

# THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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## **Meeting Paper 4-A**

# **Arrangements for an Asia Region Funds Passport**

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<b>PURPOSE</b>	For background information.
<b>ISSUE</b>	N.A.
<b>BACKGROUND</b>	N.A.
<b>PROPOSAL</b>	N.A.
<b>DECISION POINT</b>	N.A.

Financial Services Update

# Arrangements for an Asia Region Funds Passport

## WHAT YOU NEED TO KNOW

- An APEC working group comprising Australia, Korea, New Zealand, the Philippines, Singapore and Thailand have released for consultation a paper which proposes a model which will facilitate the offer of certain collective investment schemes established in Passport member economies to investors in other Passport economies
- There are an array of conditions which will need to be satisfied by a collective investment scheme and its operator to qualify for a Passport under the new regime
- Those requirements are more onerous than those which currently apply to registered managed investment schemes in Australia
- It is proposed that home and host economies will each have regulatory and supervisory responsibilities in relation to a Passport fund

## WHAT YOU NEED TO DO

- Consider the proposal and what opportunities and challenges are presented for your business by the Passport proposal as currently formulated
- Make a submission on the consultation paper – the closing date is 11 July 2014

On 16 April 2014, APEC released a consultation paper on the Asia Region Funds Passport (**the Passport**), which aims to create a regulatory arrangement for the cross-border offer of collective investment schemes in participating economies.

The Passport will enable fund operators in passport member economies to offer eligible schemes to retail investors in other member economies under a streamlined process.

The Passport working group comprises Australia, Korea, New Zealand, the Philippines, Singapore and Thailand. Following the consultation, economies who decide they want to be a Passport member will work to finalise arrangements by early 2015 with a view to the Passport commencing in 2016.

The closing date for comments on the consultation paper is 11 July 2014.

## Objectives of the Passport

Relevantly, a key objective of developing the framework document is to facilitate the recycling of the region's savings locally and to strengthen the capacity, expertise and international competitiveness of financial markets in the region. The thought appears to be that by developing the combined fund industries in the participating economies, there will be benefits to be obtained by all of them, rather than a cannibalisation by each of them of the other's markets.

## Benefits for investors, the industry and economies

The Passport is to be an arrangement under which a collective investment scheme (**CIS**) operator who operates an eligible CIS in a Passport member economy will be able to offer interests in that CIS to investors in other Passport member economies, subject to the Passport arrangements. The arrangements are the rules and process decided upon

by Passport member economies which will govern the operation of the Passport.

The consultation paper outlines the benefits to investors of the Passport. Principally, the greater availability of a broader range of investments and the potential reduction in fees as a result of greater competition, are cited as reasons why the Passport is beneficial to retail investors. One of the keys to success will be delivery of a high degree of investor protection. Because of the need for investor confidence in the Passport, the paper states that economies will ensure that the requirements for well established, competent and adequate CIS formation processes are applied consistently across the participating economies to ensure a level playing field for CIS operators who wish to participate in the Passport. The paper indicates that an increase in Passport membership may also lead to improved regulatory compliance practices across the region.

From an industry perspective, the paper also outlines the positive benefits of the Passport. In particular, a strong brand for Asia region based CIS will assist the industry to market itself within the region and potentially on a global basis. From an economic perspective, it is anticipated that the Passport will have broader benefits by improving liquidity and access to finance. Liquidity will arise, both from the transactions in the financial products into which the CIS will invest as well as the availability of credit to corporations, financial institutions and governments through investments in corporate and government bonds by CIS structures.

### **Basic regulatory structure**

The Passport regime is to be applied through a partial approach to mutual recognition, as full mutual recognition is not considered possible in the initial phase of the Passport's introduction.

It is anticipated that home economy rules will apply in some areas of regulation of the CIS. However Passport rules will supplement those home economy rules and may in fact establish a higher standard of conduct than the home economy rules provide.

The home regulator will be principally responsible for assessing and monitoring compliance with home economy rules, and the host regulator will be principally responsible for assessing and monitoring compliance with the host economy rules and regulations.

As with other global models, the rules which relate to the licensing of the Passport fund operator and operation of the Passport fund are largely based on Passport rules. However the investor facing rules, which apply in relation to disclosure, distribution and licensing of distributors and complaints, are matters to be dealt with by host economy rules.

### **Basic eligibility**

#### **Structure**

The paper proposes that only regulated fund structures would be able to be nominated by a participating economy as eligible for the Passport regime. The paper gives as an example that Australia would initially nominate a registered scheme under the Corporations Act 2001 as being one which is authorised for offer to the public in host economies.

#### **Investment restrictions**

It is proposed that investment restrictions will apply to the types of CIS which are to be eligible for the Passport regime. The paper proposes additional restrictions, namely, that eligible CIS (including MMS and exchange traded funds) which invest predominantly in transferrable securities and certain other liquid assets will fall within the scope of the Passport arrangements. This will mean that registered schemes which invest in other asset classes such as property, infrastructure and corporate debt will fall outside the Passport arrangements.

#### **Offer in home economy**

It is clear that it is intended that a Passport fund may only be offered in a host economy if there is an ongoing offer of the interests in that CIS in the home economy and it is subject to the offering and disclosure requirements that apply to public offerings in that home economy. It follows that if this aspect of the paper is adopted, a fund operator could not establish a registered managed investment scheme in Australia which is only for offer in other host economies.

It follows that it is intended that there will be no restrictions on investment by investors in the CIS in the home economy.

#### **Commissions**

Interestingly, to ensure parity, there is also a proposal that if commissions are paid by the Passport fund operator on most of its other regulated CIS to persons who arrange investments, equivalent commissions must be payable in the same circumstances in relation to the Passport fund which is the subject of the offer. However, the paper makes it clear that such a

requirement will operate subject to the rules of the home economy. The Australian prohibition on the entry arrangements for the payment of commissions or other conflicted remuneration is specifically mentioned as an example of such a prohibition.

### **Licensing of Passport operator**

In terms of licensing the Passport fund operator, the paper states that it is intended that home economy rules and regulations only will apply. The intention is that regulators in each of the Passport economies will establish rules which give regulators and investors' confidence that Passport funds are managed by operator who are adequately capitalised and have the competence and experience to manage Passport funds.

### **Operational requirements**

In terms of operational requirements, Passport fund operators and their directors are to have primary responsibility for ensuring that a CIS is operated in compliance with all relevant rules and regulations. The paper also states that operators should treat all members in the Passport fund fairly. As a technical matter, Australian law currently requires that members of the same class be treated equally and there may be issues as to how this can apply when there are members of the fund in different economies.

At a high level, all CIS operators will have obligations to ensure that certain minimum operational requirements are met, including, for example, a well-documented organisational structure with clearly assigned responsibilities, adequate internal control mechanisms to ensure that assets are managed in accordance with constitutional documents and the law and that adequate books and records are kept to sufficiently explain the transactions in the fund and ensuring that a risk monitoring and compliance framework are kept. The CIS operator will also require procedures to monitor conflicts of interest.

### **Operator qualifications and experience requirements**

An operator of a CIS will be expected to have at least five years' experience in operating CIS or other investment schemes that predominantly invest in transferable securities or money market instruments, which schemes are offered to retail investors in a jurisdiction which has a CIS regulatory framework that is comparable to that of the home economy in the opinion of the home regulator having regard to relevant IOSCO Principles.

A period during which the operator or related party was under the control of a different person will not count towards the five year experience requirement. However, that period may be counted if the relevant decision makers have been retained by the new controller and the decision making process of the acquiree under the new controller remains substantially in fact and independent. In addition to the experience requirements applicable to the operator, there are a range of additional requirements which apply to its officers.

### **Executive qualifications and experience requirements**

The proposal is that:

- The chief executive officer or similar must have a minimum of ten years' experience as an officer or employee of an entity that carries on a business in financial or capital markets;
- At least two executive directors or equivalent must have a minimum of five years' experience as an officer or employee of an entity that carries on a business in financial or capital markets and persons responsible for making discretionary investment decisions for the Passport fund must at least a bachelor degree in the relevant discipline and a minimum of three out of the last five years' experience in financial or capital markets or a minimum of five out of the past seven years' experience in financial or capital markets in each case that the home regulator considers demonstrates relevant knowledge to a sufficient degree.
- There must be at least one person responsible for making discretionary investment decisions for the Passport fund who is an officer or employee of the operator of the Passport.

### **Capital adequacy requirements**

The paper also describes capital adequacy requirements. The operator must maintain equity of at least USD1 million. Where the operator has assets under management exceeding US500 million it must maintain additional capital equivalent to .1% of the AUM in excess of USD500 million, up to a maximum USD20 million of additional capital.

An unconditional and non-repayable undertaking by a body that is subject to prudential regulation in its home jurisdiction under Basel guidelines may be counted as an asset in calculating equity. Additional requirements applicable to the operator include a

requirement that the operator and its directors and senior managers and persons having control over the operator must not have been the subject of a judgment that in the opinion of the home regulator indicates they are less than competent or not of good standing.

Further, at the time the operator seeks to have a regulated CIS authorised as a Passport Fund, the operator and its related parties must have AUM in investment schemes of at least USD500 million. Only assets in investment schemes that invest at least 50% of their assets in permissible investments, that is, assets that a Passport fund is allowed to hold under the rule on investment restrictions, may be counted towards the USD500 million requirement.

### **Additional home economy legal requirements**

In addition to those matters, the paper proposes that home economy rules and regulations be made on the following topics:

- The duties of operators
- Risk management and related party transactions
- Valuation
- Record keeping
- Custody arrangements
- Meetings of the members
- Service providers
- Redemption; and
- Investment restrictions.

Again, the Passport rules on these matters may require a higher standard than those which apply to CIS which are only offered in the home economy.

### **Safekeeping of assets**

Passport funds will be required to meet minimum criteria relating to the safe keeping of Passport fund assets, including a requirement that there be a custodian for the assets of the Passport fund. That custodian must be independent of the CIS operator. Assets of the Passport fund must be held separately from the assets of the operator and the assets of the custodian. However, omnibus accounts will be permitted subject to typical conditions.

### **Governance**

Independent governance of the CIS operation is required, so that the CIS operator must be subject to oversight by a separate and independent entity (such as a trustee), a board of directors of which at least half of the members are independent or a compliance committee of which more than half of the members are independent. Duties are to be imposed on each of those independent persons.

### **Audit**

An annual compliance audit will be required of the Passport rules and Passport fund operational requirements. The Passport fund will be required to ensure that at all times it has engaged an the auditor to audit the Passport fund's compliance with the Passport rules. That auditor must be independent. The Passport fund must ensure that for each period of twelve months (or lesser period to which the order relates), an appointed compliance auditor carries out an audit of the Passport funds compliance with the Passport rules and it defines the set of obligations under home economy rules and regulations to help ensure the Passport fund operation fund requirements re in place. The auditor must give the operator, the independent oversight entity, the home regulator and each host regulator a report on compliance, within three months following the end of the audit period.

### **Investment restrictions**

Investment restrictions are critical to the CIS proposal. Passport funds will only be allowed to hold the following assets:

- Investments in regulated CIS;
- Deposits;
- Currency;
- Derivatives;
- Transferrable securities;
- Money market instruments; and
- Depository receipts over gold, subject to additional criteria provided below.

Certain ancillary assets, such as agreements, agreements to subscribe for investment research publications, will not be treated as falling within the restriction on asset classes.

Touching briefly on one of those asset classes, transferrable securities, the paper proposes that they may only be issued and offered in a jurisdiction whose

securities regulator is an ordinary or associate member of IOSCO and where no liability arises from holding security. In other words, the security cannot include a partly paid security.

Further, the paper proposes a limit on the unquoted transferrable securities a Passport fund can hold. Unquoted transferrable securities are those that are not quoted on financial markets regulated by an ordinary or associate member of IOSCO.

The paper proposes a broad set of limits on portfolio allocation. It proposes that there will be seven broad limits in use:

- A single entity limit;
- A group limit;
- A CIS limit;
- A limit on unquoted shares, stocks and interests in investment schemes other than regulated CIS;
- A limit on investment conferring significant management influence;
- A limit on the share of securities on money market interests on issue; and
- A limit on depository receipts over gold.

It is beyond this paper to give all of the proposed limits that are set out in the consultation paper.

However, it is interesting to note there is a proposed limit of no more than 10% of the value of the assets of the CIS in shares, stock or interests that are not quoted on a financial market regulated by an ordinary or associate member of IOSCO or approved for quotation on such a regulated financial market. The exception is for a holding in an eligible CIS. This limitation would rule out the satisfaction of the Passport requirements by a fund that invests in unlisted, private equity style investments.

## **Securities lending**

The consultation paper contemplates securities lending activities by a Passport fund. In terms of borrowing, the paper states that a Passport fund must not engage in securities lending to generate leverage. It also must not reinvest any collateral it obtains or any income earned on that collateral except in the case of counterparty default. A Passport fund must not at any time have transferred more than 50% of the value of its assets in securities lending transactions excluding assets transferred where the obligations of the transferee have been terminated including by performance.

The counterparties to securities lending transactions must be subject to prudential supervision broadly under Basel guidelines or be authorised by a regulatory authority which is a member or associate member of IOSCO and subject to obligations in relation to holding financial resources and having adequate arrangements to manage risk. Effective arrangements must be in place to manage potential conflicts of interest and the agreement between the Passport fund and the counterparty must provide for collateral arrangements which meet the proposed requirements.

## **Money lending**

The Passport rules will prohibit money lending, the provision of guarantees or underwriting by Passport funds as those activities are considered to have additional risks. It would appear that a CIS that invests in, say, corporate debt, will not meet the requirements for a Passport fund.

## **Borrowing restrictions**

Not surprisingly, there are also limits proposed on borrowing by a Passport fund, in terms of the amount, the purpose for the borrowing and its nature and timing for repayment.

## **Delegations**

Functions will be able to be delegated but subject to conditions including that the operator remains responsible to members for delegated functions and has in place suitable processes for monitoring and control.

## **Valuation**

It is also proposed that any Passport rules that deal with valuations including methodologies applicable to different asset classes and to redemptions to the effect that all Passport funds must offer a reasonable opportunity to members to redeem their interests, other than interests in an exchange traded Passport fund class, at the usual redemption price. The paper has specific rules around exchange traded Passport fund classes in mind.

Interestingly, if a Passport is an exchange traded fund, the paper proposes that the Passport fund must take all reasonable and lawful steps to ensure that interests in the fund are able to be sold on the financial market at a price that is not materially different from the NAV of an interest in the Passport fund. Reasonable steps include enabling the general investing public the

opportunity to issue or redeem at a price based on NAV to enable arbitrage. Specific rules are also proposed around when redemptions may be suspended.

### **Interaction with investors**

The intention is that the host economy rules and regulations will apply in relation to a Passport fund's interaction with investors. Accordingly, a host economy may require the operator to appoint a local representative to interface with investors in the host economy and to reform certain administrative functions. This could operate as a serious limitation on the value of the Passport regime, as host regulators could require the establishment of significant infrastructure by CIS operators in their own countries.

In addition, the Passport arrangements will not have an effect on host economy rules and regulations relating to intermediaries or the distribution of CIS in the host economy. This again could operate as a serious limitation on the marketing of Passport funds in host economies as the host economies may require separate licensing for the marketing of the fund in that country.

### **Disclosure**

Not surprisingly, from a disclosure perspective, the intention is that the host economy rules will apply. There seems to be a limitation again on the value of the Passport regime, as it suggests that separate disclosure of requirements may apply in different host jurisdictions. It is for this reason that the term "partial mutual recognition" seems accurate when describing what the paper proposes in terms of the Asia region Passport.

### **Advertising and complaints handling**

Host economy rules will also establish rules about advertising and the handling of complaints. The paper contains information what it intends by way of the application process which applies to a CIS.

### **Fund authorisation and timing**

The intention is that there will be streamlined authorisation in the host economy, where subject to response to queries, there will be a 21 day assessment period. That 21 day period can be extended for an additional period of 7 days by either host regulator or the Passport fund. That host regulator assessment period is not intended to be a re-assessment of

whether the CIS meets the home economy rules and regulations or the Passport rules. Rather, that period is intended to allow the host regulator to assess the application in light of the host economy rules and regulations (for example, those applicable to disclosure documents).

It is intended that an application can only be refused by a host regulator if it is not satisfied the Passport fund is likely to comply with the host economy rules and regulations covering that are subject to host economy rules and regulations for the home economy rules and regulations or the Passport rules. There may also be the ability for the rules in certain economies to enable a refusal of an application on public interest grounds, but that is not intended to extend to a contemplation of the effects of the registration on the competitiveness of local CIS operators.

### **Regulators and enforcement**

The home regulator and host regulator are each to be given the power to issue stop orders. Passport member economies are to ensure that Passport economy regulators can use their powers in respect of matters that are governed by their home economy rules and regulations, Passport rules and also at the request of the host regulator to assist in supervision of host economy rules and regulations.

There will be an obligation on a Passport fund to notify the home regulator and the host regulator of certain matters. Interestingly, the paper suggest a Passport fund must notify a host regulator in writing within 7 days if it becomes aware of a contravention of law of the host economy that might reasonably be regarded as significant or that adversely affects the value of interests in the Passport fund in the host economy or more than 1% of the net assets of the Passport fund attributable to members in the host economy.

It is also intended that the Passport regime will give members of the CIS the power to take civil action against a Passport fund and/or its operator under home economy and host economy rules and regulations. The intention is that members will be able to bring action in their home economy unless they elect to have the matter heard somewhere else. The home regulator and host regulator will each have the power to bring criminal action in relation to breaches of their respective rules.

## Conclusion

In summary:

- The consultation paper presents a detailed proposal and the working group economies should be commended for the level of specificity which has gone into the consultation paper.
- The development of a Passport regime is clearly an attractive development and should assist with the growth of the funds management industry across the region.
- Query how workable some of the fund investment and operational restrictions will be in practice. At this stage, it is difficult to say how readily funds can be created which meet all of the proposed criteria.
- There is likely to be significant inconsistency between existing local CIS laws and those which will apply under the Passport regime. The question for each jurisdiction will be whether to upgrade local laws to accommodate some of the differences and whether some changes need to be made to

accommodate investment by investors from multiple jurisdictions.

- A number of types of CIS will be precluded from obtaining the benefit of the Passport regime. In particular, funds which invest in infrastructure, real property, private equity funds and funds which invest in corporate debt will not meet the investment restrictions which are currently proposed.
- Particular constraints arise by allowing each host regulator to apply their own rules to distribution of CIS, to disclosure and to advertising and complaints handling. Some attempt to harmonise those rules in the medium term will be essential to the success of the regime.
- In any event other practical matters such as the application of host country tax regimes to foreign incorporated CIS or differences in operational rules and procedures in different countries may hold back the practical application of the Passport regime and its success.
- The results of the consultation process are eagerly awaited.

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