



STATE STREET.

Mr. Wai-Kwong Seck
Executive Vice President
Head of Asia-Pacific
Global Markets & Global Services

State Street Asia Limited
68/F Two International Financial Centre
8 Finance Street, Central
Hong Kong

July 4, 2014

Via electronic submission to:

Australia

International Unit
Retail Investor Division,
The Treasury
fundspassport@treasury.gov.au

Korea

Asset Management Supervision Office
Financial Supervisory Service
fundpassport@fss.or.kr

New Zealand

Investment Law Team
Ministry of Business, Innovation &
Employment
investment@mbie.govt.nz

The Philippines

Markets and Security Regulation
Department
Securities and Exchange Commission
mrd@sec.gov.ph

Singapore

Primary Markets Conducts Division, Market
Conduct Department
Monetary Authority of Singapore
arfp-consult@mas.gov.sg

Thailand

Corporate Finance – Debt and Other
Products Department
Securities and Exchange Commission
pokpong@sec.or.th

Consultation Paper – Arrangements for an Asia Region Funds Passport (an APEC Finance Ministers' Initiative)

Dear Sir/Madam:

State Street Corporation (“State Street”) appreciates the opportunity to comment on the *Consultation Paper: Arrangements for an Asia Region Funds Passport* (“ARFP”) issued by the Asia-Pacific Economic Cooperation (“APEC”) Organization. The ARFP is an initiative designed to enhance the mobility of capital and the development of financial linkages in the Asia Pacific (“APAC”) region via the development of a regulatory framework for the cross-border offer of collective investment schemes (“CIS”) in participating national jurisdictions.

Headquartered in Boston, Massachusetts, with branches and subsidiaries throughout the APAC region, State Street specializes in providing institutional investors with investment servicing, investment management and investment research and trading. With USD 27.47 trillion in assets under custody administration and USD 2.38 trillion in assets under management, State Street operates in 29 countries and in more than 100 geographic markets worldwide.¹ Since our entry into the APAC region more than 30 years ago, today we have more than 3,900 employees in ten jurisdictions namely in Australia, Brunei, China, Hong Kong, India, Japan, Malaysia, Singapore, South Korea, and Taiwan, servicing our institutional investor clients throughout the region.

INTRODUCTORY COMMENTS

State Street welcomes the efforts of the APEC Organization and enthusiastically supports this important initiative to increase the capacity and strengthen the competitiveness of the region's fund management industry. With successful implementation, the ARFP will improve efficiency through increased cross border capital flows; reduce costs through economies of scale in CIS, better diversification and higher investment returns; enhance investor protection through increased transparency and regulatory harmonization across participating jurisdictions; and grow the financial services sector by further developing funds management expertise in the region.

While we support the overall objectives of establishing an ARFP, we have certain questions regarding the intended framework, as well as recommendations designed to improve policy outcomes. These recommendations, which are discussed in more detail below, can be summarized as follows:

- Clarify the liability of the primary holder or custodian of CIS assets for the insolvency of a sub-custodian and that a CIS unit trustee does not constitute an “operator”.
- Adjust the five percent cap on derivatives or securities lending transactions with a single counterparty to ensure greater flexibility.
- Allow the fund operator to establish appropriate parameters for the reinvestment of cash collateral in securities lending, subject to proper investor disclosure.
- Ban ‘naked’ short selling, but allow covered short selling to better enable the use of efficient portfolio management techniques.
- Clarify the intended definition of a “CIS Operator”.

The ARFP paper currently omits the discussion of tax related issues. Different tax regimes in the participating jurisdictions can significantly impact a fund's performance, providing incentives or disincentives for investor participation. Further information and clarity is needed on taxes related to the structure of a fund, capital gains, interests and other payouts to investors, as well as double taxation relief in cross-border flows. We recommend that Passport economies carefully review their taxation regimes and consider “tax neutrality” for the ARFP, effectively eliminating tax related considerations for investors when deciding between home and host economy funds.

¹ As of March 31, 2014.

In addition to this letter, we have participated in the development of detailed responses submitted by various financial services trade groups including response from ICI Global and the Australian Financial Services Council. State Street led the APEC Asia-Pacific Finance Forum (APFF) mutual recognition sub-workstream and contributed to the ARFP section of the APFF Interim Report and ARFP response letter to the APEC Business Advisory Board. We support the general observations and recommendations made therein. This letter aims to highlight issues of particular interest to State Street.

CUSTODIAN ARRANGEMENTS

Under the “Requirement for Custody Arrangement” sub-section (pg. 19-20), the Consultation Paper states that, “the primary holder of assets can delegate this function to a sub-custodian so long as the operator, or primary holder, retains *responsibility* to members for the acts of the sub-custodian.” The paper further states that the purpose of this requirement is to guard against the risk associated with the insolvency of the operator.

In general industry practices and standards, the primary holder of the assets (e.g. the custodian) is able to appoint one or more sub-custodian for the safekeeping of assets and related services. This appointment is governed by a written sub-custodian agreement, which holds any such sub-custodian to a standard of reasonable care in the conduct of its functions. The custodian is responsible, in this respect, for the appropriate selection and monitoring of the sub-custodian to whom it has delegated the safekeeping of assets and related services.

That said, the obligations in connection with the services delegated to the sub-custodian, and the standard of performance to which it is held and which it must satisfy in the discharge of its obligations, are subject to customary practices in the particular market where the sub-custodian is providing the relevant services. Accordingly, these obligations and standards may vary in scope and nature from the standards and market practices which apply in the custodian’s home market.

Also, while the custodian is expected to undertake ongoing and reasonable due diligence of its sub-custodians, the custodian would not be liable for the insolvency of the sub-custodian, as matters of insolvency would be outside of the control of the custodian and is more appropriately viewed as a risk of investing in the relevant market. As such, we suggest further clarification regarding the proposed scope and terms of the liability for sub-custodians.

In addition, under the “Independence of Custodian” sub-section (pg. 20), we believe it would be helpful for the ARFP to better clarify the role of an “operator.” For example, where a CIS uses a unit trust structure with a trustee and manager, and company A serves as trustee, does company A thereby constitute an operator and therefore, is not permitted to act as a custodian?

Recommendation: Remove or clarify any language that would render the primary holder or custodian of fund assets liable for the insolvency of a sub-custodian; clarify that a CIS trustee does not fall within the definition of “operator” for the purposes of this section.

INVESTMENT RESTRICTIONS

Portfolio Allocation

The “Single Entity Limit” sub-sections (pg. 26-27) states that derivatives or securities lending transactions with a single counterparty should not exceed five percent of the value of the fund’s assets. While diversification is in most cases an appropriate risk mitigation strategy, there are circumstances where it may be more suitable for higher limits to apply. The current proposed limit of five percent is in our view unnecessarily restrictive and therefore, presents the risk of reducing the attractiveness of the fund for lending.

Securities lending transactions are typically over-collateralized and the value of the collateral is generally marked against the value of the borrowed securities daily. We believe netting arrangements are a better reflection of risks associated with securities lending transactions and should be considered in the calculation of counterparty exposure. This is consistent with the UCITS, which allows for netting arrangements with regards to counterparty limits.

Recommendation: Establish a more flexible single counterparty limit or allow the fund operator the discretion to determine an appropriate limit in accordance with the fund’s risk profile, subject to proper investor disclosure. Alternatively, allow netting arrangements for collateral on security loans.

Securities Lending

Under “Securities Lending” section (pg. 33), the paper states that a “passport fund also must not reinvest any collateral it obtains or any income earned on that collateral except in case of counterparty default.” While the intention of this wording may be to address collateral in the form of securities (or non-cash collateral), where collateral is in the form of cash, it is market convention to invest that cash collateral to achieve sufficient yield with a view to offsetting and generating a spread over and above the interest payable to the borrower on the cash collateral (e.g. UCITS and Monetary Authority of Singapore Code of Collective Investment Scheme). Not allowing the reinvestment of cash collateral will substantially reduce the attractiveness of securities lending for ARFP funds, with important implications for the use of efficient portfolio management techniques to both reduce costs and enhance economies of scale.

Recommendation: The fund operator should be permitted to establish appropriate parameters to conservatively define the scope under which cash collateral can be reinvested, subject to proper investor disclosure.

Short-selling

We encourage the authorities to reconsider the ban on short selling (pg. 35). Restricting short-selling, while allowing derivative transactions (subject to the prescribed limits) can lead to operators launching or marketing funds that employ short-selling via synthetic structures (such as a swap). This is analogous to the alternative UCITs (or NEWCITs) funds that have grown in popularity in Europe, in which managers are allowed to short sell synthetically – in essence going against the spirit of the rules. U.S. mutual funds engaging in alternative strategies have seen tremendous growth in the last 18 months. These are known as “Liquid Alternatives”, and offer long/short (and other similar strategies) to retail investors via a regulated wrapper (US 1940

Investment Act). This provides the disclosure, risk management, operating infrastructure, standards and transparency to retail investors and promotes a liquid and thriving market.

Recommendation: Ban 'naked' short selling by CIS, but allow covered short selling which would benefit the fund's efficient portfolio management.

DEFINITION OF THE "CIS OPERATOR"

The current definition of a CIS operator (pg. 63) includes the trustee and the manager. While in some jurisdictions (e.g. Australia), the trustee or responsible entity is the single entity responsible for compliance with law and hence, would be responsible for compliance with the passport rules, requirements and standards, other jurisdictions (e.g. Singapore) have a split trustee/manager model. Under the split model, the trustee and the manager are co-fiduciaries, with distinct roles and responsibilities. The trustee has general oversight responsibilities including holding the assets in the fund. Typically, the manager is responsible for managing the investments of fund assets and promotional activities of the fund, including the decision to passport the funds in other ARFP jurisdictions, and in this instance, would more appropriately have responsibility for compliance with the passport rules, requirements and standards. In the view of the various models and arrangements exist in the APAC region, we encourage Passport economies to undertake a comprehensive review and harmonize standards, requirements and compliance across the ARFP jurisdictions.

Recommendation: Where the definition of a "CIS Operator" is used, it would be helpful to clarify which entity (as between a trustee and manager) in a split model is being referred to in the ARFP.

OTHER CONSIDERATIONS

In our view, there are additional structural issues that should be carefully considered in ensuring the success of the ARFP. This includes enlargement, distribution standards, and linkages with other mutual recognition schemes in the region.

Enlargement

The six jurisdictions (Australia, Korea, New Zealand, Singapore, the Philippines and Thailand) are currently participating in ARFP may not be sufficiently attractive for investors. The expansion of the ARFP to other APEC economies such as Hong Kong, Japan and Taiwan will create greater incentives for active participation by financial services providers. Broader ARFP coverage would also increase regional capital market integration, economies of scale and allow for the benefits of a common passport framework to be enjoyed by a large set of the APEC population.

Distribution

It is critical that the ARFP jurisdictions harmonize requirements, standards and regulations related to the distribution of funds, such as licensing and fees to ensure greater clarity and transparency and lower costs.

Linkages

The existing three passport initiatives (ARFP, China-Hong Kong mutual recognition, and ASEAN CIS Framework) create challenges and confusion for service providers and asset managers in the region. Asset managers may participate selectively because of the uncertain future on an optimal way to create regionally domiciled funds. Consideration of possible linkages between these three passport initiatives will be important to mitigate complexities and achieve economies of scale, cost efficiency and financial integration in the region.

Thank you again for the opportunity to comment on the important matters raised within this ARFP Consultation Paper. Attached you will find additional responses to specific questions posed, and also questions where we believe further clarification would be helpful. Please feel free to contact Steven X. Chan, Head of Regulatory, Industry & Government Affairs for the APAC region (email: Steven.X.Chan@statestreet.com; tel: +852-2230-1624), should you wish to discuss State Street's submission in greater detail.

Sincerely,



Wai-Kwong Seck
Executive Vice President &
Head of Asia Pacific
Global Markets and Global Services



Steven Chan
Vice President
Head of Regulatory, Industry & Government
Affairs, Asia Pacific

Attachment 1: State Street Response to ARFP Questions

Attachment 2: Questions for Clarification on the ARFP



Attachment 1 – State Street’s comments in response to specific questions in the ARFP Consultation Paper

Q3.3 To what extent are offers likely to be made of interests in a passport fund that is an ETF in its home country 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 country ETFs are not permitted to be traded in the host country, the ARFP will, by definition, be ineffective as a means for regional distribution across this wider client set. Host country access can be created by cross-listing, cross-trading or non-exchange based access such as product registration.

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?

No, 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 country regulations will drive increased costs and time delays in moving products abroad. These costs will reduce attractiveness of producing ETFs in the home country 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.

Q3.22 Do any of the permitted assets (for example, depository receipts over gold) lack appropriate qualities of liquidity and reliable valuation and therefore should not be permitted or should be further restricted in keeping with the object of passport funds being relatively non-complex investments while enabling passport funds to be offered that will attract investor interest? If so what should be excluded or what restrictions should apply?

As the initial focus of the ARFP is on funds which are retail in nature, the scheme should start with plain-vanilla products with permissible assets that are less complex and more understandable by general retail investors. The list of permissible assets should exclude exotic/sophisticated assets, and may be restricted to investments in regulated CIS, deposits, derivatives, transferable securities, ETFs and money market instruments.



Attachment 2 – Questions for clarification on the ARFP Consultation Paper

Location of CIS (pg. 12)

- How will this be enforced and what oversight will be in place to ensure competence?

Track record of operator (pg. 15)

- What is the basis of the five years' experience requirement? Active funds usually require three years' experience to be marketable and none for passive funds for reputable operators.

Independence of custodian (pg. 20)

- In the instance that a CIS uses a unit trust structure with a trustee and manager, and company A serves a trustee, does company A constitute an operator and therefore, is not permitted to engage in custodian activities?

Investment Restrictions - Deposits (pg. 24)

- The current recommended standard for fund deposit is unclear. How will the ARFP consider or address country specific or more precise standards such as Rule 17f-5?

Securities lending (pg. 33)

- Are there any requirements for securities lending operators?
- Are there specific considerations with regards to the legal requirement that governs the securities lending program?
- Are there any disclosure requirements with regards to securities lending activities?