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May 4, 2014

APEC Consultation Paper: Arrangements for an Asia Region Funds Passport

[28087]

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TO: ETF ADVISORY COMMITTEE No. 6-14
ICI GLOBAL ASIA PACIFIC CHAPTER No. 3-14
ICI GLOBAL ASIA PACIFIC FUND PASSPORTS TASK FORCE
ICI GLOBAL ASIA PACIFIC SENIOR LEADERS No. 3-14
ICI GLOBAL EXCHANGE TRADED FUNDS COMMITTEE No. 1-14
ICI GLOBAL TAX COMMITTEE No. 9-14
ICI GLOBAL STEERING COMMITTEE No. 5-14
INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 5-14
INTERNATIONAL COMMITTEE No. 12-14
TAX COMMITTEE No. 14-14 RE: APEC CONSULTATION PAPER: ARRANGEMENTS FOR AN ASIA REGION FUNDS PASSPORT

On 16 April 2014, the governments of the Asia Region Funds Passport (ARFP) working group released a consultation paper (CP) [\[1\]](#) to seek views on the proposed implementation arrangements for the ARFP. The release of the CP follows the signing of a Statement of Intent by finance ministers from Australia, New Zealand, Republic of Korea and Singapore on 20 September 2013. [\[2\]](#) Of particular note, Thailand and The Philippines are now listed as participating economies in the CP, having not been signatories to the Statement of Intent.

A brief summary of the background of the ARFP and a summary of the main elements of the CP are below. Submissions in response to the CP are due by 11 July 2014. ICI Global intends to submit a response.

As previously advised to members of the ICI Global Asia Pacific Fund Passports Task Force [\[3\]](#), a member call has been scheduled for 8 May to discuss this consultation and other related developments (including an update on the ASEAN CIS Framework). The member call will be held at 10am British Summer Time/5pm Singapore Time, Hong Kong Time. If you wish to join the call please contact either Lesley Dunn (based in London and on +44 203 009 3103 or at lesley.dunn@iciglobal.org) or Mandy Law (based in Hong Kong and on +852 2910 9242 or at mandy.law@iciglobal.org) by the close of business in your timezone on Wednesday 7 May.

An additional member call will be arranged at a time more suitable for US based members. Details of this call will be circulated in due course.

Background to the ARFP

At a high level, the concept behind the ARFP is akin to the UCITS framework in the European Union. In essence, fund operators of investment funds that are domiciled or established in one of the passport member jurisdictions countries are able to seek a licence for such funds to be sold in one or more of the other passport member jurisdictions.

UCITS or other funds that are sold, but not domiciled or established, in passport member jurisdictions would not appear to be eligible under the proposed passport framework. The general approach envisaged under the ARFP is for a combination of home and passport rules to govern the licensing of the fund operator as well as the operation of the fund. The home jurisdiction's rules will be the baseline set of rules for the passport fund. Host jurisdiction rules will not apply to the operation of the passport fund. With respect to dealings and communications with investors, host jurisdiction rules will govern activities such as fund disclosure, distribution and complaints. As a result, supervision and enforcement responsibilities are complex as they will involve multiple regulators in different jurisdictions and a variety of investigative and enforcement tools (e.g., administrative, civil and criminal). While the home regulator will have primary responsibility for the areas where the home jurisdiction's laws apply and the passport rules apply, the host regulator will have responsibility for those areas to which its laws apply.

Of particular note, the CP does not include any discussion of tax issues that may affect the attractiveness of a passport fund in passport jurisdictions. Differential tax treatment of foreign and domestic investors could, in some scenarios, pose challenges for passport funds to compete with local funds because of differential tax treatment. This is an area that needs to be evaluated and considered further when assessing the relative attractiveness of particular passport funds, irrespective of the attractiveness of the fund in its own right.

Objectives of the ARFP

The CP lists the following five core objectives that underpin the development of the ARFP:

- providing investors with a more diverse range of investment opportunities, enabling them to better manage their portfolio, and meet their investment objectives;
- deepening the region's capital markets to attract finance for growth in the region;
- facilitating the recycling of the region's savings locally, growing the pool of funds available for investment in the region;
- strengthening the capacity, expertise and international competitiveness of financial markets in the region and the fund management industry with a view to supporting sound economic development; and
- maintaining legal and regulatory frameworks which promote investor protection, fair, efficient and transparent markets for financial services, supporting financial stability, and providing high standards in the management and distribution of CIS.

Substantive Requirements

The CP outlines the substantive requirements applicable to "passport funds" and their operators. Such arrangements are described as a partial approach to mutual recognition, under which a mixture of home economy and host economy laws and regulations would apply. A "home economy" is, for this purpose, the economy in which a passport fund is constituted or established and, furthermore, is authorised for offer to the public in that economy. A "host economy", on the other hand, is the economy in which the passport fund

is permitted to be offered or is proposed to be permitted to be offered to the public. In addition to home and host rules and regulations, so called “passport rules” will also apply. The CP outlines the following methodology through which these rules will apply:

- The basic eligibility criteria outlining which Collective Investment Schemes (CIS) can access the passport will be set out in passport rules.
- There are some areas of the regulation of passport funds and passport fund operators in which mutual recognition will apply. In these areas, only the home economy laws and regulations will apply to passport funds.
- There are some areas of regulation in which the home economy laws and regulations apply but are supplemented with passport rules. This is to ensure a common minimum standard in light of the diversity in the region.
- Depending on the level of regulation in the home economy, the passport rules might go beyond the home economy laws and regulations and require a higher standard. Alternatively, the home economy laws and regulations might go beyond the passport rules. In this case, compliance with the home economy laws and regulations will result in compliance with the passport rules.
- Finally, there are some areas in which the host economy laws and regulations apply. These primarily relate to the interaction of passport funds with investors.

Basic Eligibility Requirements for Funds

The CP outlines basic eligibility criteria applicable to funds seeking to apply for passporting rights under the ARFP. These requirements are summarised, at high level, below:

- The fund must be of a type that has been nominated as being eligible to apply for passporting rights under the ARFP by one of the participating economies. Particular types of fund, including Money Market Funds (MMF) and Exchange Traded Funds (ETF), will need to comply with any specific additional requirements in host economies;
- The fund must be constituted or established in participating economies and subject to the necessary regulatory authorisation by the home and host economies. The operator of the fund must also be authorised and have its principal place of business in the same economy;
- The fund must be subject to an ongoing offer to the public at large in its home economy before it can be offered in the host economy. Other conditions apply concerning the contracts the fund enters into, and the commission it pays to operators;

For specific “types” of funds, such as a MMF or ETF host jurisdiction rules also will apply. The CP seeks input regarding host jurisdiction laws relating to ETFs as well as whether there is a possibility of a passport ETF being available for sale in a host country but not traded on an exchange in that country. This is an area that warrants further evaluation and consideration.

Basic Eligibility Requirements for Fund Operators

The CP outlines basic eligibility criteria applicable to the operators of those funds seeking to apply for passporting rights under the ARFP. These requirements are summarised, at high level, below:

- The operators of a fund must comply with certain operational requirements, including in respect of its structure, controls and the qualifications of executive officers and portfolio managers. Subject to certain additional conditions/exemptions the operator must have at least a five year relevant track record;

- The operators must also meet certain minimum capital adequacy requirements, based in part on the value of assets under management, and meet “good standing” requirements in respect of any previous regulatory action;
- The operators must also have a minimum of USD 500 million in assets under management.

The CP also seeks input regarding the extent to which minimum capital adequacy requirements can be met through a combination of regulatory capital and, or as a substitute, professional indemnity insurance.

Operational Requirements for Passport Funds

Passport funds will be subject to the laws and regulations of their home jurisdiction in respect of their operation. In several areas, including those outlined below, additional “passport rules” will apply.

- Safekeeping – passport fund assets are subject to requirements in respect of safekeeping including the appointment of a suitably independent authorised custodian (separate from the operator or manager of the fund) and requirements in respect of segregation/ separation;
- Audit and independent oversight – the performance of the passport fund operator’s duties must be overseen by a separate and independent entity, in turn subject to various additional governance related conditions, and subject to an annual compliance audit [\[4\]](#);
- Redemption – passport rules will be developed concerning the right of a fund investor to redeem, including whether a fund can suspend redemptions and, if so, how the redemption price is determined. Additional rules will apply to specific fund types including ETFs.

A passport fund would also be required to appoint a compliance auditor to carry out an annual audit of the passport fund’s compliance with the passport rules and obligations set by the home economy laws and regulations. This requirement is mandatory and a report setting out the auditor’s opinion concerning the compliance of the fund against the relevant rules must be provided within three months of the end period covered by the audit. The CP requests comment on the practical difficulties in such an audit being undertaken and subsequent the compliance opinion from the auditor being obtained.

Additional requirements are proposed in other areas concerning the operation of passport funds. This includes the valuation of the passport fund’s assets for net asset value and pricing purpose. This is subject to general valuation rules for quoted assets and unquoted assets. For “specific valuation requirements” (which are not described), passport funds can rely on their home jurisdiction requirements. Valuation, however, must occur at a time after purchase and redemption requests are received.

Passport rules are envisaged concerning redemption. This includes the suspension of redemptions, the conversion of currency for redemption and specific requirements concerning the redemption of ETFs. Passport funds (with the exception of ETFs) are required to offer a reasonable opportunity for investors to redeem their interests in a fund at the usual redemption price, within a specified period (maximum 15 days). Redemptions must either be in an investor’s local currency or paid in another currency, the rate of exchange for which has been determined fairly and based on certain pre-defined criteria. The ability of a passport fund to suspend redemptions is envisaged, subject to certain requirements, where it is in the best interest of investors and is fair between different

groups of investors (e.g. remaining investors and redeeming investors).

A passport funds that is an ETF, must take all reasonable and lawful steps to ensure the interests in the fund can be sold on the financial market at a price that is not materially different to the NAV. In instances where the ETF is suspended from trading for more than five consecutive days, additional requirements are applied including in respect of any redemption fee charged to redeeming investors during this period.

Passport fund operators are responsible for compliance with home economy, host economy and passport rules as relevant.

Investment Restrictions

Passport funds will be subject to a number of investment restrictions including:

- Asset class restrictions – passport funds will be permitted to only hold a defined set of asset classes. In some instances, including in respect of deposits, derivatives, transferable securities and money market instruments, fund investments are subject to additional criteria;
- Portfolio allocation restrictions – limits concerning single entity, group and fund level investments, will apply to passport funds. These limits are based on the same concept as risk spreading under EU UCITS rules [\[5\]](#);
- Derivatives – global exposure limits, calculated under the UCITS Commitment approach and taking into account netting and hedging, non-centrally cleared counterparty exposure and embedded derivatives, will apply to passport funds;

In addition to the investment restrictions outlined above, passport funds will not be permitted to engage in securities lending or short-selling. Prohibitions also apply to lending, guarantees and underwriting. Borrowing will generally not be permitted. The CP seeks input as the other assets that should be permitted for investment by passport funds. Members should carefully analyse the restrictions, including as comparable to existing funds they manage (e.g. UCITS), to identify challenges and problems and suggest modifications to the proposed rules. Comparisons should be drawn including against master/feeder structures, specific investment strategies and country specific strategies to identify all potential nuances.

Delegation

Passport fund operators may delegate functions as permitted under their home laws and regulations. This delegation is subject to various requirements including that operators remain responsible for delegated functions. The delegation of portfolio management is subject to additional requirements including in respect of the regulatory framework to which the delegate is subject (i.e. the person to whom the function has been delegated). The delegate undertaking portfolio management must also meet basic eligibility requirements.

The CP seeks input on whether this approach ensures delegates have the necessary experience to perform delegated functions.

Publication and distribution of audited accounts

In relation to the publication of financial statements and audit reports, passport funds will be subject to a combination of home economy, host economy and passport rules. The latter includes the production of an annual report comprising of the financial statements and audit report for the passport fund. This report must be produced within 3 months of the end

of the period to which it relates and provided or made available (together with certain foreign language translations) to relevant regulators and investors in each host economy in accordance with host economy laws and regulations.

The language and content of financial statements and audit reports is subject to additional requirements.

Dealing with investors

Host economy laws and regulations will, in general, apply to passport funds concerning their interaction with investors. Host economies are able to apply additional rules to passporting funds subject to such rules not being unduly burdensome in comparison to those rules applicable to domestic funds.

Host economy rules will govern the distribution of passport funds by intermediaries. Such rules must apply to passport funds under the same treatment as local funds in that host economy.

Host economy rules will also govern disclosures to be given to investors, promotional marketing and the process for handling complaints.

Regulatory Functions

The CP outlines proposals for how the regulatory functions covering licensing, supervision and enforcement could operate under the AFRP. The framework is quite complex. The CP seeks input on whether the proposals present any practical or legal difficulties as well as whether the proposed arrangements are operationally practical and sufficient. The CP seeks details of any other matters that are relevant to these arrangements that should be considered.

Licensing

The CP outlines the process and requirements concerning the licencing application to be submitted by a fund seeking to qualify for the right to distribute on a cross-border basis under the ARFP. In simple terms, a two-stage process is envisaged. In the first instance an application is lodged with the home regulator for the fund. Subject to approval by the home regulator, the fund will then either be subject to a streamlined authorisation process or a notification process (akin to that applicable under the EU UCITS Directive) undertaken by the host regulator(s) in those jurisdictions into which the fund was seeking to distribute.

Subject to approval by the host regulator (initially within a 21 day assessment period), a passport fund is then eligible to distribute in the home economy or economies subject to the relevant home, host and passport laws and rules.

Supervision and Enforcement

The home regulator will have primary responsibility for monitoring and enforcing the home economy laws and regulations, and the passport rules to which a passport fund is subject. The host regulator will have primary responsibility for monitoring and enforcing host economy laws and regulations. The latter includes a number of aspects relating to distribution. The CP discusses the operation of various additional regulatory powers including investigative action, breach reporting, administrative action, regulatory action and civil and criminal actions. The operation of these powers and actions, including the rights of action of host regulatory authorities, is also discussed in the CP.

The process for regulators to permit exemptions and apply modifications from the rules, and to deregister funds, is outlined. In respect of the former, it is notable that home and host regulators have the power to exempt certain passport funds from the rules. In respect of deregistration, a fund can apply to its home regulator to no longer be considered a passport fund. This process is distinct from a fund ceasing to be a regulated CIS in its home economy as the process of deregistration only concerns the offering of the fund under the ARFP on a cross-border basis.

Implementation

The CP envisages that economies who decide to participate in the ARFP will finalise arrangements for the overarching framework applicable to passport funds in late 2014 or early 2015. Domestic implementation of these arrangements will then be undertaken. The CP envisages that arrangements could be in place by 2016 to allow passport funds to begin exercising their rights to distribute on a cross-border basis among participating countries.

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endnotes

[1]

<http://fundspassport.apec.org/files/2014/04/20140411-Consultation-Paper-on-the-Passport-Arrangements-FINAL.pdf>

[2] http://www.apec.org/Meeting-Papers/Ministerial-Statements/Finance/2013_finance.aspx

[3] <http://www.iciglobal.org/portal/site/ICI/menuitem.9ad35c6866c5fcca09ce3110b52001ca/?vgnextoid=2886e8f966b55410VgnVCM1000005a0210acRCRD&vgnnextchannel=db262a8b8ec63410VgnVCM1000005a0210acRCRD&vgnnextfmt=global>

[4] The CP envisages that the fund operator can be independently overseen by: (i) a separate and independent entity (e.g. a trustee); or (ii) a board of directors; or (iii) a compliance committee. Half the membership of the governance bodies referred to in (ii) and (iii) must be independent. The CP seeks comment on whether other approaches should be considered and in turn permitted.

[5] The passport funds deviate in some respects from those under UCITS. Notably, a 10% on single entity exposures for money market instruments, transferable securities and derivatives is set for passport funds.