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FSC Arrangements for an Asia Region Funds Passport Feedback Submission

Introduction

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The Council has over 125 members who are responsible for investing more than $2.5 trillion on behalf of 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The Financial Services Council (FSC) promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

General Comments

Thank you for the opportunity to comment on the consultation paper for the Asia Region Funds Passport ("Passport") rules. From an Australian funds management industry perspective, the rules have improved significantly since the first iteration. This has significantly increased the commercial viability of the Passport and we expect Australian fund managers will be able to participate and offer funds under the regime. We appreciate the difficulty in negotiating this arrangement with several economies and congratulate both the Australian Treasury and the APEC working group.

The ultimate aim of this program is to increase economic activity, employment and tax collection in the Asian region. As such, the Passport needs to offer access and functionality that meets or rivals the UCITS regime. The Passport also needs to be commercially viable and have workable rules for industry. As seen in the early stages of the ASEAN CIS Passport regime, a lack of clarity and non-commercially viable rules can hinder progress. However we do understand this is the pilot of the program and the rules are likely to change and improve over time as the participating economies become familiar with the program and other regulators' processes in the region. The commercially viable and UCITS comparisons tests should be applied to each rule, if this program is to succeed.

As a general comment, the investment rules in particular appear to be strict and restrictive and will rule out many existing funds from participating in the program. In particular, the single entity limits and derivative rules will significantly affect the number of funds that managers will be able to offer.

Overall, we need to ensure Australia is not at a comparative disadvantage from these rules. As the largest economy in the program at this juncture, it is vital Australia is not disadvantaged from any particular restriction. This will involve the regulators working together to ensure each economy is on a level playing field.

The key remaining issues affecting Australia's competitiveness are our tax rates, tax certainty issues and collective investment vehicles regime. We congratulate the Treasury on the progress in these areas. When these have been resolved, we note this program will be likely to succeed for Australian managers and allow Australia to compete with other economies in the region.

Annex 1: Host Economy Laws and Regulations

FSC has no major issues with the rules in Annex 1. The below are areas where we envisage potential issues in practice if the rules were not implemented correctly and fairly. A level playing field is required for all economies. Over time, the optimal outcome would be for the rules to allow mutual recognition of licensing as well as a common disclosure document.

<u>Distribution</u>

As we understand it, fund managers will need to use a qualified distributor in the host country (these will be identified by the host country) or obtain the relevant licence. The rules are intended to provide sufficient coverage so that discussions between an operator and qualified distributor could take place.

In theory, this should not cause any issues as long as fund managers are able to genuinely access these distributors and are on a level playing field with local managers.

Ultimately, over time the rules should allow for mutual recognition of licences including distribution so these qualified distributors would no longer be required. It would be desirable that the ARFP ultimately provides for operators to offer and distribute their passport funds to both wholesale and retail investors in host jurisdictions without requiring them either to hold the relevant licence or equivalent in the host jurisdiction or to have a distribution arrangement in place with an appropriately licensed distributor in the host jurisdiction.

Recommendation: move to full mutual recognition of licenses over time. Prior to this, dialogue between regulators takes place to avoid any issues when the program is launched.

Disclosure

Use of wrappers

Operators will need to meet each host regulator's disclosure requirements including translation into local language. In practice, this may mean a different Product Disclosure Statement (PDS) for each economy the fund is offered in, or a PDS with wrappers for each market.

We expect that Australia's short form PDS will be unlikely to meet the requirements of several of the other economies. If the short form PDS is allowed for overseas product providers issuing in Australia, they would also be subject to further documentation including incorporated by reference (or in practice, a home country prospectus with an Australian wrapper). This will ensure a level playing field in terms of disclosure.

Preferably, Australian operators would be able to use a PDS with a wrapper prepared for each host jurisdiction (each translated into the official language of the host jurisdiction), and inbound operators would be able to use their usual form of retail disclosure document with a wrapper prepared for Australia (each translated into English).

This would seem to be the most cost-effective and practical solution to ensure that retail investors under the ARFP receive broadly equivalent levels of disclosure, as well as to ensure that operators have, as far as possible, a level playing field.

Similarly, UCITS enables a Country Supplement to be issued which focuses on the disclosures required for the specific country being entered, but doesn't duplicate the whole information based off the PDS.

FSC has no major issues with the current Passport rules but the objective over time should be a common disclosure document for all Passport funds, similar to the disclosure document used for UCITS funds. This approach would result in in a level playing field for all countries.

Materiality requirement

The use of 'materiality' requirement for disclosure should get around any major changes for issuing disclosure in each market. ASIC has advised that a PDS in each country should cover the same information as it should be 'material'. However, in practice there may be some discrepancies in disclosure documents in the participating economies, which should be investigated by regulators prior to the programs' launch.

Recommendation: Australian operators should be able to use an Australian PDS with a wrapper prepared for each host jurisdiction (each translated into the official language of the host jurisdiction), and inbound operators should be able to use their usual form of retail disclosure document with a wrapper prepared for Australia (each translated into English).

Annex 2: Common Regulatory Arrangements

Regulator approval

Currently the host regulator can reject a fund based on host and home requirements. FSC members did not see the need for it to be rejected based on home requirements. This should be up to the home regulator only in approving the fund. We recommend this line be removed from the rules.

It also appears as though each regulator would have discretion to reject a fund based on differing criteria. If this were the case it would create significant uncertainty for product issuers. For the Passport to be commercial operators will require greater certainty that they can rely on the Passport rules and that after registering with the home regulator and gaining approval, this will not be rejected by other regulators.

Recommendation: we suggest deleting paragraph 4(5)(a)(ii) of Annex 2 and provide more clarity under what circumstances a host regulator can reject a fund and what 'procedural fairness' will entail.

Notification processes

There are issues with the two different notification processes. We understand the method Australia will likely use is the notification process, whereby the regulator must notify the fund if it does not comply within a set period. The streamlined method on the other hand will notify the fund of approval within the same set period – this is the method that will likely be used by the other economies as is their common practice.

We are concerned this may result in the perception that Australia uses a 'lighter-touch' approach. Whilst this will not necessarily be the case in practice, we would suggest the approach be reviewed after a set period of time to see if it is working equally across all countries.

Recommendation: review this rule after a set period. If the two processes are not working, all economies should move to the same process.

Regulator powers

The regulator powers are very extensive and it will be difficult for fund operators to budget for the unknown additional costs in order to meet the host jurisdictions' regulatory requirements.
The Host Regulator may potentially have power to access fund records and information. For example, operators may be required to provide personal information of its members to a foreign Regulator (including information of its members that are not even based in that jurisdiction). It would be ideal if the type of information able to be accessed was clarified.

Both the Host and Home Regulators can issue orders on a fund operator or on the fund itself. Although the intention of the orders would be to protect the current and future members of the fund, if different orders are placed by different Regulators and if the orders are not the same, there may be conflict as to which order will take precedence. The Passport fund and operator will, in essence, be subject to the rules and laws of multiple countries and subject to the discretion of multiple regulators.

In addition, under the Passport rules (Annex 3), the constituent documents must provide a mechanism to commence action (against the fund or the member). With a passport fund, there is potential for legal actions to commence in different jurisdictions and accordingly increasing regulatory risks for the fund.

Recommendation: FSC suggests drafting changes to Part 4, paragraph 10 of Annex 2, to provide for a more objective and reasonable standard. The point of this is to ensure that there is a reduced risk of uneven levels of regulation across the different jurisdictions by the different regulators.

For example: the standard in paragraph 10(2) should refer to "breach or likely breach of Home Economy laws". The standard in paragraph 10 (4) should refer to "breach of likely breach of Host Economy laws". Lastly a stop order should be considered appropriate where it is thought necessary in light of the potential impact of breach on members of the passport fund.

In paragraph 12 in Part 4 (sub-paragraph (2)), the powers of a regulator should be restricted to situations of serious breach - the current use of the word "may" suggests that it's up to each Passport economy to determine. This could create an uneven playing field for operators if different regulators have different standards in each jurisdiction.

Annex 3: Passport Rules

<u>Delegation rule</u>

The FSC welcomes and supports the change to the delegation rule to allow IOSCO appendix A countries for delegation purposes up to 20% of the value of assets in the fund and countries with a similar regulatory framework for more than 20% (examples include US, UK, Luxembourg, Ireland, France and Germany).

The delegation rule covers where managers can be located based on the function of making discretionary investment decisions. It is unclear exactly what 'discretionary investment decisions' entails and more clarity is needed on what constitutes this. This could materiality impact which funds are eligible.

Further clarification is required from ASIC for Australian managers on what must be done before setting up a Passport fund where an investment manager is located in a jurisdiction not set out in the list of qualifying delegates, for example:

- Can a fund be set up on the basis that ASIC will reject it if the jurisdiction is not acceptable or will funds be required to consult with ASIC before each fund is set up?

- Once ASIC has agreed a jurisdiction is acceptable, does that jurisdiction remain on the "approved" list going forward or are funds required to ask ASIC for approval every time a fund is set up with an investment manager in that jurisdiction until the Rules expressly refer to that jurisdiction in the Explanatory Note?

Recommendation: the delegation rule (see para 11(4)) should be amended to provide that a delegation agreement must require that at all times each of the qualifying delegates must have 1 or more investment officers with the requisite qualifications and experience. Clarity on what constitutes an 'investment decision' should also be provided.

Compliance review

The FSC notes the rule has been changed from a compliance audit to a compliance review but still must be undertaken by an independent auditor/audit firm. This may not have a significant impact in Australia as our law requires an audit of a fund's compliance plan annually. We appreciate this may be less burdensome for some countries.

Home country offer

The change in the home country offer provides more flexibility and this is welcomed by the FSC. It would be further improved through the implementation of domestic tax and legal structures as recommended under the Johnson review. We would envisage as the program matures, this rule may become redundant when regulators are more familiar with each others processes.

Permitted investments

Generally the permitted investment rules are restrictive and will mean many funds are not eligible under the program – in particular the derivative rules and ban on short selling.

In a comparison with UCITS:

- Neither synthetic nor physical short selling is restricted in UCITS. An example of additional risks to consider is fast tracked regulation such as the EU ban on short selling ban that can put a temporary stop on short selling.
- UCITS have a separate limit for OTC derivatives counterparty exposure of 10% to each regulated credit institution. This is one of the exposure types that also count towards the 20% whole of entity limit in addition to what is measured under the 5/10/40 rule.
- UCITS is not crystal clear on the topic of netting. For example "Profit seeking strategies" are not allowed "full netting", but hedging doesn't have to be maturity matched.

Recommendation:
Derivative restrictions should be loosened as they are currently very restrictive for many funds especially fixed income.

The hedging requirements for derivatives appear strict and should be loosened.

Allow partly paid shares on an exchange.

Short selling restrictions are also very strict and would preclude many active funds that use this routinely as a tool of the fund. This should be removed. It would be helpful if the gross exposures to short sales could be limited to a certain proportion of net assets or if extension products were allowed.

Restrictions on portfolio allocation

These restrictions are very prescriptive and restrictive on the fund operator. They will also increase the compliance cost to ensure compliance with the restrictions. We note that there is breach reporting obligations to both the home and host regulators for non-compliance with the portfolio allocations, which is onerous.

The single entity and group limits are both particularly restrictive. We suggest that the fund operator should have the power to set the strategy and the allocation, provided that the investment strategy and allocation is appropriately disclosed in the disclosure document. We would therefore recommend these limits are removed. If this is not possible, we offer alternative recommendations below.

Firstly, as per the consultation question we would not advocate for a blanket limit of 10%. A blanket limit of 10% for the single entity limit in all cases would run counter to the spirit of risk management as it would force a lot more credit risk into a portfolio, especially if it were applied to government entities.

The single entity limit would not work commercially in the Australian market. For example, looking at Australian equities, there are major Australian companies with greater than a 10% share for example currently CBA is at 10% and BHP has been even higher than that in the past. Even non-passive fund managers still use the benchmark as a reference point to constructing the portfolio. Somewhere around 20% for other funds as well as replicators would be better for the single issuer limit.

However there should also be exceptions to the above, such as:

- Exceptions for investments issued or guaranteed by governments, local authorities or certain public international and supra-national bodies;
- That index replicators can take exposures up to 20% of net assets to single issuers, with up to 35% to a single issuer in exceptional market conditions;
- That up to 100% of net assets can be invested in other CIS, provided no more than 20% invested in any one CIS.

The meaning of risk-assessed government entity is unclear. Practically, clarity is required on how provincial/state governments (e.g. NSW Treasury Corporation in Australia) or quasi-government securities should be treated. Also, what amount of government ownership or guarantee implicit or explicit would be needed to qualify? Higher concentration in these types of securities (as distinct from pure corporates) would be recommended. In the case of a single country bond portfolio, we think that the 30% limit on government securities of that country would be counterproductive; perhaps this would need to be an exemption (e.g. an Australian Bond Fund).

Recommendation: limits should be less prescriptive. The single entity and group limits will cause significant issues for fund managers and should be increased; we oppose the proposed blanket 10% rule.

If the single entity limit cannot be removed it should be increased to 20% as the starting point, rather than 10%.

The single entity limit should also only apply to transferrable securities and not passive funds which should allow for between 20% and 35% at least.

The limits should not apply to Government securities.

Performance fees

FSC members noted the wording of this rule may not be optimal or reflective of what the rule is trying to achieve and is quite subjective. It was noted that this rule should be re-drafted to better reflect its objectives.

For example, the document states: 'A Passport Fund must not permit a fee to be paid in relation to the Passport Fund based on any returns of the Passport Fund or increase the value of assets of the Passport Fund relative to a measure'. This should be re-worded to say that the fund should not charge investors (the fund) for performance bonuses to managers.

Recommendation: redraft this rule to better reflect its objectives. It currently reads to be quite subjective and requires more clarity.

Redemption period

The redemption period of 15 days may cause an issue for some funds' constitutions. Redemption provisions are enshrined in the fund constitutions. Trustees of the Australian funds have a fiduciary duty to make decisions that are in the best interests of members. They have a duty to treat all members in the same class equitably and members in the different classes fairly. We suggest that rather than prescribing redemption requirements, the fund operator should have the power to determine what is best for the fund and the members.

Recommendation: the fund operator should have the power to determine what is best for the fund and the members in terms of redemption periods. Alternatively the redemption period should be increased to 30 days.

We would be pleased to discuss this submission further and clarify any issues or questions you may have.

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Yours sincerely

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