INVESTMENT MANAGEMENT
ASSOCIATION OF SINGAPORE

FEEDBACK TO APEC CONSULTATION

ARRANGEMENTS FOR AN ASIA REGION FUNDS PASSPORT ("PASSPORT"): FEEDBACK STATEMENT AND CONSULTATION ON DRAFT RULES

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INTRODUCTION

The Asia Pacific Economic Cooperation ("APEC") is seeking feedback on Annexes 1, 2, and 3 to the draft memorandum of understanding ("MOU"), which when completed and signed, will signal an economy's commitment to participate in the Passport and implement the Passport arrangement. The 3 annexes set out areas in which a participant will impose obligations on Passport Funds, regulatory arrangements for Passport Funds, and the passport rules respectively.

The Investment Management Association of Singapore ("IMAS"), representing more than 100 investment managers in Singapore, has aggregated comments and feedback from our members, in response to the consultation questions. We are aware that some members may be responding directly to the APEC.

Please note that not every individual response has been included. Where responses have been repetitive, those have been condensed into a single response. Also, some responses have been edited to make them more succinct.

As always, IMAS would be happy to follow up on any comments by facilitating further dialogue with members and look forward to the conclusions of APEC' consultation.

ANNEX 1 – HOST ECONOMY LAWS AND REGULATIONS

Question 1: For certainty, the Working Group intends to provide a table which will specify who is a qualified distributor in a Participant. This will reflect the approach identified in subsection (3), although there will be some differences.

For Singapore, a qualified distributor may be restricted to certain entities such as banks and holders of a capital markets service license. For Australia, a qualified distributor would be the holder of an Australian financial services licence authorised to deal in interests in managed investment schemes.

The Working Group is seeking feedback on whether, in relation to each economy, there are adequate avenues through which an Operator is able to market a Passport Fund without obtaining a licence in that economy.

We welcome the suggestion of including a table which will specify who is a qualified distributor in a Participant.

With regards to whether there are adequate avenues through which an Operator is able to market a Passport Fund without obtaining a licence in that economy, in Australia, the six major advice businesses cover some 75% of the advisers there. Each is part of a very large institution and they all must operate under an Australian Financial Services Licence. From this perspective, we believe that there are adequate avenues (being the "Big 6" as they are commonly known) for operators to market funds without needing their own local licence in Australia.

In New Zealand, fund operators can market Australian-domiciled and registered funds after registering the funds in New Zealand. We believe that this existing arrangement is optimal.

In South Korea, at present, if a foreign fund is registered there by approval of the local regulator (Financial Supervisory Service), the fund can be sold to the retail investors through local distribution channels. In this regard, the fund operator does not need to obtain a licence in Korea to market a Passport Fund.

In Thailand and the Philippines, currently, foreign fund operators (referring to those not licenced locally) can only work with domestic fund operators on 'white-labelled' products for distribution via local banks. The distribution channels for foreign fund operators to participate in the domestic funds distribution are limited due to current regulatory constraints. We urge the Working Group to consider opening up the distribution landscape in these two countries and/or those qualified under the Passport regime to foreign fund operators through consumer banks, insurance companies, and even independent financial advisors (if applicable to such markets).

For sophisticated investors, the Working Group can also consider a more flexible approach for the marketing of Passport Funds to these investors. In other words, fund operators can directly sell the registered Passport Funds to any type of non-retail investors. For example, in Singapore, if foreign fund operators were to sell any funds (registered or unregistered) to Institutional Investors (for example, Singapore government bodies and financial intermediaries), the foreign fund operators need not be licensed by the Monetary Authority of Singapore. In order to level the playing field, we request the Working Group to consider similar exemptions in the other participating countries.

Additionally, we would also like to understand better whether the host regulator requires the Operator to establish local presence and obtain a fund management or dealing licence from the host regulator, before entering into distribution arrangements with qualified distributors.

ANNEX 3 – PASSPORT RULES

Question 2: The financial resources test is set with reference to a specific currency, USD. Is it appropriate to set the currency as USD for the purposes of the requirements, given possible fluctuations in currency?

Given the general applicability of the Passport's detailed rules and operational arrangements across multiple Host Economies, it would almost be inevitable for the underlying regulations, especially those pertaining to measurements, to be founded upon a common currency denominator. Given USD's status as the world's primary reserve currency, it would by far be the most appropriate (as well as unbiased in favour of any specific Host Economy) candidate to serve as that common currency denominator by which financial resources of the relevant Operators from various Participants be measured. It would accordingly be unfortunate that such a measurement basis would inadvertently invoke foreign currency differences which may vary the financial resources of the Operators, when expressed in USD and compared back to their base local currencies. Nonetheless, for Host Economies whose foreign currency variances against USD tend to be significant, the relevant Operators may also employ legal entity specific means, such as foreign currency hedging instruments, to manage their individual entities' foreign currency exposures, if necessary.

Question 3: The Passport rules currently do not allow Passport funds to short sell, both synthetically and physically. Nevertheless, the Working Group acknowledges the importance of using financial derivatives instruments for hedging and netting off existing exposure. Exceptions are therefore provided for a Passport Fund to take a short position in derivatives that are subject to hedging or netting arrangements.

The Working Group notes these proposed Passport rules may be stricter than some existing cross border frameworks for retail CIS and is considering the conditions and what additional safeguards should be introduced to ensure short selling will not result in the Passport Funds taking excessive risks.

The Working Group would like to seek industry input on whether physical or synthetic short selling should be restricted, and if so, what safeguards would be appropriate to mitigate risks associated with physical or synthetic short selling:

(1) Synthetic short selling – Are the current safeguards relating to derivatives, such as global exposure limit (section 39), cover rule (section 42), quality of counterparty to derivatives (section 27), and general requirements for derivatives (section 25) sufficient to mitigate the risk of synthetic short selling? What other safeguards should be considered?

(2) Physical short selling – Some existing cross border frameworks for retail CIS jurisdictions do not currently permit retail CIS to carry out physical short selling, citing increased settlement risk involved in and absence of requirements governing such transactions. Should Passport Funds be permitted to engage in securities borrowing and physical short selling transactions? Accordingly, what requirements and safeguards should be introduced to ensure that Passport Funds minimise the risks arising from securities borrowing and physical short selling transactions, if such transactions were to be allowed? For example, what are some of the safeguards available to ensure that a Passport Fund's short positions in such transactions are fully covered at all times?

We think the current guidelines relating to derivatives are sufficient to mitigate risks of using such instruments.

On synthetic short selling, as it should be considered in the 20% limit referenced in subsection 39 (1) (b), there are reasonable controls in place on the amount of synthetic short selling that could take place in a fund. With reasonable limits in place, it would seem the ability to close out the position in adverse market conditions should be a focus, and that would appear to be covered under section 42 where the Operator has to reasonably believe they have the assets available to cover and that can be converted into sufficient assets (as required).

On physical short selling, consistent with many local fund rules, we believe this activity should be prohibited. Should physical short selling be allowed, in principle, the same risks of asset liquidity and available cash would both apply to physical short selling. In addition, the 20% derivatives would not capture any physical short sells, so a requirement would be needed to add a limit for maximum amount of physical short selling.

Question 4: Should the single entity limit be 10% in all cases, as opposed to the graduated approach as drafted under section 30? Would this significantly reduce the extent to which diversification is used in Passport Funds to reduce risk? Does the wording in the text give rise to practical problems?

If the limit is increased to 10% for subsection 30 (1), does that mean that the other limits will be removed (for example, 15%, 20% and 35%)? Ultimately, larger exposures in entities where the funds have security, deposit, and counterparty exposure (i.e. 20%), should be allowed, as well as allowing larger concentrations in government securities.

The blanket limit of 10% 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 bond funds. Cash management could also be an issue. Diversification is an important concept, but so is the performance objective, which may be opposed against concentrated benchmarks / markets (although not specifically disclosed).

The meaning of risk-assessed government entity is unclear. Practically, how should provincial/state governments (for example, NSW Treasury Corporation in Australia) or quasi-government securities be treated? 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. Do we need to put any limits at all?

No matter what number is assigned, we think that such a limit will be arbitrary. There is no investment theory that has proven that setting an entity limit of 10% is superior to 5% (or 15%) in terms of long term portfolio performance (higher return or lower risk, or both). For practical purposes, we therefore suggest that the

Working Group adopt portfolio diversification restrictions that are consistent with widely accepted guidelines, such as those of UCITS. Crafting “new” limits should only be done with sound investment rationale.

Question 5: The Working Group is seeking feedback on whether the proposal in subsection 30(2) to increase the single entity limit to 15% for banks regulated under Basel Guidelines is preferable to having a separate limit for derivatives from other forms of counterparty exposure.

Yes, we think that the proposal in subsection 30(2) is preferable to having a separate limit for derivatives from other forms of counterparty exposure. On the other hand, we wish to reiterate our suggestion in response to Question 4 above to adopt portfolio diversification restrictions that are consistent with widely accepted guidelines.

Question 6: Should the acceptable risk assessment apply even if the total of holdings that exceed the limit in subsection 30(1) was less than 40%? Would this significantly reduce the risk of such exposures? What, if any, costs of practical problems would arise?

Since the current language tallies with existing UCITS limits, and will not require additional documentation of “acceptable risk” from the investment teams, we do not see how applying the acceptable risk assessment will improve control. On the other hand, it would make the investment process inefficient when managing multiple portfolios, and if these specific funds were held up for an assessment, this could delay orders and disadvantage them against other portfolios. In most cases, the investment team will be monitoring and have a view on a stock, and it is unclear whether additional documentation processes will really reduce the risk. This would simply become a box ticking exercise.

Question 7: For the entity limits (subsections 30(1), 30(2), 30(4), 30(8) and 31(1)), the Working Group has taken the approach to disregard the offsetting effects of derivatives as this is a more conservative approach. Would this be unduly restrictive for industry?

We welcome the Working Group’s approach in not allowing the offsetting of derivatives exposure. The netting mechanism often involves qualitative judgment and applying netting rules to a large number of derivatives transactions will be problematic. If there is a real need to allow some level of offsetting, we suggest that the Working Group put in place some limits to control it.

Question 8: Would the proposed Passport Rules on the charging of performance fees be unduly burdensome? What impact, if any, would this have on current commercial arrangements?

We believe subsections 47 (1) (a) and (b) would be sufficient without further requiring (c).

From a fund accounting perspective, we do not think there will be any impact in the performance fee arrangement.

From an investment compliance perspective, to the extent that taking excessive risk and going beyond the objectives would breach the investment guidelines of the Passport Fund, this can certainly be monitored. However, if the Fund is investing within its investment guidelines, but taking excessive risk via its choice of investments, then this ought to be monitored and flagged out by the risk management department of the Fund Operator.

Question 9: Would the proposed Passport Rules over suspension of redemptions be too restrictive? What impact, if any, would this have on current commercial arrangements?

Subsection 50 (2) references a redemption period of 15 days. It may be pertinent to note that this is 15 *business* days.

Subsection 51 (2) requires the Operator to suspend redemptions in the Passport Fund if the Fund is in the process of being wound up. We request greater clarity on why this suspension is mandated and how long it will last.

Subsection 51 (3) is generally an enabling, rather than mandatory, clause in investment documents.

We would also like to understand better whether a pricing error (e.g. due to system, administrative errors, etc.) would warrant a suspension. Could this be dealt with by way of compensation instead if the error exceeds a certain amount?

On the other hand, we suggest not to restrict suspension to only scenarios under subsections 51 (1), (2), and (3). There may be other circumstances when a fund would need to be suspended. For example, when a fund is being merged into another fund, the fund operator may ask to suspend subscriptions and redemptions for a short period leading up to the merger.

Subsection 51 (3) (c) (ii) states that “the Operator of a Passport Fund must suspend redemptions in the Passport Fund if the Operator reasonably expects that more than 20% of the assets of the Passport Fund could not be realised at or above the market value of the assets within the period for satisfying redemption requests.” We do not agree with this provision. If the assets cannot be realised at market value, then there is a fair valuation issue in that the assets are not being priced at fair market value. Is it sufficient to suspend redemption or subscription in this case? Investors redeeming from the fund would be particularly concerned. If the fund can be valued by other means, fund dealing should continue.

An exception would be a 9/11 situation when all markets have been impacted and there is inability for markets to function normally for assets to be realised at ‘normal’ market values. Then a suspension pending financial markets returning to normalcy would seem appropriate.

On subsections 52 (5) and 52 (6), it will be helpful if elaboration and examples are provided. In general, these 2 subsections require that all investors are treated equally and earlier requests must be fulfilled in priority to later requests. However, references to priority class are confusing.

Question 10: Should the value referred to in subsection (1)(b) above be market value or notional value of the equivalent position in the underlying asset, whichever is the most conservative?

Similar to our response in Question 4, we suggest adopting portfolio diversification restrictions consistent with widely accepted guidelines.

OTHER FEEDBACK

With regards to fund structure in the Feedback Statement, it is mentioned that there are no restrictions placed in the draft MOU. Since umbrella structures are allowed (that is, sub-funds within umbrella structures are allowed to be registered), how does the fund management company register the sub-fund if, for example, the prospectus is on an umbrella fund level?

Referring to Annex 1, subsection 2(e), we would like greater clarity on the criteria for appointment of local representative/agent.

In Annex 2, section 2 states that “unless otherwise specified, all notifications required to be given by this Annex are to be in writing”. We would like to seek further clarification whether there will be options provided by all Passport Regulators for applications to register as a Regulated CIS and provision of notifications by an Operator to be performed online over the Internet. This would allow timely notifications to be given and enhance the communication between Passport Regulators and Operators.

Under Annex 2, subsection 4-2(c), an application for entry to a Host Economy must contain any document or information required by the Host Regulator which is reasonably required under or is necessary to assess the Passport Fund’s compliance with the Host Economy Laws and Regulations. We suggest the Working Group to put together a clear list of required documents/information specific to the various participating Host Economies.

Under Annex 2, subsection 4-3, it is mentioned that there will be two entry processes a Participant can implement: (a) the streamlined authorisation process; or (b) the notification process. We would like the Working Group to clarify the main differences between these two entry processes.

Additionally, in Annex 2, subsection 4-5, we note that the Operator must first register the Passport Fund with the home regulator. Subsequently, the Operator will then apply with the host regulator for the Passport Fund to be offered in that host jurisdiction. The entry may be refused if the host regulator is of the opinion that the Passport Fund or its Operator does not comply with either the host rules, the home rules, or the Passport

rules. To avoid duplicate regulatory reviews, we suggest for the process to be streamlined so that the host regulator can place reliance on the due diligence performed by the home regulator.

On Annex 2, subsection 5-3 on the streamlined entry process, we would like to suggest to have the Host Regulator issue a confirmation notification to the Passport Fund / Operator when the application is complete.

In Singapore and Thailand, a locally registered feeder fund is able to invest a substantial amount of its net assets in an offshore fund, such as an UCITS fund, upon meeting certain regulatory requirements. On the other hand, under subsection 34-3 of Annex 3, no more than 20% of the value of the assets of a Passport Fund may be held in UCITS funds. To be consistent with the current regulatory practices in Singapore and Thailand, one respondent would like to request for a master feeder fund under the ARFP framework to be allowed to invest substantially in UCITS funds.

In Annex 3, Part 7 details suspension of and deferral of redemptions, but there appears to be no requirement on the Operator to inform the Home or Host Regulator when the Operator suspends or defers redemption. We request further clarification whether this is indeed the intent.

End

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