

MEMO# 28829

March 13, 2015

Arrangements for an Asia Region Funds Passport: Feedback Statement and Consultation on Draft Rules - Member Call on 16 March

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TO: INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 7-15 RE: ARRANGEMENTS FOR AN ASIA REGION FUNDS PASSPORT: FEEDBACK STATEMENT AND CONSULTATION ON DRAFT RULES - MEMBER CALL ON 16 MARCH

On 27 February 2015, the governments of the Asia Region Funds Passport (ARFP) Working Group (ARFP WG) [\[1\]](#) released a feedback statement (FS) and consultation paper ("second CP") on draft rules for the ARFP. [\[2\]](#) The FS summarises the public comments [\[3\]](#) on the first consultation paper ("first CP") published on 16 April 2014. [\[4\]](#) Three annexes with detailed rules and operational arrangements for the ARFP are included in the second CP, along with 10 questions. Comments are due by 10 April 2015. ICI Global intends to submit a comment letter.

Background to the ARFP

The concept behind the ARFP is akin to the UCITS framework in the European Union (EU) – in essence, to provide a framework for a fund vehicle that is established in a Passport Member jurisdiction that can be sold in other Passport Member jurisdictions. [\[5\]](#)

The original signatories to the ARFP initiative were Australia, Korea, New Zealand and Singapore. The Philippines and Thailand were also listed as parties in the first CP. The ARFP WG has expressed interest in expanding the group of participating economies.

Only investment funds established in a Passport Member appear eligible under the proposed passport framework. The general framework for the ARFP includes a combination of Home Rules, Host Rules and Passport Rules. [\[6\]](#)

Overview of Feedback Statement and Consultation Paper

The FS summarises the key public comments on the first CP. Although some commenters

raised concerns about foreign competition, the majority were generally supportive of the ARFP. Many submissions also emphasised the importance of achieving greater scale and ensuring that the Passport Rules do not prohibit the participation of a broader group of economies. Some submissions also urged the ARFP WG to consider linkages with the other mutual recognition schemes being developed in the Asia Pacific region. A key theme from commenters was the need to achieve greater harmonisation by moving obligations into Passport Rules rather than being governed by Home Rules or Host Rules.

The second CP outlines the Passport Rules that, once final, will be formalised in a Memorandum of Understanding (MoU). The MoU will evidence a passport member's commitment to participate in the ARFP and to implement the Passport Rules.

In some areas, the proposed Passport Rules are unchanged from the first CP (e.g., financial reporting and valuation); however, in other areas, the rules have been modified (e.g. delegation, investment restrictions, custody, independent oversight, compliance audits, ETFs and fund operator qualifications). ICI Global made recommendations in all of these areas in its response to the first CP.

A large number of submissions to the first CP, including ICI Global's comment letter, highlighted the challenges presented by tax issues for funds distributed cross-border. Unfortunately, very limited reference is made to tax in the FS and the second CP beyond a commitment to share among the ARFP WG "information about their taxation and capital controls settings" and "provid[ing] further clarity and identif[ing] potential issues that could impede use of the passport."

Proposed Rules and Operational Arrangements

Basic eligibility

Fund Structure

The ARFP WG are not proposing to apply restrictions on the legal form of Passport Funds, a position unchanged from the first CP. Furthermore, Passport Members will be able to explicitly nominate funds that are regulated broadly in accordance with the IOSCO Principles and Objectives relating to CIS as eligible legal fund forms. [7] Sub-funds within umbrella structures appear to be eligible for the Passport, too.

Fund Labelling

The ARFP WG proposes that Host rules will govern the naming of a Passport Fund, particularly an exchange-traded fund, index fund, capital-guaranteed fund or money market fund (MMF). [8] The requirement will only apply to labels rather than descriptions about the fund. [9] ICI Global raised a concern that Home Rules and Host Rules concerning labelling may be incompatible, for instance in respect of MMF portfolio requirements if such rules are different. The ARFP WG acknowledges that its proposed approach will "likely mean meeting the most stringent requirement in any Participant". It remains unclear how this would practically work if, for example, the Host Rules are "less stringent" than the Home Rules. It would appear to be difficult for a fund to comply with Home Rules while effectively competing with host country funds.

Location

The first CP specified that a Passport Fund could only be offered if constituted and

authorised in a Passport Member and, furthermore, if the Operator [\[10\]](#) also was authorised and had a principal place of business in that same economy. Despite recommendations from many, including ICI Global, that a management company passport be considered for the ARFP, the requirement for the fund and manager to be located and authorised in the same economy was not changed in the second CP. The second CP indicates that the ARFP WG was concerned about complexities with such a concept for proposes of the initial stages of the ARFP.

Home Economy public offer

The ARPF WG had proposed that a Passport Fund be subject to an “ongoing offer of the interests in its home economy.” [\[11\]](#) ICI Global recommended that a fund be eligible if it is authorised by its home economy supervisor and is eligible to be offered to the public in its own economy (e.g. made available on the home economy website). Based on the feedback, the ARPF WG has modified the eligibility requirements for Passport Funds by requiring that a fund meet one of three tests. [\[12\]](#) Two of the tests require (a) the offer of the Passport Fund (or sub fund in the same umbrella) to be subject to the laws and regulations that would normally apply to funds offered to the general public and (b) a bona fide offer of the fund in the Home Economy, from which retail investors are not excluded. A third eligibility test that a fund could meet requires that at least 30% of funds managed by the Operator are held by local residents. A disclosure document, compliant with Home Rules, also must be provided to the Home regulator under the third test.

The revised approach appears to provide some degree of clarity as to the requirement for a fund to be subject to a home economy public offer. It is, however, unclear as to how an Operator will be required to comply with certain aspects of the tests. For instance, in the case of the first two tests it is not clear how the Operator will be required to demonstrate that the offer of the fund is bona fide, beyond confirming its compliance with the relevant Home Rules. In the case of the third test, the Operator will need to establish the value of interests held by local residents, including in cases where investors have invested in one of the Operator’s funds through an intermediary.

Requirements relating to the Passport Fund Operator

Operational requirements

The first CP proposed that the operational requirements on an Operator be set out in Home Rules and, furthermore, that compliance with those requirements would be subject to a compliance audit under the Passport Rules.

ICI Global highlighted that obtaining such an audit could be challenging given the interaction and complexity of complying with the Home Rules and Passport Rules. The ARFP WG reevaluated this proposal and determined that it would be clearer to impose the Passport operational requirements as substantive obligations in the Passport Rules. This change means that Operators will be subject to the same requirements regardless of their Home Rules, and that compliance with these requirements will automatically be subject to a revised compliance “review” rather than an audit (see below). There may still be complexities under the revised arrangements as it would appear that Operators will still remain subject to Home Rules as well.

Track record and Qualifications of the Operator

The requirements concerning the track record and qualifications of Operators have been modified in a positive manner and broadly in line with the thrust of many submissions, including ICI Global's recommendations. The revised requirements are still highly specified but take account of a broader range of fund operational experience [\[13\]](#) and, furthermore, additional flexibility has been introduced to reflect different organisational structures, particularly concerning investment decision-making. [\[14\]](#)

The revised requirements mandate that an Operator, or a related entity of the Operator, meets certain tests concerning its track record. Specifically, the tests require that for at least 5 years the Operator has been responsible for the operation of public investment funds in either one of the passport members or an economy that has a regulatory framework for funds "that is broadly similar in effectiveness" to the Home Economy, having regard to IOSCO principles. [\[15\]](#) It is envisaged that related parties to the Operators (perhaps including Group companies) may be able to meet the track record test.

An Operator must also have "officers with the relevant qualifications", comprising a chief executive officer (or equivalent), at least two executive directors (or equivalent) and at least one investment officer. These Officers must have a set number of year's relevant experience in an IOSCO financial services related business according to the requirements below.

Role Number Experience (in an IOSCO financial services related business) CEO 1 10 years within previous 15 years, with 5 of the 10 years in managerial or supervisory role.
Executive Director At least 2 5 years within previous 7 years, in a managerial or supervisory role.
Investment Officer At least 1 (i) a bachelor degree, or equivalent, or higher qualification in a relevant discipline and 3 years within previous 5 years, in a role with responsibility for making or supervising discretionary investment decisions; or (ii) 5 years within previous 7 years, in a role with responsibility for making or supervising discretionary investment decisions
Financial resources of the Operator

The first CP sought feedback as to whether professional indemnity insurance (PII) should be permitted as a substitute to regulatory capital. ICI Global supported allowing PII as a substitute for some capital. The ARFP WG has proposed that, while PII cannot be used to meet base capital requirements, Operators can use PII to cover up to 80% of the additional capital requirements.

Funds under management

The first CP required Operators to have at least US\$500mn in assets under management (AuM) in investment schemes and, in turn, have at least 50% of the assets in these schemes invested in assets that would be eligible for Passport Funds.

ICI Global proposed that other assets, such as discretionary or managed accounts, be included towards the Operator's AuM for the threshold test. The ARFP WG has maintained the US\$500mn threshold and broadened the scope of fund assets, for instance to include pension funds. It does not appear however that assets outside funds, for instance in managed accounts, can be included towards the funds under management threshold test.

Operation of the Passport Fund

Custody

The first CP include specific requirements related to custody and eligible custodians, including the requirement for the custodian to be authorised by the home regulator.

ICI Global noted that some Passport Members permit the use of non-resident custodians under certain conditions and suggested that in some instances it may be more efficient for a fund to use such a custodian. The ARFP WG has recast the requirements to more explicitly recognise that different entities in each economy could have the responsibility in law for holding CIS assets and, furthermore, removed the requirement for sub-custodians to be regulated in the Home Economy. [\[16\]](#)

Independent oversight

The first CP specified the manner in which an Operator should be subject to independent oversight. Most submissions supported the concept of independent oversight but expressed a need for more flexibility to be permitted in how the requirements are met. ICI Global drew on prior work undertaken by IOSCO on fund governance to illustrate the various ways in which independent oversight could be performed.

The ARFP WG acknowledged the need for greater flexibility and modified its approach. The second CP proposes that each passport member provide for an entity or person that is sufficiently independent and capable of performing the independent oversight function. [\[17\]](#)

Compliance review

The first CP proposed that Passport Funds be subject to an annual audit of their compliance with the Passport Rules by a regulated auditor. As noted above, ICI Global raised concerns with obtaining such an audit. The ARFP WG has revaluated this requirement and proposes that Passport Funds be required to complete a review, rather than an audit, of their compliance with the Passport Rules. [\[18\]](#) The ARFP WG has also specified a list of entities in each Passport Member whom are able to conduct compliance reviews (e.g. certain auditors, trustees, public accountants etc.)

Delegation

The first CP proposed various restrictions on the ability of an Operator to delegate certain functions. In particular, the delegation of investment management was subject to the delegate being subject to regulation that, to the satisfaction of the home regulator in consultation with other Passport regulators, provides “substantially equivalent regulatory outcomes”.

In its comment letter, ICI Global highlighted the benefits and importance of delegation and expressed strong concern that the proposed requirements could limit delegation. ICI Global proposed a number of alternative approaches.

After taking into account submissions to the first CP, the ARFP WG proposes several modifications to the requirements on delegation. Specifically, two tests are proposed to determine the percentage of the Passport Fund’s portfolio that can be delegated. For delegation, Operators can (1) delegate up to 20% of a fund’s portfolio to an entity regulated in a jurisdiction that is an IOSCO Appendix A signatory (referred to as a “qualifying delegate”) [\[19\]](#) ; or (2) delegate more than 20% of a fund’s portfolio, if the delegate is subject to a regulatory regime that “is broadly similar in effectiveness to that of the Home Economy” [\[20\]](#) and the meets minimum experience requirements if discretionary

management is delegated. [\[21\]](#)

Investment restrictions

The first CP proposed investment requirements in a number of areas, including permitted assets, diversification, derivatives, securities lending and short selling. ICI Global proposed changes to the draft requirements including that passport funds be able to invest in other regulated CIS established both inside and outside passport members. ICI Global also recommended changes to the global exposure limit governing derivatives usage. ICI Global also expressed concerns about the impacts of differences between Home Rules and Host Rules.

The ARPF WG has made relatively limited revisions. Some requirements have been strengthened, including applying a geographical test under which a Passport Fund can only hold assets that are issued and offered in a jurisdiction whose securities regulator is an ordinary or associate member of IOSCO. [\[22\]](#) In other areas the investment restrictions have been relaxed including permitting a higher global exposure limit of 100% for index funds using futures for index replication. Concerning portfolio allocation restrictions, two alternative options have been presented for single entity exposure limits including it an “acceptable risk” is assessed as having been met by the Operator.

Redemptions

The first CP proposed that a passport ETF allow investors to redeem if there was a suspension of trading for five consecutive days. ICI Global noted the harm that such a requirement may have on investors and the potential for market conditions to be exacerbated.

The ARFP WG has modified its proposal to only apply to new passport ETFs in recognition of the additional burden that would be imposed on existing ETFs. [\[23\]](#) This would appear to raise competitive issues between existing and new passport ETFs.

Application of Host Rules

The first CP provided that several areas, such as distribution, disclosure, marketing and complaints, would be governed by Host Rules. ICI Global raised concerns that the licensing frameworks for distribution in certain Passport Members did not extend to foreign entities. As such Operators may be required to establish a physical presence and/or complete an additional licencing process.

In the second CP, the ARFP WG has more clearly specified the areas in which Host Rules apply. In the context of distribution, it states that an Operator will not require licensing in order to approach a so called “qualified distributor” in a Host Economy. A qualified distributor is defined as “an entity or person that arranges for the acquisition or, who may market, solicit, or offer interests in a Passport Fund on behalf of its Operator.” The second CP also states that the exemption from the licensing requirements for Operators to approach a qualified distributor only applies “where retail investors are not involved.” It is not clear whether this exemption is only available in cases where the Passport Fund will not be distributed to retail investors by the intermediary.

On disclosure, ICI Global proposed that the Passport Members work together to harmonise Passport Fund disclosure rules with the goal that cross-border funds could deal with investors with a single document for all Passport economies. The ARFP WG is open to

considering this as a potential future development.

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endnotes

[1] The working group comprises the following countries: Australia, Korea, New Zealand, the Philippines, Singapore and Thailand.

[2] Arrangements for an Asia Region Funds Passport: Feedback Statement and Consultation on Draft Rules, 27 February 2015, available from <http://fundspassport.apec.org/files/2015/02/ARFP-Feedback-statement-for-release.pdf>.

[3] Twenty-eight responses were received and non-confidential responses are available from <http://fundspassport.apec.org/consultation-paper/>

[4] The first CP published in April 2014, Asia Region Funds Passport consultation on the detailed rules and operational arrangements, is available at <http://fundspassport.apec.org/files/2014/04/20140411-Consultation-Paper-on-the-Passport-Arrangements-FINAL.pdf>). More information on the first CP is available at <http://www.iciglobal.org/portal/site/ICI/menuitem.9ad35c6866c5fcca09ce3110b52001ca/?vgnextoid=03e05745f29b5410VgnVCM1000005a0210acRCRD&vgnextchannel=db262a8b8ec63410VgnVCM1000005a0210acRCRD&vgnextfmt=global> See also, ICI Global Letter to ARFP Working Group members, 10 July 2014, available from <http://www.iciglobal.org/pdf/28259.pdf>.

[5] The term “passport member(s)” is used in this memo to refer to the jurisdictions that are parties to the ARFP MoU.

[6] References to “Home Rules” in this memo are to the relevant laws and regulations in the passport member jurisdiction where the fund is established. References to “Host Rules” in this memo are to the relevant laws and regulations in the passport member jurisdiction where the fund is being sold into. References to “Passport Rules” in this memo are to the various detailed rules and operational arrangements under the ARFP.

[7] paragraph 3(3), Annex 2

[8] paragraph 2(1)(a), Annex 1 of Second CP

[9] paragraph 3, Annex 1 of Second CP

[10] The term “Operator” throughout this memo refers to the operator of the ARFP fund

[11] p12, First CP

[12] part 5, Annex 3 of Second CP

[13] paragraph 9, Annex 3

[14] paragraph 9, Annex 3

[15] “an economy that has a regulatory framework applying to financial asset CIS that is broadly similar in effectiveness to that of the Home Economy in the opinion of the Home Regulator, having regard where relevant to the IOSCO principles and assessment methodology relating to CIS”.

[16] p13, Annex 3

[17] paragraph 14, Annex 3

[18] paragraph 15, Annex 3

[19] Appendix A of the IOSCO Multilateral Memorandum of Understanding (MMoU) concerning consultation and cooperation and the exchange of information. A list of current signatories is here

(<http://www.iosco.org/about/?subSection=mmou&subSection1=signatories>)

[20] paragraph 11(3), Annex 3. The CP also lists several jurisdictions whose regulation is considered to be “broadly similar in effectiveness.” The jurisdictions include France, Germany, Ireland, Luxembourg, the United Kingdom and the United States of America

[21] paragraph 11(4), Annex 3

[22] paragraph 20, Annex 3

[23] paragraph 55, p16, FS