banned from trading, like the case of Quanstellation, the firm Martin Lockstrom talked about which was mainly run by two Russians. They made RMB 2 billion within two years from an original principal of RMB 9 million. I heard it was high frequency spoof orders that created the profits during the market crash that generated most of the gains. It did raise huge concerns of the regulators and a series of legal actions followed. I think it is understandable how the Chinese regulators reacted to try to protect the stability of the market. And, the China market structure is far more complex for anyone to hold grasp of.

**Matthias Knab**

Can you tell us more about the set up of Chinese private funds?

**Kenny Li:** China Private Securities funds all go through security houses or banks as a custodian. Theoretically, the money cannot be touched by the managers; but can only be advised on. So the money always stays in a closed system. If anything goes wrong, it's also easy for the regulators to track.



So basically having a state-owned securities house or bank as custodian offers a sovereign level of protection. If the securities houses go bust, what happens to the asset custodian? Don't worry, the government will have to bail out as it involves the money of hundreds of thousands of people. So in effect, these are pretty safe structures. Regulations and operation of these private securities funds will be assumed by state-owned securities or banks. It's quite unlikely to have a Madoff situation, for example.

**Robert Welzel**

I understand, but still, I assume that many regulated institutional investors may have concerns and raise questions.

**Kenny Li:** Yes Robert, you are certainly right, and that is also one reason why we try to bring on foreign managers to localize in China where they have built enough trust and are compliant to international regulators. Any bad practice here may have recourse let's say in the US.

If you think about it, there have to be more effective structures than TRS (Total Return Swaps). I can create an index, put it on Bloomberg and do a Total Return Swap on it, right? That could be done tomorrow. We can also build smart beta products that are also based on customized indices or customized strategies in a fairly passive way in order to give returns to customers. Except for the fact that the funding will actually cost you an arm and a leg right now. So, in theory, there could be a lot more innovation, but it's the cost of funding, the cost of quota, all these added layers of fees from the different channels which is preventing this.



Matthias Knab

Kenny, you said you were also involved with setting up the hedge fund park in Shanghai. This is something that people out there internationally have heard about, but there is very little understanding what's actually happening there. Could you please give us an update on this hedge fund park: what is the intention; and what has actually happened; where it is now? Is it a success?

**Kenny Li:** Yes, the Shanghai Hedge Fund Park is perhaps one of the most interesting projects I have come across in China.

Hongkou is a relatively quiet district of Shanghai. You could say this is where all the strange quant guys live. To give you an idea, this is not Pudong, it's not Lujiazui, it's not Jing'an, it's not Huangpu, where the Bund is. Hongkou is not a glamorous place, but except that it also has a riverfront stretch which they call North Bund.

The Government realized that the financial sector is the future of Shanghai, and decided to pick a niche. So, what is the niche? Well, you can't really compete with Lujiazui with their 300 major insurance, banks and major financial institutions. So Hongkou decided to focus on the private fund industry. But the private fund industry is already picking up in Pudong. However, Pudong created incentives for a pool of private equity funds and private securities funds. Therefore, Hongkou decided they should focus on something unique: hedge funds. The Hongkou government launched the first ever development zone for hedge funds in China. When I first came to China like four years ago, the term "hedge funds" was probably being muttered. No one really admitted they are a hedge funds or managing high risk derivatives for clients.



I was invited to meet with the Hongkou District Government to being a consultant to the entire effort. It was exciting that **through the launch of the Shanghai Hedge Fund Park a mark of legalization of the hedge fund industry has been established.** I have been consultant to the government from an early stage which also helped me to understand the China market a great deal.

We have been advising the zone to build on resources and facilities that will make a difference to the hedge fund industry.

Matthias Knab

So hedge funds are already operating from there, the Hongkou Hedge Fund Park?

**Kenny Li:** Yes. Basically, it initially started with the CITIC Plaza, about 10 offices there, but the amount of registrations climbed rapidly to over 250, which beat the original 18-month target of 70 firms by about four times, and also at a rate which was five times quicker than expected.

They were hoping to get about 70 firms registered in one zone, in one building, with a collective AUM of RMB10billion within a year-and-a-half. But within a year-and-a-half they already had 250 firms in May 2015, managing a total AUM of 150 billion. So it's probably one of the biggest hedge fund centers by AUM for a zone in China. In Pudong, you find some of the more traditional larger asset managers, but Hongkou just beats it with a larger number of private securities funds, many of which are hedge funds, CTA's and Quant funds.

We helped the government launch the first ever large scale hedge fund event that attracted a huge institutional crowd from China and abroad, local and international media.



But then, my question has always been “where would we house all the international hedge funds that will eventually localize in China?” Apart from the QDLPs, Citadel, Man, OZ, Winton, Canyon and Oaktree, there hasn’t been any new regulations to help foreign hedge funds to be on the ground. The access to China is too difficult. We at QuattroQuant intend to become the local partners for foreign hedge funds to help them run a China Business.

We are in discussion with a select handful of funds which have strategies that we can advise on localizing in China. We will also be responsible for raising money in China for these funds. Our plan is really to establish about 20 partners over the next two years.

**Dr. Martin Lockstrom**

As far as I understand, there are also a hedge fund park in Pudong and then there’s one planned in Hangzhou as well.

**Kenny Li:** Yeah. I think that in terms of Hedge Fund Parks or hedge fund development zones, there are probably a few very popular ones.

The first being the Shanghai Hedge Fund Park, which is in Hongkou. In Pudong, the fund development zone holds hedge funds and private equity funds collectively. The Hangzhou fund development zone holds hedge funds and private equity funds together under a “Greenwich-like” environment.

The idea of developing hedge funds as a highly developed and sophisticated segment of asset management is popular in China. I have been approached by at least like three different provinces to become a hedge fund development zone consultant. I was actually approached by governments of Changsha of Hunan, Hangzhou of Zhejiang, Chongqing and Chengdu of Sichuan. They understand hedge funds can grow AUM quickly in China, and that it is relatively inexpensive to give incentives to support them. **Many Government officials tell me that their focus will be in financial services, health sector and big data (TMT).** So it’s a no-brainer that these different provinces want a piece of the action, because these zones would eventually contribute to the provincial / district tax revenues.



In our talks with a number of provinces it’s of course also about resources the province can offer rather than just incentives. The challenge is really about the attracting the right talent. Shanghai is obviously the most preferred destination for new funds setup as the city houses the major stock and the futures exchanges.

One has to be a bit careful when picking up the zone to work with. The most prominent ones are in Shanghai, so Pudong and Hongkou, and then the one in Hangzhou. We are also expecting the private sector to develop centers that have more facilities for hedge funds in the near future. Putting more facilities into these development zones is the next step. That’s one thing we are trying to work with the government on as well.

**Martin Ng:** Hangzhou is actually doing other things as well. For example it set up a pilot e-business zone in late 2015. Remember that Alibaba is based there. Another aspect to bear in mind is that cross-border fund flow and RMB internationalization could have gone beyond those regulations which are very much biased to securities sector.

However, the major part of China’s economy promotion policies so far are very industry-focused and many European and German corporations are industrial complexes which interact with China on that side. Looking forward, everybody is expecting regulatory relaxation, but on the other hand there is a challenge to strike a balance.



There's so much bias to the securities sector, like the Hong Kong-Shanghai Stock Connect. But for trading and manufacturing sectors, we are seeing growing pressure in terms of the foreign exchange control.

Given the background of relaxation, we are still seeing fund flow difficulty a commonplace, contrary to the regulatory development trend. We see the recent crash in the local stock market, the crack-down and the arrests. There seems to be political content in it. It's not simply an economical issue. So that's making investors panic.

So you can call it making a scapegoat out of it, but it is also an issue of transparency or public relationship. In a case, it was called malicious selling, but how malicious is defined is unclear, and how it is distinguished from speculation is unclear.

And if you watch the development of the case and the several arrests, how the arrest is linked to the crash is unclear. Maybe it is insider dealing or whatever. It should be properly explained and disclosed.

So you cannot make a scapegoat out of several persons and hope that the issue is resolved. So that's people commonly criticizing - it's too political, unstable and unforeseeable. Further, you cannot make an example out of the securities market and assume that the industrial market is not affected.

Another real-life example has happened to a foreign company that I know. Their corporate bank account was recently frozen by SAFE, within a very short notice. That's a very serious penalty for a company running cross-border business. This is due to the substantial fluctuation in their cross-border account payable and account receivable settlements. One can expect that that is quite normal in trading business, but the fluctuation itself has caused the alarm in the system and then they get the penalty.

And today, I hear another case. A company has warned in the SAFE system. They have the red signal in the system sent from SAFE. It is like warning the company because its foreign exchange parameter has fluctuated beyond the boundary.

So companies are getting more signals, as if a child is put to a test. You have a bad score today, do it better tomorrow. So how to strike a balance is a challenge.

Of course, you see more relaxation and more channels for securities trading or funding but moving fund around in other sectors is difficult. It is glad to see more overseas RMB settlement centers are emerging, like in Frankfurt, Canada and Hong Kong. To what extent these centers can effectively support the China business operators in fund flows is subject to interpretation.

### Matthias Knab

Kenny mentioned that 300 major banks, insurance and financial companies are operating from Pudong alone. So these are obviously part of what's usually called the institutional investor base.

There is a trend now in Europe and other regions where wealth managers and even sometimes banks buy asset management companies or strategy providers so that they can actually expand their value-add chain and have more products that they actually fabricate in-house to either sell or to also invest some of their own capital.

We know that China is also building up those huge reserves and savings, also on the Government and the institutional side. What's your view on how those assets will be invested? When will alternative investment managers, hedge funds, private equity, venture capital, the whole range of alternative investments, including quants, be able to access that pool of money? Or is it already happening?

**Kenny Li:** If you look at the alternative investment market in China, I guess it's quite active already with the private funds market as of September 2015 reaching AUM 1.6 trillion RMB. And this is just the private securities funds, mutual funds AUM is 8 trillion.

The private equity market is a very enclosed market and very difficult for foreign firms to enter because of their lack of local knowledge and hard access to deals. It's a very enclosed system.

But that part of the industry has spectacular cycles, and with the reopening of the IPO markets, you basically have all the necessary components in place. Good VC funds have taken a lot of companies to IPO already. PE firms have access to good size projects. I'd say that **the Chinese PE market is a lot more mature than what many think**, it's just that to the outside world, it is still a highly inaccessible market. Larger deals are usually held by SOE in China which can be difficult to strike deals with.

Also, the golden period in PE where you could made five to ten times return is already over. People were queuing up to invest in these kinds of funds. But now the return profile has been different. A PE fund with an IRR of 25-30 is a good PE fund. Private Investors are now more focused on VC and angel investing, not to say these are without a higher risk profile.

So, that part of the alternative investment industry overall is maturing relatively quickly, and people have been experiencing cycles relatively quickly as well. But what is really lacking are the secondary market products. Hence, China has opened up the private securities funds sector to allow different styles of fund management using liquid instruments such as stocks, bonds and commodities. These funds offer better liquidity overall as compared with a private equity lockup period of for three to five years.



With that opening, there are now probably about 20,000 private securities funds with roughly 10% offering hedge fund or CTA investment style. The broader 80% of private funds are still long only. About 3,000 funds were launched in the first four months of 2015 during the bull market period but some 2,400 funds were closed down after the stock market collapse later in the year.

The other thing is that there is also still of course a certain lack of strategies. In good times everybody is long-only, buying small caps and getting like a 50% return and all are happy, but they don't realize the risk until recently.

**Matthias Knab**

What type of alternative strategies are run in China?

**Kenny Li:** Within the Chinese private securities fund industry, probably about 15% of AUM has been invested in a quant, CTA, or hedge funds. So it's still very under-allocated. But, as we mentioned before, there is of course a lack of talent in China. Most of the hedge fund groups are actually returnees, and the other 85% is basically the long-only strategies.



**Martin Ng:** The financial sector in China, like most other sectors in China, is very fragmented. There are a couple of titans in the marketplace, but then you have the myriad of smaller players as well. So you find the same market structure in finance as you have it in the manufacturing or logistics industry.

You find this fragmentation pretty much present all along the value chain in finance. Maybe less so in banks, because they are more state controlled. There are the large national banks, and then we have the provincial as well as some city level banks as well. Banks are probably the sector in which you would see the least fragmentation, but if you're looking for example at B2B lending and these kinds of things, so far that segment is pretty much unconstrained and so there is a plethora of different players as well.



We have to question ourselves what are the economies of scale in the industry? If there are no economies of scale in the industry and if the barriers of entry are very low, then it's very easy for new entrants to get going. They may also be able to operate profitably if their fixed costs are relatively low and the marginal profitability will not necessarily increase just because you are getting bigger.

Until some consolidation happens, maybe primarily driven from a regulatory point of view, the industry will remain fragmented of course. Still, those companies that merge or grow inorganically will become more visible and have better means of establishing a trusted brand in the marketplace.

**Sun Suzhi:** The regulatory demands on the banking sector, security houses, and asset management businesses is now quite substantial. When you look a few years back, certain sectors of the financial industry had their own unique set of laws about what products can be issued, whereas now certain restrictions have been lifted. This means that going forward, companies and talents active especially in the asset management areas will be provided with more opportunities.

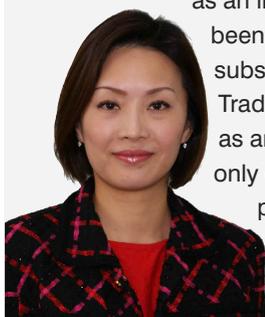
**The opening up of the private security licenses has been very encouraging. I expect other sectors like investment consultancy and risk management consultancy will benefit from a further potential opening.** Certainly, the industry needs more such professional services.

The new Introductory Brokers Program now encourages the futures houses introducing clients to security houses which is another development where new mechanism are worked out and established.

This shows how the Chinese regulator and the Government are looking into every single little detail and trying to open it up so that there will be a more seamless structure across the financial sector. Also, just considering how the larger banks have resources in a lot of areas and the potential to expand in a lot of areas, there's no doubt that one day also Chinese banks will grow into a universal banking structure, like that of Deutsche Bank in Germany. This will also take place at some point in China, but of course it's still going to take time.



**Sophia Sung:** Based on our expectation of further growth in the capital investments out of China in the upcoming years, we, as an international exchange, also target the outbound potential businesses. Several Chinese brokers have been approved by the regulator to establish overseas footprints to offer inbound and outbound services, subsequently, channeling both retail and institutional flows via their Hong Kong-based subsidiaries. Traditionally familiar with the HK and the US markets, the Chinese investors now view the European markets as an important next step for business expansion as well as portfolio diversification. In view of this, we not only offer our benchmark blue chip German equity and fixed income derivatives, but also strive to broaden our product offerings.



Recently, Deutsche Boerse completed its acquisition of 360T, which is a globally established multi-dealer

platform for OTC FX and interest rate products. The acquisition is anticipated to strengthen our distribution capacity in the listed FX derivatives space. We also continue to expand our MSCI product offering, launching 12 additional futures on the MSCI indices to complement our existing 47 MSCI futures and 15 options in December 2015.

Understanding the investment needs of our Asian clients, we also continue to introduce more Asian focused products. For instance, on 28 October 2015, we introduced the Mini-DAX® futures to complement the original DAX® futures (Deutsche Boerse's blue chip index for the German stock market) to further broaden market participation from the retail and smaller institutions.

**Kenny Li:** I just like to point out that the internet space will continue to expand into finance. We see a real need of roboadvisors which can cater a broad mass market and cutting out expensive middlemen fees. In our industry, fund raising is traditionally very expensive, so having new and very cheap channels for product placement and asset raising will be a major revolution in the industry.

Products are usually distributed by armies of salesmen who often lack product knowledge but have their ways of selling into retail. Providing a professional service on financial products online with low fees is a big potential in China.

And don't forget, there are already internet payment systems in China that process huge amounts of money, like Alibaba's Taobao or WeChat's payment system. Something like this could work as well to sell liquid hedge funds or liquid alternatives that say beat the money market benchmark by 4% or so.

Right now, the internet space is pretty much free and open, it's anybody's to grab. Five years later the regulation is going to be super strict; that I know for sure, but right now that's a big opportunity that can potentially change the wealth management landscape in China in a way that most other countries can never imagine.



**Martin Ng:** Before we end, just a brief comment from tax perspective, because I think this Roundtable can't be perfect if we do not touch on tax...

[laughter]

We talk about the fund flow in securities and in e-business. One observation worth noting is that China's tax system is still lagging behind, in very infant stage. That means it poses a risk to business operators, because the China tax system is biased, and is meant to be biased to cope with its economic development stages. Some sectors are treated more equal than others. Some are water-tight regulated, and some are let loose.

E-business is a typical example of insufficient regulations. Individual e-shop operators and cross-border online games are often outside tax net. Many China-made online games are played by overseas players and paid to overseas bank accounts. How they are going to be brought back to the China tax net is not yet resolved.

So these are examples of high-risk areas that should be tackled from a tax perspective. So far we haven't yet seen a clear strategy from the regulators.



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