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A Public-Private Sector Initiative

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Meeting Paper 4-C

Draft Response to the Asia Region Funds Passport (ARFP) Consultation Paper

APFF Regulatory Mutual Recognition Sub-Stream/
Office of the Advisory Group Chair

PURPOSE	For consideration
ISSUE	This is the draft response of ABAC to the ARFP Consultation Paper
BACKGROUND	This letter contains the response of the APEC Business Advisory Council (ABAC) to the Consultation Paper - Arrangements for an Asia Region Funds Passport. This response is the result of deliberations of the Council aided by collective advice from more than two dozen experts from leading banking, financial, asset management and legal firms in the region as well as multilateral and research institutions under the auspices of the APFF.
PROPOSAL	Various comments and suggestions to improve the current ARFP arrangements with respect to the ARFP framework and enlargement and taxation and transparency issues, as well as areas needing further clarifications and other proposals.
DECISION POINT	Endorse the draft response to be approved by ABAC, signed and submitted to ARFP participating regulatory authorities.



APEC Business Advisory Council
Office of the ABAC Chair 2014



9 July 2014

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Dear Ladies and Gentlemen,

Re: Consultation Paper – Arrangements for an Asia Region Funds Passport

This letter contains the response of the APEC Business Advisory Council (ABAC) to the Consultation Paper - Arrangements for an Asia Region Funds Passport. This response is the result of deliberations of the Council aided by collective advice from more than two dozen experts from leading banking, financial, asset management and legal firms in the region as well as multilateral and research institutions under the auspices of the Asia-Pacific Financial Forum (APFF), a policy initiative entrusted by the APEC Finance Ministers to ABAC.

We wish to acknowledge the valuable contributions of experts from State Street and Deutsche Bank in coordinating the discussions and Clifford Chance in consolidating and analyzing participants' views, as well as the insights made available to us by senior representatives of the Asian Development Bank (ADB), APEC Policy Support Unit, Ashurst, Asia Securities Industry and Financial Markets Association (ASIFMA), Barclays, Cathay Holdings, Citi, Ernst & Young Asia Pacific, HSBC, Nomura Securities, Nomura Asset Management, PricewaterhouseCoopers and SWIFT.

Since we proposed a pathfinder initiative to introduce a funds passport scheme in our 2010 report to APEC Economic Leaders, we have supported efforts to develop the Asia Region Funds Passport (ARFP). We are pleased to see these efforts now beginning to bear fruit and express our deepest appreciation to your Governments for joining this historic initiative that promises to bring substantial benefits to our region. If successful, the ARFP will facilitate capital flows among our economies, improve liquidity and efficiency of our markets, offer investors more investment and diversification opportunities, higher returns and better protection, improve the efficiency of our region's asset management industry and help develop our financial services sector.

We have identified a few key issues that are crucial to this success, and list them below. Specific comments in response to various questions on substantive requirements of the Consultation Paper are attached in Schedule 1. Following are our general comments:

1. The ARFP framework and enlargement

The enlargement of the ARFP is critical to its success. With your Governments' decisions to join the initiative, the ARFP has crossed an important milestone toward attaining a critical mass that would attract active industry participation. While not all APEC economies that can potentially join the ARFP may be ready to do so by the launch date foreseen by the current timeline, this critical mass can be reached through the addition of jurisdictions that have an established history of public fund offerings, a robust legal and regulatory framework that provides best-practice investor protection, and a large and growing savings pool that would make the economy attractive as a host market.

Examples of such economies include Hong Kong, Japan and Chinese Taipei. The potential inclusion of such economies and the opportunity for future enlargement would provide significant incentives for active participation by financial service providers in ARFP; further increase its coverage and thereby increase capital market integration in the region, and allow its benefits to be enjoyed by more people in our region. We recommend the following practical steps to ensure that these aspirations are fulfilled:

Clear message on enlargement. First, we propose that participating jurisdictions convey a clear message to the industry that they strongly support the goal of future enlargement. We believe that such a clear message will be conveyed by the following measures:

- amendment of certain clauses (e.g. see "legal architecture" below) that would act as barriers to enlargement;
- acknowledgement that the current ARFP framework provides a starting point and not a fixed foundation for the future direction of ARFP ;
- acknowledgement that potential new ARFP economies can be evaluated on a case-by-case basis notwithstanding the current ARFP framework; and
- the application, where possible, of an equivalence principle where comparable investor protection may be acceptable if the legal architecture of the applying economy prevents its adherence to the current ARFP framework.

Framework approach. The Consultation Paper states that eligible economies wishing

to join the ARFP would mutually decide to adopt those arrangements. Such an approach is a practical way to inclusively address various details across economies that can facilitate the launch of the ARFP. This could, however, over time, risk leading to a network of inconsistent bilateral deals, which could become a barrier to enlargement. It is therefore essential to have greater clarity about the mechanisms for the management of ARFP and how consistency of implementation, facilitation of enlargement, accessibility to investors, wider choices, cost-effectiveness and continued relevance of the ARFP can be ensured.

We note that the Consultation Paper provides useful details on mechanisms to promote close cooperation and understanding among participating jurisdictions, particularly with respect to breach reporting and regulatory coordination. On this subject, we recommend the creation of a *regional college of regulators* to consider matters of interpretation and mitigate any potential regulatory frictions. This could comprise a joint body with representatives from each jurisdiction dealing with ARFP-related questions.

A dispute resolution mechanism would also be needed in the event of disputes between the host and home regulators and between regulators. Under the UCITS regime, disputes are referred by the host regulator to the home regulator. If an issue cannot be resolved, it is referred to a monthly meeting of regulators. Likewise for the ARFP, if disputes arise, it could be determined that the host regulator would defer to the home regulator. The regional college of regulators proposed above could provide such a mechanism.

We also recommend that identical standards and notification procedures for implementing host regulatory assessment be developed for adoption by relevant regulatory authorities in each participating jurisdiction in order to ensure greater efficiency. (See our response to Question 4.2 in Schedule 1.)

Legal architecture. Some aspects of the current arrangements serve to limit enlargement opportunities. The arrangements currently proposed include a requirement for independent oversight over performance of eligible operators' duties. Such a requirement is not immediately compatible with existing arrangements in particular jurisdictions based on civil law, which utilize a stringent regulatory framework and rely on robust monitoring and inspections to ensure sound operation of funds (or trust vehicles), rather than on governance structures at the fund level. (See our response to Question 3.17 in Schedule 1.) In such civil law jurisdictions, the requirement for independent oversight as it stands poses a significant deterrent for established fund and asset management firms to participate in ARFP. Even if bilateral negotiations can bridge differences, the time required to complete negotiations and legislative changes poses significant barriers. Additionally, the requirement for compliance audit represents a "one-size-fits-all" approach to investor protection at fund level that adds significant costs and compliance burdens for operators in such jurisdictions. (See our response to Questions 3.8 and 3.20 in Schedule 1.)

Membership categories. The current arrangements presume that member economies will act concurrently as both home and host regulators. The requirement for funds to be offered in the home economy presents problems for companies where certain

home market requirements make funds unsuitable for cross-border offerings. (See our response to Question 3.5 in Schedule 1.) Creation of two different categories of ARFP membership based on these two distinct roles, i.e., home economy members and host economy members, could facilitate enlargement efforts. As is appropriate, much of the ARFP framework is focused on home regulator rules where the funds are manufactured; the rules required for host regulator functions focus on fund offering and distribution and are therefore less onerous from the perspective of legal architecture. Consequently, the barriers to becoming a host economy member are less onerous (from a legal framework perspective) than those for becoming a home economy member. Allowing economies to apply for host economy status would:

- enable effective enlargement without severe disruption to ARFP framework;
- increase the commercial attractiveness for the industry and, therefore, the ARFP home economy members;
- provide a pathway for immediate inclusion of APEC economies into ARFP as they work towards home-economy status;
- create incentives for host-economies to undertake appropriate capital market reforms; and
- provide benefits to host-economy investors arising from ARFP through investment choice.

Flexibility for future consolidation of funds passport initiatives. The current funds passport proposals (ARFP, ASEAN CIS Framework and China-Hong Kong mutual recognition of funds) and the existing European UCITS structure create challenges for service providers and asset managers with respect to prioritization and identification of best ways to create regionally domiciled funds, and may end up leading to regional asset managers' participation on a selective basis. The ARFP structure should have flexibility to facilitate potential future convergence of the various initiatives and structures. An example scenario is one where funds that previously qualified for either of one Asian passporting initiative were to be merged to achieve economies of scale and cost efficiency. This will create greater economies of scale, reduce market fragmentation effects and improve financial market integration while ensuring that alternatives continue to be available to retail investors.

In relation to this concern, we suggest that *investment restrictions* (as discussed on pages 23 and 26 of the Consultation Paper) be closely aligned with another CIS scheme such as UCITS to allow more efficient management of portfolios. We also suggest that restrictions be highly consistent with the planned ASEAN CIS Framework, to allow funds to be accessible by investors in a larger number of jurisdictions.

2. Taxation and transparency issues

Different tax regimes in participating jurisdictions can significantly impact a fund's performance and returns earned by retail investors, creating incentives or disincentives for participation. Of particular relevance are taxes related to the fund's structure e.g. unit trust and open-ended investment company and those related to funds' payout to investors. There are also further considerations on applicable double tax reliefs in cross-border flows. Further analysis and transparency in this complex area based on participating economies' tax frameworks can be valuable in guiding

further work to make ARFP more competitive and inclusive.

We believe it would be helpful if passport arrangements address taxation at the fund level, taxation of distributions in each participating economy and the use of different structures to invest into an ARFP mutual fund (which could pose transparency issues for the ultimate beneficiaries if taxation necessitated their identification and reporting). We also believe that ARFP could benefit from a streamlining of tax treatment of eligible funds in participating jurisdictions that would promote a level playing field. Passport arrangements should also address issues related to transparency and how differences in capital gains and withholding taxes should be dealt with.

To aid market participants in their preparations, we recommend that regulators of participating jurisdictions host forward-looking discussions that would provide greater clarity and certainty in tax related matters, help industry incorporate known developments in their views and identify solutions that are already in place to facilitate ARFP's launch. An example of an issue that could be discussed is the potential challenges, particularly high costs of compliance, involved in jurisdictional investor-centric tax- and non-resident investor identification-related transparency measures in the context of varying legal relationships and structures, documentation and privacy requirements where numerous retail investors from different jurisdictions invest into a fund. Another example is OECD's Common Reporting Standards (CRS) on the automated exchange of tax information, which involves eleven APEC member economies and three ARFP participants.

3. Issues requiring further clarification

Other products. Passport arrangements should include guidance on the treatment of capital guaranteed products and performance fees.

Distribution and intermediaries. While the Consultation Paper states (on page 41) that passport funds may only be distributed in a host economy in accordance with its laws and regulations, the paper does not make any reference to the fund distribution structure and requirements. We suggest that more information be provided on how a fund manager can implement the distribution of passport funds in host economies, particularly on whether there is a need for a representative in the host economy to oversee the registration of the fund and attend to investor's enquiries. In addition, there is a need to clarify whether an employee of a fund management company will be allowed to conduct training or seminars on passport funds in host economies where they are neither licensed nor regulated.

Suspension of redemptions. The Consultation Paper states (on page 39) that a passport fund must suspend or restrict redemptions if, and only if inter alia, based on the information available to the passport fund, the passport fund reasonably expects that more than 20 per cent of the passport fund's assets could not be realized, at the market value of the assets or more, within the period for satisfying redemption requests. There is a need to clarify whether the reference to "more than 20 per cent of the passport fund's assets" is a "gating provision" and whether this is inconsistent with current market practice, under which managers limit redemptions to 10 per cent

of the fund's net asset value.

Data privacy and protection. We recommend that the issue of whether home rules on distribution, marketing restrictions and data privacy or protection apply under or should be contained within the ARFP be clarified. Under the ARFP, it is likely that information on investors would need to be made available among participating jurisdictions. As such, domestic requirements on data confidentiality need to incorporate ARFP-related considerations. We welcome future opportunities for the industry to contribute ideas related to balancing domestic requirements and industry solutions.

4. Other issues

ARFP will involve jurisdictions with different languages, legal foundations, currencies and market practices. It is likely to also involve asset management industries at different development stages. While there is an unlikely point of “perfect” balance of such complex variables, the following practical steps could be undertaken to further facilitate the successful launch of a competitive ARFP:

Cost-benefit analysis. A clear cost-benefit analysis of ARFP can be important to clarify misconceptions and concerns. For example, retail investors can be “intuitively” deterred by the mix of a fund’s expenses, tax and different currencies that can actually be addressed. Asset managers can also benefit from such analysis to facilitate business case preparations to reflect the potential and incremental investments to join ARFP e.g. compliance audit, language translations, possible host economy rules and licensing requirements, foreign exchange and other reporting requirements, among others.

Location of the CIS. Page 12 of the Consultation Paper contains the requirement that a CIS can only be offered as a passport fund if (i) the CIS is constituted or established and authorized in a passport member economy; and (ii) the operator is authorized and has a principal place of business in that same economy. We suggest that the only requirement for CISs to participate in the ARFP should be that its operator is regulated in a passport member economy.

Standardized formats for information. The multitude of currencies and official languages in the region can be addressed with today’s experiences and technical platforms in the industry. For example, a standardized ARFP key investor disclosure pack with a prescribed number of pages to contain basic, key and numerical information of a fund can be made available as an information pack to all host economy investors. By being uniformed and standardized, formatting and language translation costs can be limited as a “one-time” cost while ensuring accessibility to investors, minimizing mis-selling, promoting trust and confidence and the branding of an ARFP fund. Through it, home economy and host economy investors would have access to the same basic information in identical and equivalent formats and within similar time frames, promoting a common standard of investor protection.

Investor protection. The ARFP’s investor protection regime is commendable in addressing many salient points. The Consultation Paper has used “reasonableness” as a benchmark in various areas. Interpretation of such a standard, however, can vary

according to economies and market conditions. Additionally, responsibilities for investor protection should be proportionate to the ability of various actors to monitor and manage the risks that are within their control. Non-proportionate requirements on service providers to assume strict and onerous responsibilities that are outside their effective risk management control can only introduce moral hazard, increase costs and lower risk management standards in other parts of the industry. To facilitate the launch of ARFP, a forum to exchange and harmonize the interpretation of what is considered “reasonable” can help in managing stakeholders’ expectations and identifying best ways to deliver these standards.

ABAC is keen to continue supporting these efforts to promote the successful launch of the ARFP. We welcome collaboration with relevant authorities in APEC member economies in promoting a deeper understanding of key issues, developing ways to ensure that passport arrangements remain flexible, dynamic and responsive to market developments and progressing recommendations we have set forth in this submission. We encourage authorities and APEC senior finance officials to use the APFF platform to undertake regular discussions with industry and experts from private sector, international organizations and academe.

We sincerely hope that these comments are helpful to you in finalizing the passport arrangements. Should you have any questions, please contact ([name, telephone and email](#)).

Yours faithfully,

Ning Gaoning
Chair, APEC Business
Advisory Council

John Denton
Chair, ABAC Finance and
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Hiroiyuki Suzuki
Chair, Asia-Pacific
Financial Forum

Cc: Chair, APEC Finance Ministers’ Meeting
Chair, APEC Senior Finance Officials’ Meeting
Dr. Alan Bollard, Executive Director, APEC Secretariat

SCHEDULE 1

Specific Comments to

Questions in the Consultation Paper About The Substantive Requirements

	Consultation Question	Comment
Q3.1	Should there be any restrictions on the legal form of passport funds in some or all economies such as for example an exclusion of CIS that are partnerships? If so why?	<p>Yes, structures which do not provide / have restrictions on liquidity should be excluded.</p> <p>Putting aside partnerships, there are many different legal form of funds in participating economies and those that could participate. Therefore, any immediate restrictions based on legal forms can prevent the ARFP from being more accessible and open to participation.</p>
Q3.3	To what extent are offers likely to be made of interests in a passport fund that is an ETF in its home economy but not able to be traded on a financial market in the host economy?	The advantage and attractiveness of a fund passport is to produce global and regional products and offer them to a wider client set, thereby driving liquidity and reducing clients' incentives to trade ETFs overseas. If home economy ETFs are not permitted to be traded in the host economy, the ARFP will, by definition, be ineffective as a means for regional distribution across this wider client set. Host economy access can be created by cross-listing, cross-trading or non-exchange based access such as product registration.
Q3.4	Q3.4 There is a risk of retail investors misunderstanding how they can realize their investment in an ETF where the interests are not traded on a local financial market. Is there a reason for concern that this risk is not sufficiently addressed by host economy laws and regulations about disclosure and distribution?	Investors' misunderstanding of the investment content of a CIS is always a risk, and is not specifically related to ETFs. ETFs are scale products and additional host economy regulations will drive increased costs and time delays in moving products abroad. These costs will reduce attractiveness of producing ETFs in the home economy and reduce the speed of market developments. The focus should be on harmonization of rules and standards on disclosure and distribution across jurisdictions rather than placing additional restrictions in home or host

		economy.
<p>Q3.5</p>	<p>Would the requirement for an offer in the home economy give rise to any practical problems? If so please explain.</p>	<p>We propose that the public offering requirement in the home economy be eliminated from the draft framework. There may be case where a management company wishes to launch an export-only scheme with no public offering in its home economy into host economies with investor profiles and needs that differing from its home economy. For such cases, ARFP could develop a set of high-quality standards under which management companies be allowed to offer an export-only scheme, especially where legal, accounting and regulatory requirements in particular jurisdictions could render funds offered in home economies unsuitable for offering abroad.</p> <p>We understand that the home economy public offering requirement might work to guarantee the quality of passport funds, but we still believe that this can be achieved by the new product pre-clearance process conducted by home economy regulators. As a sample case, the EU UCITS framework does not impose such home economy public offering requirement.</p> <p>Also, in the case of Japan, such export-only scheme is more likely because of many existing requirements unique to Japan applicable to existing funds, which are not suitable for cross-border offerings. This includes (among others) unique accounting standards set by the Investment Trust Association, Japan, a self-regulatory organization covering Japan-domiciled mutual funds, and the restriction upon multi-share classes denominated in multiple currencies, which is not permitted under the Japanese existing regulatory framework.</p> <p>An export-only scheme primarily relying upon the ARFP single passport standards, (and not on the existing Japanese framework applicable to</p>

		Japanese domestic marketing), may facilitate Japanese players effectively utilizing the ARFP framework.
	<u>Licensing of the Passport Fund Operator</u>	
Q3.8	Are there any practical problems associated with the compliance audit rule? In particular are there any particular aspects that would be burdensome or inappropriate to audit?	<p>We propose that the compliance audit requirement be eliminated. Alternatively, the ARFP should provide and define conditions under which the compliance audit requirement could be waived.</p> <p>Most Asian jurisdictions do not have such compliance audit practice and this requirement might increase the operational expenses especially to the players in the jurisdictions without such compliance audit practice.</p> <p>In Japan there is no system requiring compliance audit, except for financial.</p> <p>Our proposal to eliminate this requirement is supported by the fact that there is no such requirement in the EU UCITS regime.</p>
	<u>Operation of The Passport Fund</u>	
Q3.17	Are there other means to ensure the policy objective of independent oversight is met? If so please explain these other means and why they should be permitted.	<p>We strongly submit that the ARFP should be able to omit the external oversight framework in case where the management company is periodically inspected by a home regulator or home self-regulatory organization.</p> <p>Alternatively, the ARFP could provide and define conditions under which the external oversight framework may be omitted, such as in the above case.</p> <p>In Japan, most funds are organized as a trust-type investment vehicle, for which the management company acts as a settlor sponsor for trusts. There is no requirement of external compliance committee nor independent custodian trustee (Affiliated trustees are permitted). In Japan, the fund management industry is subject to a stringent regulatory framework, which</p>

		<p>has assisted the industry to ensure a sound management and operation of trust vehicles.</p> <p>We think most jurisdictions with civil law tradition follow a similar regulatory model, and this is also true in Europe. As a matter of fact, the EU UCITS regime does not require such external oversight system (except for listing up three types of permitted frameworks), which was designed to accommodate the jurisdictions, e.g. Germany, relying upon the external regulator's monitoring and inspection rather than governance framework within funds.</p> <p>We think that there is wider difference in framework in Asian region than there is in Europe, and for this reason, we think that the ARFP should have more flexibility in fund structures like the EU UCITS in order to welcome more member economies in the region.</p>
<p>Q3.20</p>	<p>Would there be any practical difficulties in an auditor providing the opinion proposed? If so please elaborate and identify any alternative measures or alternative form of report that would sufficiently address the policy objective of ensuring compliance through independent checking where reasonable (for example, a review engagement providing negative assurance or an agreed upon procedures report from the auditor).</p>	<p>While the requirement for a compliance audit will serve as an independent review to ensure compliance with the Passport rules, this would increase the operating cost for the participating funds. As most, if not all, participating jurisdictions would have requirements for registered funds to have fund audit on a periodic basic i.e. half yearly or annually etc. to ascertain that the funds are managed in accordance to home economy requirements, such fund audits should be factored into the requirement for compliance audit.</p> <p>For example, rather than a full compliance audit, reliance can be placed on the annual fund audit as required under home economy requirement and an add-on review engagement providing a negative assurance certification on the passports rules from auditor should be considered, with a standardised certification template for consistency, cost and efficiency reasons.</p>

<p>Q3.28</p>	<p>Is it appropriate for a host regulator to require financial statements and audit reports to be translated to an official language of the host economy? If not, why not?</p>	<p>We think it is sufficient for the fund manager to submit the financial statements and audit reports to the home regulator as requiring translations in each host economy would be costly and increase the costs payable out of the CIS and such costs will in turn be borne by the investors.</p>
<p><u>General Requirements About the Substantive Requirements</u></p>		
<p>Q3.29</p>	<p>Do you agree with the proposed approach in terms of whether home, host or passport rules apply to this area of CIS regulation?</p>	<p>There should be clarification on whether home rules on distribution, marketing restrictions and data protection should apply or there should be passport rules on the same.</p> <p>In order to ensure that there is equal access of CISs in all passport economies, there should be passport rules on the distribution, marketing of funds and data protection in passport economies. ARFP to elaborate on how funds may be distributed in local jurisdictions. While distributions are largely influenced by licensing rules in each jurisdiction (e.g. distribution by licensed local intermediaries), it would be helpful if there is some common standard or conditions spelt out in the ARFP (for example, whether funds representatives can fly into local jurisdiction to explain fund products if accompanied by locally licensed staff, whether funds can be distributed through online internet platforms).</p>
<p>Q3.31</p>	<p>Where the passport rules apply, do you agree with the proposed content of the passport rules? If you do not agree, please explain why not. In your view, are there better ways to achieve the underlying purpose of the proposed rules?</p>	<p>We would highlight the single entity limit where the passport fund must not acquire an asset or enter into a derivative or securities lending transaction if it results in the passport fund holding or holding to an increased extent more than 5% of its value in transferable securities and money market instruments issued by the same entity together with any derivatives that have securities of the entity as the underlying reference asset. We find that is more restrictive than the Code of CIS and even UCITs regulations).</p> <p>In addition, while this can be increased</p>

		<p>to 10% subject to the fund manager having processes in place to conduct an assessment on the creditworthiness of the issuer in accordance with written policies and procedures established by the operator which include having regard to the independent sources of information. There are already existing process in place to assess counterparties.</p> <p>We would like to clarify what additional checks are required to further enhance the assessment of counterparties.</p>
Q3.36	Do you have questions about how the passport will work that are not addressed in the proposed framework? What are they?	Please see the section “Issues requiring further clarification” in the letter.
	<u>Questions About Regulatory Functions</u>	
Q4.2	If not, what changes would you propose? What impact would the proposed approach have on competitiveness and ensuring investor confidence?	To improve efficiency, different regulatory authorities should have the same standards when implementing host regulator assessment.