



**Asia-Pacific
Economic Cooperation**

Consultation Paper: Arrangements for an Asia Region Funds Passport

An APEC Finance Ministers' initiative

© Copyright 2014

ISBN 978-0-642-74967-3

Use of the APEC logo

Use of the APEC logo has been approved for this publication. Unauthorised use of the APEC Logo without the approval of the APEC Secretariat is a breach of copyright. For information of the use of the APEC logo please visit <http://www.apec.org/About-Us/About-APEC/APEC-Logo-Use.aspx>.

Other Uses

For more information regarding copyright and use of content in this publication please refer to the copyright section on the website from which the document was obtained.

CONTENTS

CHAPTER 1: INTRODUCTION	1
Background	1
Structure of this paper and scope of consultation	2
Process for submissions	2
CHAPTER 2: OBJECTIVES.....	5
Investors	5
Delivering the benefits of greater competition.....	5
Ensuring adequate investor protection	6
Industry.....	6
Strengthening the capacity and competitiveness of the Asia region fund management industry.....	6
Economy	7
Deepening the region's financial markets.....	7
Maintaining financial system stability and efficiency	7
CHAPTER 3: SUBSTANTIVE REQUIREMENTS	9
General.....	9
Basic eligibility.....	11
Types of CIS.....	11
Location of CIS.....	12
Home economy public offer	12
Licensing of the passport fund operator	13
Operational requirements	13
Experience	15
Capital adequacy	17
Good standing.....	18
Funds under management	18
Operation of the passport fund	19
Requirement for custody arrangements	19
Independent oversight	21
Compliance audit.....	21
Investment restrictions — asset classes	23
Investment restrictions — portfolio allocation.....	26
Derivatives	30
Securities lending.....	33
Lending, guarantees and underwriting	34
Borrowing and partly paid securities	34
Short-selling.....	35
Delegation.....	36
Valuation for pricing	37
Redemption.....	37
Publication and distribution of audited accounts.....	39
Dealing with investors	41
Distribution and intermediaries	41
Disclosure	42
Marketing.....	42
Complaints	42

CHAPTER 3 CONSULTATION QUESTIONS	43
CHAPTER 4: REGULATORY FUNCTIONS.....	45
General approach	45
Application process	45
Home regulator application	45
Supervision and enforcement	50
Powers of investigation and breach reporting.....	50
Administrative action.....	51
Civil and criminal actions.....	51
Exemptions and modifications	53
Deregistration.....	53
CHAPTER 5: IMPLEMENTATION	55
LIST OF CONSULTATION QUESTIONS	57
Questions about the substantive requirements	57
Basic eligibility	57
Licensing of the passport fund operator	57
Operation of the passport fund	59
General questions about the substantive requirements	60
Questions about regulatory functions	60
Registration and assessment	60
Supervision and enforcement	61
Civil and criminal actions.....	61
Other.....	61
GLOSSARY.....	63
SCHEDULE A	67
SCHEDULE B.....	69

CHAPTER 1: INTRODUCTION

BACKGROUND

- Asia has witnessed a trend towards increasing capital mobility since the early 1990s. Strong financial linkages between Asian markets and markets in advanced economies in Europe and North America have developed; however, the development of financial linkages within the region has lagged.
- A number of regional bodies and forums, including the Association of South East Asian Nations (ASEAN), ASEAN+3 and the Asian Development Bank, have been progressing efforts to improve these linkages. Regional financial integration is seen as important for Asia-Pacific financial markets to achieve economies of scale and greater depth and liquidity, and, ultimately, better support the region's economic development goals.
- The Asia Region Funds Passport (the passport) is an APEC initiative that is furthering these objectives through the creation of a regulatory arrangement for the cross-border offer of collective investment schemes (CIS) in participating economies.
- Since 2010, a number of APEC economies (including Australia, Chinese Taipei, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and Vietnam) have been meeting twice yearly to explore options to progress the concept of a passport. This has led to the development of a passport framework document.¹
- The development of the framework document was guided by the following objectives:
 - providing investors with a more diverse range of investment opportunities, enabling them to better manage their portfolio, and meet their investment objectives;
 - deepening the region's capital markets to attract finance for growth in the region;
 - facilitating the recycling of the region's savings locally, growing the pool of funds available for investment in the region;
 - strengthening the capacity, expertise and international competitiveness of financial markets in the region and the fund management industry with a view to supporting sound economic development; and
 - maintaining legal and regulatory frameworks which promote investor protection, fair, efficient and transparent markets for financial services, supporting financial stability, and providing high standards in the management and distribution of CIS.

1 The framework document forms part of the statement of intent signed by Finance Ministers from Australia, Korea, New Zealand and Singapore in September 2013.

- Recognising the potential benefits of the passport, finance ministers from Australia, Korea, New Zealand and Singapore signed a statement of intent in September 2013, committing to consult publicly within their economies on the detailed rules which would be necessary to implement the passport, as proposed in the framework document.
- That commitment has resulted in this consultation document which seeks public views on the arrangements for the passport.
- Following this consultation, economies that are eligible and that want to become passport member economies will revise and finalise the passport arrangements and commit to becoming passport member economies by mutually deciding to adopt those arrangements.
- The consultation relates to the initial operation of the passport arrangements. It is envisaged that the passport arrangements may develop over time subject to the agreement of the passport economies. For example, in a later stage there might be scope to consider harmonising or recognising regulation in the passport economies in relation to additional subject matters such as certain disclosure requirements.

STRUCTURE OF THIS PAPER AND SCOPE OF CONSULTATION

- The passport will be an arrangement under which a CIS operator who operates an eligible CIS in a passport member economy will be able to offer interests in that CIS to investors in other passport member economies subject to the passport arrangements. The passport arrangements are the rules and processes decided on by passport member economies which will govern the operation of the passport.
- The signatories to the statement of intent have developed the proposed passport arrangements. The objectives that have guided the development of the proposed passport arrangements are detailed in chapter 2 of this consultation paper.
- Chapter 3 details the substantive requirements that will apply to CIS wishing to use the passport. Chapter 4 details the procedural requirements for passport funds and processes relating to the supervision of passport funds and the enforcement of the passport arrangements.
- This paper seeks views from the public on the practical operation of the proposed passport arrangements.

PROCESS FOR SUBMISSIONS

- A list of consultation questions is included at the end of each chapter and further questions included in relation to particular issues within the consultation paper. The questions are intended to guide the preparation of submissions. Nevertheless, any other views relating to the practical operation of the proposed passport arrangements are also welcome.
- Submissions may be directed to any one or more of the agencies below. We envisage submissions from persons in the economies publishing the consultation paper will be directed to the person's home agency from the list below. Each home agency will take account of the submissions it receives in negotiating the final passport arrangements with the other agencies.

Australia

International Unit
Retail Investor Division
The Treasury

Email: fundspassport@treasury.gov.au

New Zealand

Investment Law Team
Ministry of Business, Innovation and
Employment

Email: investment@mbie.govt.nz

Singapore

Primary Markets Conduct Division
Market Conduct Department
Monetary Authority of Singapore
10 Shenton Way
MAS Building
Singapore 079117

Email: arfp-consult@mas.gov.sg
Fax: (65) 6225 1350

Korea

Asset Management Supervision Office
Financial Supervisory Service

Email: fundpassport@fss.or.kr

The Philippines

Markets and Securities Regulation
Department
Securities and Exchange Commission

Email: mrd@sec.gov.ph

Thailand

Corporate Finance – Debt and Other
Products Department
Securities and Exchange Commission
333/3 Vibhavadi-Rangsit Road
Chomphon, Chatuchak
Bangkok 10900
Thailand

Email: pokpong@sec.or.th
Fax: (66) 2 695 4611

- The due date for submissions is 11 July 2014.
- Submissions will be published on the passport website (www.fundspassport.apec.org) unless a submitter specifically requests that the whole or part of the submission (such as any financial information) is treated as confidential.
- Chapter 5 of this consultation paper details the process for the finalisation of the passport arrangements and the implementation of the passport.

CHAPTER 2: OBJECTIVES

- The passport will allow CIS established and regulated in one passport member economy (the home economy) to be offered to investors in other passport member economies (host economies), under a clearly defined framework which seeks to ensure that the laws and regulations of the participating economies are applied in a sound and coherent manner.
- By supporting regulatory consistency, it is envisaged that the passport will result in an increased number of Asia region-based CIS being offered in each member economy. There may be a number of these CIS that are offered in multiple member economies.
- The expected increase in CIS activity in the region is, over time, expected to have a positive impact on investors, the Asia region CIS industry, and the broader economy in each participating jurisdiction.
- The development of the passport arrangements outlined in this consultation paper has been guided by particular objectives in each of the impact areas. These are outlined below.

INVESTORS

Delivering the benefits of greater competition

- As outlined above, the passport is expected to result in greater competition in the Asia region CIS industry. One of the key objectives of the passport is to ensure investors receive the benefits of this, for example, in terms of lower fees and greater CIS choice.
- In the Asia region, the degree of choice faced by investors varies. In some economies, there is a high degree of choice; in others, choice is more limited in terms of:
 - *location of CIS operation*: for example, there may be only very limited penetration of foreign operated CIS in that economy;
 - *geographical focus of CIS*: for example, a vast majority of CIS may be domestically focused; and
 - *investment type and approach*: for example, there may be only a limited number of options for investors looking for index or money market funds (MMFs).
- By increasing the number of foreign regulated CIS being offered in member economies, the passport is expected to increase the diversity of CIS available to investors. This, in turn, will improve investors' ability to diversify their portfolio and reduce concentration risk.
- Similarly, the costs faced by investors in CIS also vary across the region. Investors in the Asia region face some of the lowest and some of the highest CIS fees and expenses.
- An increase in the number of Asia region-based CIS being offered in passport member economies may see some reduction in fees as a result of greater competition.
- For CIS offering in multiple passport member economies, larger investor bases may create economies of scale benefits that can be passed onto investors in the form of lower fees.

Ensuring adequate investor protection

- One of the key objectives of the passport is to provide a high degree of investor protection. That is, to promote informed and confident passport investors. This is to be achieved by ensuring that the standards embodied in the passport arrangements for the operation and offer of passport funds are high.
- Confident and informed investors are important for the efficient functioning of financial markets. If a high rate of non-compliance or failure is observed among passport funds, demand for such funds may be limited.
- In developing the arrangements, economies have been mindful to ensure that passport funds develop an early reputation for being transparent and well-regulated products. This has been a critical success factor in other similar schemes, such as the Undertakings for Collective Investment in Transferable Securities (UCITS) regime.
- Many of the elements of the framework reflect this objective. For example, it is for this reason that there are requirements to ensure that CIS operators who participate in the passport are well established, competent and adequately set up to manage retail CIS. Economies will ensure that these requirements are applied consistently across the participating economies to ensure a level playing field for CIS operators who wish to participate in the passport.
- A regional framework, which represents the combined expertise of multiple regulatory agencies and promotes the sharing of strong regulatory practice, may also have a broader influence on the regulation of CIS in the region. By establishing de facto regional standards, the passport may serve to improve the regulation of local CIS in passport member economies. Any increase in passport membership may also lead to improved regulatory practice across the region.

INDUSTRY

Strengthening the capacity and competitiveness of the Asia region fund management industry

- Another key objective of the passport is to strengthen the capacity and competitiveness of the region's fund management industry.
- Providing passport fund operators with access to a larger pool of potential investors may allow them to realise economies of scale and enhance their competitiveness vis-à-vis funds constituted outside the Asia region. The passport may also put the region's industry on a competitive footing by creating a strong brand for Asia region-based CIS, assisting the industry to market itself within the region, and potentially on a global basis.
- Potential increases in the size and number of CIS based in the region may also see increases in employment opportunities in the Asia region fund management industry – from administrative and support services to research, investment management and settlement activities.

ECONOMY

Deepening the region's financial markets

- It is also expected that the passport will have broader economic benefits by improving liquidity and access to finance. The passport is likely to support greater financial market liquidity and access to finance by providing an additional pathway for investors to invest in the region's debt and equity markets.
- As institutional investors managing the region's savings, passport funds may:
 - facilitate access to equity capital by participating as investors in primary equity markets (for example, through initial public offerings and private placements);
 - contribute to the liquidity of Asia region financial markets through the transactions they conduct in listed shares, debt and other financial products; and
 - provide credit to corporations, financial institutions and governments through investments in corporate and government bonds including, for example, for infrastructure financing.
- It is an objective of the passport to facilitate these benefits to the broader economy.

Maintaining financial system stability and efficiency

- Greater financial market integration also brings with it additional risks including increased exposure to external shocks and contagion, increased volatility of capital flows, and increased complexity for financial regulators.
- One of the objectives of the passport is to ensure economies can continue to maintain financial system stability and efficiency. Keeping capital flows within the Asia region could help to strengthen the region's resilience to external shocks and volatility.

CHAPTER 3: SUBSTANTIVE REQUIREMENTS

GENERAL

- Participating economies have been focused on developing robust and practical arrangements for the passport. Recognising that economies in the region are at different stages of development and have varying regulatory systems, full mutual recognition is not seen as possible in the initial phase.
- As such the arrangements set out in this chapter adopt a partial approach to mutual recognition. This means that a mix of home economy laws and regulations, host economy laws and regulations, and specific passport rules will apply.
 - The home economy refers to the economy in which the passport fund is constituted or established, and is authorised for offer to the public in that economy. The home economy laws and regulations refer to the laws of the home economy, associated regulations, and any other regulatory requirements that apply to regulated CIS in that economy.
 - The host economy refers to any economy (other than the home economy) in which the passport fund is permitted to be offered, or is proposed to be permitted to be offered, to the public. The host economy laws and regulations refer to the laws of the host economy, associated regulations, and any other regulatory requirements that apply to regulated CIS in that economy.
 - The passport rules will be a separate set of rules applicable to all passport funds (regardless of where they are established or where they are offered) which are implemented in each passport economy in a form that achieves substantially equivalent outcomes.
- It is proposed that the home economy and host economy laws and regulations and passport rules will apply in the following way:
 - The basic eligibility criteria outlining which CIS can access the passport will be set out in passport rules.
 - There are some areas of the regulation of passport funds and passport fund operators in which mutual recognition will apply. In these areas, only the home economy laws and regulations will apply to passport funds.
 - There are some areas of regulation in which the home economy laws and regulations apply but are supplemented with passport rules. This is to ensure a common minimum standard in light of the diversity in the region.
 - Depending on the level of regulation in the home economy, the passport rules might go beyond the home economy laws and regulations and require a higher standard. Alternatively, the home economy laws and regulations might go beyond the passport rules. In this case, compliance with the home economy laws and regulations will result in compliance with the passport rules.
 - Finally, there are some areas in which the host economy laws and regulations apply. These primarily relate to the interaction of passport funds with investors.

- The application of home, host and passport rules is outlined at a high level in table 1 below.
- The home regulator will be principally responsible for assessing and monitoring compliance with the home economy laws and regulations and passport rules. The host regulator will be principally responsible for assessing and monitoring compliance with the host economy laws and regulations.

Table 1 — Application of home, host and passport rules

Element	Home	Home + passport rules	Only passport rules	Host
Basic eligibility				
Types of CIS			✓	
Location of CIS			✓	
Offer in host economy			✓	
Licensing of the passport fund operator				
Operational requirements	✓*			
Experience requirements		✓		
Capital adequacy		✓		
Good standing		✓		
Funds under management		✓		
Operation of the passport fund				
Custody arrangements		✓		
Independent oversight		✓		
Risk management	✓#			
Investment restrictions		✓		
Delegation		✓		
Valuation basis for pricing		✓		
Redemption		✓		
Financial reporting and auditing		✓		
Related party transactions	✓			
Duties of operators	✓			
Record keeping	✓			
Dealing with investors				
Disclosure (including annual and periodic reports)				✓
Distribution and licensing of distributors				✓
Complaints				✓

* Home economy operational requirements will be subject to compliance audit required by the passport rules

Governed by home economy rules with the additional compliance audit requirement in the passport rules

BASIC ELIGIBILITY

There are three types of basic eligibility criteria. These relate to:

- the types of CIS that are eligible;
- where they are located; and
- the CIS having made an offer in the home economy.

Types of CIS

Across the Asia region, there are a variety of legal structures used by CIS. Unit trusts and company structures are the most common. To accommodate the current variety of structures used and future developments, the rules will not restrict the legal structure of passport funds other than to require that they are regulated as a CIS by the home regulator in a manner which is consistent with the IOSCO principles and assessment methodology relating to CIS.

Each economy will nominate types of CIS that are authorised for offer to the public in its economy and could be offered under the passport. Passport member economies will assess and agree on the types of CIS that can be offered under the passport.

Example: Australia would initially nominate a registered scheme under the *Corporations Act 2001*.

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?

Given the investment restrictions (see page 23), only eligible CIS (including MMFs and exchange traded funds (ETFs)) which invest predominantly in transferable securities and certain other liquid assets will fall within the scope of the passport arrangements.

MMFs

A passport fund must not be called a MMF or otherwise promoted as a MMF in a host economy unless it complies with any specific additional requirements for a MMF in the host economy.

Q3.2 Would the restriction on naming and promotion in relation to MMFs give rise to any practical problems? If so please explain.

ETFs

Similarly, a passport fund must not be called an ETF in a host economy unless it complies with any specific additional requirements for an ETF in the host economy.

An ETF seeking quotation in a host economy would have to comply with any additional requirements that may apply under the host economy law and regulations. If an ETF is not traded in the host economy and there is no provision for ongoing redemption from the passport fund because it is traded in the home economy, this will be a key point for disclosure to investors. Under host economy laws and regulations any disclosure that the passport fund that is an ETF must not be misleading and in particular must not give

investors the impression they can sell their interest on a market in the host economy or redeem their interests from the passport fund where that is not the case.

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?

Q3.4 There is a risk of retail investors misunderstanding how they can realise their investment in an ETF where the interests are not traded on a local financial market. Is there reason for concern that this risk is not sufficiently addressed by host economy laws and regulations about disclosure and distribution? If so please explain.

Location of CIS

A number of jurisdictional requirements will apply to passport funds to ensure that only funds constituted or established and relevantly authorised in a passport member economy qualify.

As the passport arrangements are founded on passport member economies being satisfied with the efficacy and robustness of each other's regulation of CIS, it is important that only CIS that are principally regulated in passport member economies can access the arrangements. Requiring passport funds to be constituted or established and relevantly authorised in the region will also help to ensure that the economic activity associated with fund location (including legal, auditing, registry and compliance services) is kept within the region.

A CIS can only be offered as a passport fund if:

- the CIS is constituted or established, and authorised in a passport member economy; and
- the operator is authorised and has a principal place of business in that same economy.

It is not currently envisaged that an operator regulated in one passport economy could constitute and seek primary authorisation for a passport fund in another passport economy if the operator was not authorised in that economy.

Home economy public offer

In addition to the other requirements described in this paper (including for example those in the section on the application process, page 47), interests in a passport fund may be offered in a host economy only if the following conditions are met:

- there is an ongoing offer of the interests in the home economy;
- the offer attracts the offering and disclosure requirements of the home economy that would apply to an offer to the public at large;
- the interests may be acquired by any member of the public in the home economy on an application under the offer, subject to applicable laws;

- information about the offer is made available to persons who customarily arrange for investments in regulated CIS operated by the passport fund operator in an equivalent way to the way in which information about some or all other regulated CIS of the operator is made available;
- if commissions are paid by the passport fund operator on most of its other regulated CIS to persons who arrange for investments in the regulated CIS, equivalent commissions to that payable in relation to another regulated CIS are payable in the same circumstances in relation to the passport fund which is the subject of the offer; and
- if the passport fund operator enters contracts under which persons arrange for investments to be made for most of its other regulated CIS, those contracts or substantially equivalent contracts are entered in relation to the passport fund which is the subject of the offer.

Please note the above requirements do not apply if they would operate to require a passport fund operator to breach the laws of its home economy. For example, passport funds based in Australia are not permitted to enter into arrangements for the payment of commissions or other conflicted remuneration.

Q3.5 Would the requirement for an offer in the home economy give rise to any practical problems? If so please explain.

Q3.6 Would the requirement for an offer in the home economy promote investor confidence in the effectiveness of supervision of passport funds by the home regulator? What other possible measures could be applied?

LICENSING OF THE PASSPORT FUND OPERATOR

In general, the home economy laws and regulations only will apply to the licensing of the passport fund operator including, for example, risk and conflict management requirements.

This means CIS operators authorised under the home economy laws and regulations can operate passport funds, subject to a number of additional requirements outlined below.

The purpose of these criteria is to set appropriate standards for passport fund operators to give regulators and investors confidence that passport funds are being managed by operators who are adequately capitalised and have the competence and experience to manage passport funds.

Operational requirements

Passport fund operators and their directors have primary responsibility for ensuring that a CIS is operating in compliance with all relevant laws and regulations. Operators should treat all members in the passport fund fairly.

It is recognised that all passport member economies set standards for the eligibility, governance, organisation and operational conduct of those who wish to market or operate a CIS in accordance with IOSCO principles and assessment methodology. This means that under the home economy laws and regulations, all operators will have obligations to help ensure that the following are in place (passport fund operational requirements):

- a well-documented organisational structure that clearly assigns responsibilities and provides for the flow of information between all persons involved;
- adequate internal control mechanisms including procedures and systems which ensure that;
 - assets are managed in accordance with the constitutive documents and disclosure documents of the passport fund, as well as all laws and regulations of the home economy, the applicable laws and regulations of the host economy and the passport rules;
 - books and records are kept to sufficiently explain the transactions of the passport fund, and all transactions in the interests of the passport fund; and
 - registers of members are duly kept;
- a risk monitoring and management process including a risk management framework for the assets under management, based on the size, complexity and risk of the assets;
- a compliance framework that ensures ongoing compliance with relevant laws and regulations; and
- procedures to monitor conflicts of interest.

In recognition of the importance of home economy laws and regulations in these areas, compliance with those obligations, to the extent that they ensure or help ensure the passport fund operational requirements are in place, will be subject to the compliance audit required by the passport economy rules (see section on compliance audits, page 22). The particular home economy laws and regulations that are relevant for this purpose will be specified in the rules.

Q3.7 Is the requirement for an audit of certain home economy laws and regulations related to the passport fund operational requirements sufficient to ensure that passport funds are operated in accordance with the prescribed standards?

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?

Q3.9 Would it be clearer or more practical to instead require an audit of whether the passport fund operational requirements are being met?

Experience

Track record of operator

The operator or a related party that the home regulator considers relevant for this purpose must have at least five years' experience as the operator of CIS or other investment schemes that:

- predominantly invest in transferable securities or money market instruments (see section on investment restrictions – assets classes for definitions of transferable securities and money market instruments, page 23); and
- are offered to retail investors in a jurisdiction which has a CIS regulatory framework that is comparable to that of the home economy in the opinion of the home regulator having regard where relevant to the IOSCO principles and assessment methodology relating to CIS.

For the purposes of the requirement for five years' experience, any period/s when the operator or related party (acquiree) was under the control of a different person or entity cannot count towards the five year period unless the new controller may itself enable the operator to meet the requirement for five years of relevant experience (as a related party).

In assessing if the experience of a related party is relevant, following a change of control or otherwise, the degree of commonality between the parties in relation to decision-making processes, systems and staff would be relevant.

The rationale for this requirement is to restrict a person or entity that does not have the required level of operational experience from meeting the requirement through the acquisition (by it or its related party) of an operator that does.

Exception

Where a CIS operator that meets the track record requirement is acquired by a new controller and the acquired CIS operator is to be the passport fund operator, the period it was under the control of a different person or entity may be counted where:

- most of the persons responsible for making discretionary investment decisions are retained by the new controller; and
- the decision-making process of the acquiree, under the new controller, remains substantially intact and independent.

This is broadly consistent with certain provisions of the Global Investment Performance Standards (GIPS), particularly clause 5.A.8 which sets out where the performance of an acquiree must be represented as the acquirer's.

Examples:

- (1) An inexperienced CIS operator or an entity not authorised as a CIS operator (Company A) wants to operate a passport fund. It does not meet the track record requirement so it acquires a controlling interest in a CIS operator (Company B) who does meet the track record requirement. Company A then uses its controlling interest to replace many of the key directors and officers in Company B, including those responsible for portfolio management. In this scenario, Company B would not meet the track record requirement.

- (2) An experienced CIS operator (Company A) is acquired by an entity that is not authorised as a CIS operator (Company B). The acquisition has no effect on the people involved in operating Company A or how it is operated. Company A can count its experience prior to being acquired by Company B for the purposes of the track record requirement.
- (3) An experienced CIS operator (Operator A) acquires another CIS operator (Operator B). Operator A wants Operator B to be the passport fund operator for commercial reasons but Operator B does not meet the track record requirement. This is allowed because Operator A meets the track record requirement in its own right but only if Operator A can demonstrate to the home regulator that its experience should be regarded as relevant in considering the experience of Operator B.

Q3.10 Is this restriction on counting the experience of an operator or related party under different control sufficient to ensure that the operator has the capability to act as a passport fund operator? Would the restriction give rise to any practical problems? If the experience of the operator is permitted to be counted despite a change in control because it meets the requirements about continuity of staffing and decision making processes, should there be additional documentation requirements? If so please explain.

Q3.11 Should operators be allowed to count experience operating other types of retail investment schemes (for example, pension funds) as the requirement is currently drafted? Are there other types of experience which should be allowed to be counted?

Qualifications of officers of the operator

In addition, the following requirements apply to the operator.

- the chief executive officer, or equivalent, must have a minimum of 10 years' experience as an officer or employee of an entity that carries on a business in financial or capital markets;
- at least two executive directors, or equivalent, must have a minimum of five years' experience as an officer or employee of an entity that carries on a business in financial or capital markets; and
- persons responsible for making discretionary investment decisions for the passport fund must have:
 - at least a bachelor degree or equivalent in a relevant discipline that the home regulator considers demonstrates relevant knowledge to a sufficient degree, and a minimum of three years' (in the past five years) experience in financial or capital markets that the home regulator considers demonstrates relevant knowledge to a sufficient degree; or
 - a minimum of five years' (in the past seven years) experience in financial or capital markets that the home regulator considers demonstrates relevant knowledge to a sufficient degree.

There must be at least one person responsible for making discretionary investment decisions for the passport fund who is an officer or employee of the operator of the passport fund.

Q3.12 Are the qualification standards appropriate and sufficient to ensure the ability of the passport fund operator to perform its functions?

Q3.13 Should they apply to any other persons involved in the operation of a passport fund?

Q3.14 Should the proposed requirements for there being a qualified person who is an officer or employee of the operator apply to ensure this important function is done in the organisation directly regulated as a passport fund operator? What if any practical problems would arise?

Capital adequacy

The operator must maintain equity (for a body corporate that has shares, shareholders' equity) (unimpaired by losses) of at least USD 1 million. Where the operator has assets under management (AUM) exceeding USD 500 million, it must maintain additional capital equivalent to 0.1 per cent of the AUM in excess of USD 500 million, up to a maximum of USD 20 million of additional capital. The rationale for this is to ensure that operators are in a sound financial position and adequately capitalised to meet the obligations arising from their activities.

For this purpose, unconditional and non-repayable undertakings by a body that is subject to prudential supervision by a financial supervisory authority in its home jurisdiction broadly under the guidelines of the Basel Committee on Banking Supervision (BCBS) may be counted as an asset in calculating equity. For example, certain forms of bank guarantee.

Q3.15 The European Securities and Markets Authority (ESMA) in its technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive recommended allowing a degree of substitutability between professional indemnity insurance and capital to cover professional liability risks. Should a passport fund operator be able to substitute for capital (in whole or in part) the amount of cover provided by holding professional indemnity insurance which meets specified requirements given that a purpose of the requirement for capital for passport fund operators is to address professional liability risk?

Q3.16 If professional indemnity insurance is permitted as a substitute what requirements should apply? Should there be minimum requirements concerning the terms and level of coverage of the insurance policy and the insurance provider? For example:

Requirements on the terms and level of coverage:

- (a) The policy must have an initial term of no less than one year.
- (b) Coverage must include liabilities of the fund's directors, officers or staff of third parties for whom the fund has vicarious liability.

Requirements concerning insurance provider:

- (a) The insurance provide is a third party entity and subject to prudential regulation and ongoing supervision.
- (b) The fund manager must assess that the insurance provider has sufficient financial strength with regard to its ability to pay claims.

Are there any other set of requirements that need to be applied?

For the purpose of this requirement, AUM refers to the value of the following assets, as they would appear on a balance sheet under the accounting standards applying to regulated CIS in the home economy, if they were held by a single entity:

- the assets of each relevant regulated CIS for which it is an operator; and
- any other assets for which it performs discretionary investment management on behalf of another (including assets managed in other regulated CIS, other CIS or investment schemes and assets not managed on a collective basis).

This includes assets different from that permitted for a passport fund, for example, real property or infrastructure assets.

Good standing

The operator, and its directors and senior managers and persons having control or significant influence over the operator, must not have been the subject of a judgement or finding by a court or regulator that, in the opinion of the home regulator, indicates they are less than competent or are not of sufficient good standing to be permitted to operate a passport fund.

Under this requirement, discretion is given to the home regulator to judge whether a previous judgement or finding has sufficient relevance to the participation of an operator in the passport. Judgements or findings that specifically relate to the operator's past operation of CIS will be relevant. Judgements or findings that relate to the fitness and propriety (including honesty) of the operator (as well as its directors, relevant senior managers, and persons having control or significant influence over the operator) are also likely to be relevant.

The reference to a judgement or finding includes an enforceable undertaking, agreement or settlement.

Funds under management

At the time the operator seeks to have a regulated CIS authorised as a passport fund, the operator and its related parties must have AUM in investment schemes of at least USD 500 million.

For the purpose of this requirement, only assets in investment schemes that invest at least 50 per cent of their assets in permissible investments (that is, assets that a passport fund is allowed to hold under the rule on investment restrictions – asset classes, page 23) may be counted toward the USD 500 million requirement.

The level of AUM is partly being used as a measure of experience and capacity to manage sizeable funds but is also important to ensure the passport fund being set up can benefit from the economies of scale enjoyed by the operator.

OPERATION OF THE PASSPORT FUND

In regard to the operation of the fund, the home economy laws and regulations will apply as a baseline. Host economy rules will not apply. For example, passport funds must comply with their home economy laws and regulations on:

- the duties of operators;
- risk management and related party transactions;
- valuation;
- record keeping;
- custody arrangements;
- meetings of the members;
- service providers;
- redemptions; and
- investment restrictions.

There are a number of areas which will also be governed by the passport rules, for example, valuation for pricing, custody arrangements, investment restrictions and redemptions. The passport rules apply in addition to the home economy laws and regulations. Each economy will ensure that the application of its home economy laws and regulations to passport funds is not inconsistent with the passport rules.

Depending on the level of regulation in the home economy, the passport rules may go beyond the home economy laws and regulations and require a higher standard. Alternatively, the home economy laws and regulations may go beyond the passport rules, in which case compliance with the home economy laws and regulations will result in compliance with the passport rules.

The passport rules that will apply to the operation of passport funds are outlined below.

References to what a passport fund can or must do or not do should be read on the basis that it is the passport fund operator that is responsible for what can or must be done or not done.

Requirement for custody arrangements

In addition to their home economy laws and regulations, passport funds must meet minimum criteria relating to the safe-keeping of passport fund assets.

The purpose of these requirements is to establish minimum standards for the safe-keeping of passport fund assets because effective mechanisms to protect assets are necessary to promote confidence in the passport.

Use of a custodian

A passport fund must ensure that there is a custodian for the assets of the passport fund. The custodian must not be the relevant operator and must be authorised by the home regulator to carry on a business of holding assets on behalf of others or be subject to regulatory

requirements in relation to holding assets in the home economy. The primary holder of the 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 purpose of this requirement is to guard against the risk of loss arising from the insolvency of the operator and to facilitate the segregation of passport fund assets.

In this context, the relevant operator is the entity responsible for making investment decisions and generally operating the fund. This means that the assets are allowed to be held by a trustee (if the CIS uses a unit trust structure, with a trustee and a manager) even though the trustee is an operator.

Example: In Australia the operator is the responsible entity, and the assets must be held by a separate custodian. In Singapore, the operator is the manager, and the assets may be held by the trustee.

A passport fund could also use a custodian authorised by another regulator to carry on the business of holding assets on behalf of others, if this is allowed under the home economy laws and regulations.

Independence of custodian

Whether or not the operator and the custodian are related parties, the activities that relate to the asset holding must be performed by officers who are separate from, and able to act independently from, people involved in investment or trading decisions whether in relation to the passport fund or otherwise (except for deposit accounts and currency investments or trading).

This requirement recognises that, in some cases, passport funds may wish to use custodians that belong to the same corporate group or that have other investment or trading activities if this is allowed under the home economy laws and regulations. This rule allows the use of such custodians but requires legal and functional separation between the two activities.

Example: The home economy may require additional standards. In some economies there are specific requirements prescribing aspects of independence such as physical separation of staff which would apply in the home economy of the fund.

Separation of assets

In general, the assets of the passport fund must be held separately from assets that are not assets of the passport fund (for example, the assets of the operator, the assets of the custodian, or the assets of other CIS). However, passport fund assets are allowed to be held in an omnibus account as long as the account:

- is managed in accordance with good custodial practice,
- is reconciled on each business day in the economy of the custodian; and
- does not also hold the assets of the holder of the omnibus account.

The account may hold both the assets of the passport fund and the assets of the holder of the omnibus account where the custodian has paid money into the account to prevent the continuation of a shortfall because of circumstances outside its control, such as a failed trade.

When the amount in the omnibus account goes into surplus as a result of the defaulting client's assets being received, the custodian has an entitlement to recover the surplus amount and would be required to do so as quickly as reasonably practicable.

Identification of assets

A passport fund must ensure that assets of the passport fund are identified in the records of the custodian as assets of the passport fund.

Independent oversight

A key element of CIS governance is the presence of independent oversight over performance of the operator's duties. Internationally, independent entities are the primary source of independent oversight.

The independent entity's main objective is to ensure that operators comply with the applicable rules, their contractual obligations, and their duties from 'an outside perspective', and, therefore, protect members from divergent behaviours of the operator. In this regard, the operator must be subject to oversight by:

- a separate and independent entity (for example, a trustee if applicable);
- a board of directors of which at least half of the members are independent; or
- a compliance committee of which more than half of the members are independent.

The independent entity, independent directors, or compliance committee will have duties to:

- exercise care and diligence including when performing their functions for the purpose of safeguarding the rights and interests of the members of the passport fund;
- monitor the operator and its personnel for compliance with the constitutive documents and offer documents of the passport fund, and laws and regulations relating to the operation of the passport fund; and
- report any non-compliance to each regulator to whom the operator is generally required to report non-compliance, within five business days of the entity, directors or committee becoming aware of the operator having failed in a requirement to make such a report.

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.

Compliance audit

To give investors confidence that passport funds are being operated in accordance with the passport rules, and to assist regulators in supervising passport funds, passport funds will be required to appoint an auditor to conduct an annual compliance audit in relation to the passport rules and the passport fund operational requirements.

Auditor appointment

A passport fund must ensure that at all times an auditor is engaged to audit the passport fund's compliance with the passport rules. The auditor must be a person or persons who are

allowed to conduct compliance audits required of regulated CIS under the home economy laws and regulations or audits of the financial statements of passport funds.

The auditor must also be independent. This means that the following persons cannot be appointed as an auditor of a passport fund in respect of the compliance audit:

- the operator or a related party of the operator;
- the custodian or a related party of the custodian; or
- the individual who is in charge of the audit of the passport fund's financial statements (although they may work for the same firm of auditors or audit company).

Exception

Where the oversight function (see independent oversight, page 21) is conducted by a separate and independent entity, that independent oversight entity may conduct a compliance audit relating to obligations applying to another operator of the passport fund despite the fact that it will be the operator in some contexts and/or the custodian (for example, a trustee if applicable). However, the independent oversight entity cannot conduct a compliance audit in relation to its own obligations under the passport rules and the passport fund operational requirements. Such an audit must be undertaken by an independent person.

Q3.18 Should an independent oversight entity be permitted to conduct a compliance audit?

Q3.19 Should an independent oversight entity be permitted to self-certify its own compliance in respect of its own obligations under the passport rules instead of arranging its compliance to be audited in any circumstances? If so, under what circumstances should such self-certification be allowed and how can the potential conflict of interests be satisfactorily mitigated?

Compliance audit

A passport fund must ensure that for each period of 12 months (or lesser period to which the audit relates), an appointed compliance auditor must carry out an audit of the passport fund's compliance with:

- the passport rules; and
- a defined set of obligations under home economy laws and regulations that help ensure the passport fund operational requirements are in place.

Within three months following the end of the period, the auditor must give the operator(s), the independent oversight entity, the home regulator, and each host regulator, a report that states whether, in the auditor's opinion, the passport fund was operated in compliance with the passport rules and the defined set of obligations for that period and if not, in what respects this was not the case.

In relation to a requirement that depends on the existence of a reasonable expectation or belief of the operator, the auditor need not express a view about whether the relevant expectation was reasonable but will have to express an opinion about whether any requirements for documentation of the basis for a view or expectation of the operator have

been met, and express a view that having reviewed the operations of the passport fund, the auditor has no reason to believe the expectation or belief was not reasonable.

Q3.20 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).

Economies will engage with the auditing profession to help determine appropriate standards, taking into account auditing and assurance pronouncements issued by the International Auditing and Assurance Standards Board. The auditor will be required to provide a report in accordance with standards approved by the home regulator in consultation with the other passport economy regulators.

Q3.21 Is this the most appropriate approach to ensure there are adequate standards which are applied consistently?

The operator, each delegate and custodian must do all things necessary to assist the conduct of the audit.

Investment restrictions — asset classes

Passport rules will govern the types of assets a passport fund is allowed to hold. The reasoning behind this rule is that it is important for the passport to gain a reputation as a regulatory arrangement that provides for liquid investments that are readily able to be priced.

Passport funds will only be allowed to hold the following assets:

- investments in regulated CIS;
- deposits;
- currency;
- derivatives;
- transferable securities;
- money market instruments; and
- depository receipts over gold,

... subject to the additional criteria provided below.

For the purpose of the restrictions on assets classes and portfolio allocation, agreements for the provision of services or goods acquired for operational and not investment purposes will not be treated as assets. For example, a subscription to an investment research publication paid in advance.

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?

Q3.23 Are there any other assets that have appropriate qualities of liquidity and reliable valuation that should be permitted consistent 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 assets should be permitted and within what limits?

Deposits

Deposits of the passport fund must be with deposit taking institutions that are regulated broadly under the guidelines of the BCBS.

They must also be:

- repayable on demand or have the right to be withdrawn on no more than 31 days' notice; and
- not subject to loss of interest or penalty if repaid at the request of the holder at a time that is more than 12 months after the date which the amount was deposited.

Derivatives

Underlying

For derivatives, the underlying asset or index from which the value of the instrument is ultimately determined must be the value of one or more of the following:

- an investment that the passport fund is entitled to hold other than a derivative;
- a rate of interest including a rate of inflation on the basis of which a rate of interest is calculated;
- a currency of any jurisdiction; or
- an index.

The delivery of an asset under the derivative can only relate to an asset that the passport fund is permitted to hold, other than a derivative.

Indexes

If the underlying is an index, it must meet the following requirements:

- the index must predominantly relate to financial assets or commodities (that is, fungible physical assets such as silver or platinum) that are regularly traded;
- the index must have a clearly defined objective, or the market or sector which it aims to represent is clearly defined;
- the index must represent a reasonable benchmark for a market or market sector for which it is widely used;

- the index provider must not be a related party of the operator or, where the two parties are related parties, there are effective arrangements in place for the management of conflicts of interest specifically arising in connection with the index;
- 100 per cent of the constituents of the index, with the exception of those related to commodity prices, are investments that the passport fund would be permitted to hold;
- no constituent exceeds 25 per cent of the index; and
- information about the index (including the composition of the index and the information on methodology used to construct and rebalance the index) is freely accessible.

In assessing whether a commodity index satisfies the 25 per cent diversification limit, constituents relating to commodity prices which relate to substantially the same commodity, even if in a different quantity, or delivered at a different place or time should be treated as giving the exposure to the same underlying. This would mean, for example, that US and Brazilian corn futures would be treated for the purposes of this requirement as having the same underlying but not iron ore and aluminium futures. This approach of aggregating certain highly correlated exposures is in line with that adopted in UCITS.

Liquidity

The market value of the derivative should normally be able to be determined on each business day in the economy in which the derivative was acquired by the passport fund other than in exceptional circumstances.

Where the derivative is not regularly entered, formed or traded on a financial market, the value of the derivative should be able to be determined by the passport fund in a way that does not solely rely on a valuation provided by the counterparty to the derivative.

Example: The value could be determined by competing quotes to take an opposite position on the derivative from entities that are regarded as subject to similar counterparty risk.

The derivative should normally be able to be closed out or sold for the value determined above on each business day in the economy in which it was acquired other than in exceptional circumstances.

Transferable securities

Passport funds can only hold transferable securities, including interests in investment schemes, that are issued and offered in a jurisdiction whose securities regulator is an ordinary or associate member of IOSCO and where no liability arises from holding the security.

Note that there is a limit on the unquoted transferable securities a passport fund can hold. Unquoted transferable securities are securities that are not quoted on financial markets regulated by an ordinary or associate member of IOSCO (see limit on unquoted securities below, page 29).

Money market instruments

The passport fund must reasonably expect that each money market instrument will be able to be:

- closed out or sold for their market value on each business day in the place where it was acquired by the passport fund; and
- reliably valued on each business day in the place where it was acquired by the passport fund at its market value.

Investment restrictions — portfolio allocation

The passport rules will set out the portfolio allocation restrictions with which passport funds must comply. The reasoning behind this rule is that it is important that the passport gains an early reputation for promoting investor confidence. As with UCITS, this means that funds must be well-diversified between issuers and fungible assets, and invested primarily in liquid assets. Issuer diversification mitigates the risk of loss inherent in investment concentration.

There will be seven broad limits based on those in UCITS:

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

Exceptions are provided to some of these limits and these are detailed below.

If a passport fund exceeds or is likely to exceed any holding limit provided below, whether by making an acquisition or otherwise, it must promptly take all reasonable steps to avoid exceeding or cease to exceed the limit and must comply with any directions of the home regulator in this regard. If it does not, the home regulator may take appropriate action (see section on supervision and enforcement on page 50).

Single entity limit

Subject to the exemptions outlined below, a passport fund must not acquire an asset or enter a derivative or securities lending transaction if it results in the passport fund holding or holding to an increased extent:

- more than 5 per cent of the value of its assets in transferable securities and money market instruments issued by the same entity together with any derivatives that have securities of that entity as the underlying reference asset;

- derivatives or securities lending transactions with a single counterparty that could expose the fund to a maximum potential loss of more than 5 per cent of the value of its assets should the counterparty default; or
- more than 20 per cent of the value of its assets in deposits with, or depository receipts issued by, the same entity.

The maximum potential loss for a derivative is to be determined in accordance with the method set out in Schedule A.

For derivatives, or an asset that is a liability of another entity, the net holding of the passport fund may be determined after netting off any liability of the passport fund to the other entity where there is a legally effective netting arrangement.

Exceptions

Central clearing counterparties (CCP): Liabilities of CCP that clear transactions entered through a financial market regulated by a passport economy or an OECD economy are excluded if the following apply:

- the passport fund believes on reasonable grounds, having regard to independent sources of information, that there is very low risk of the CCP defaulting in any of its obligations over a five year period, and
- the passport fund has documented its reasons for that belief in writing.

Note that this does not affect the requirement to consider any liability of the issuer of the securities or derivatives that are acquired.

Additional credit risk check: The single entity limit for money market instruments, transferable securities and derivatives, may be raised to 10 per cent if the operator has:

- conducted an assessment of the creditworthiness of the issuer in accordance with written policies and procedures established by the operator which include having regard to independent sources of information;
- documented its assessment that the issuer is creditworthy and the basis for that conclusion; and
- satisfied itself that the increased concentration of investments does not impose a disproportionate increase in risk for members of the passport fund given the creditworthiness of the issuer.

This process is in addition to, or may form part of, the standard due diligence that an operator would conduct on asset holdings that do not exceed the single entity limit.

In coming to these limits, signatory economies considered the portfolio allocation rules under the European Union regime for UCITS. Given the relative concentration in some developing Asia region markets, it was considered that a 10 per cent limit would better reflect regional circumstances. However, to balance the increased concentration this allows, it was considered important that operators of passport funds satisfy themselves of the creditworthiness of issuers in which they hold an increased interest and document their analysis.

Government securities: The single entity limit for transferrable securities and money market instruments may be raised to 35 per cent if the interest is issued or guaranteed by a government or central bank of an economy, or a supranational organisation. This applies only if prior to the passport fund holding more than 5 per cent of its assets in interests that are issued or guaranteed by a government or an organisation as referred to above, the operator conducts a credit risk check as described above.

Index funds and benchmark funds: The single entity limit for money market instruments, transferable securities and derivatives may be raised if the passport fund is:

- an index fund which has publicly disclosed that it has an investment strategy of seeking to achieve returns which meet a particular index and the passport fund predominantly invests in the index constituents; or
- a benchmark fund, meaning an index fund which has publicly disclosed that it has an investment strategy of seeking to achieve returns which meet or exceed a particular index and the passport fund predominantly invests in the index constituents.

Please note there are additional limitations on index funds contained in the definition of index fund in the glossary.

An index fund or a benchmark fund can hold interests in a constituent which represents the value of the constituent as a proportion of the value of the index plus two per cent up to a maximum of 25 per cent.

Regulated CIS: The single entity limit does not apply to the holding of assets that are interests in regulated CIS. Such holdings must comply with the CIS limit below.

Group limit

A passport fund must not acquire an asset if it results in it holding more than 20 per cent of the value of its assets in:

- deposits, transferable securities or money market instruments issued by entities controlled by the same entity; together with
- any derivatives with counterparties controlled by that entity (the value of the derivative for this purpose is the maximum potential loss that the fund could suffer in the counterparty defaulted).

As above, the maximum potential loss for a derivative is to be determined in accordance with the method set out in Schedule A.

For derivatives or an asset that is a liability of another entity, the net holding of the passport fund may be determined after netting off any liability of the passport fund to the other entity where there is a legally effective netting arrangement.

This is called the group limit and is intended to restrict the proportion of passport fund assets that can be invested in the assets of the same corporate group to reduce the risk that may arise from concentration risk relating to a particular group.

Exceptions

The exceptions for CCPs, government securities, and regulated CIS apply to this limit.

If the passport fund is seeking to achieve or exceed an index and meets the other criteria under the index and benchmark exception, the passport fund can hold interests in constituents controlled by the same entity which represent the value of the constituents as a proportion of the value of the index plus two per cent up to a maximum of 25 per cent.

CIS limit

There will be two restrictions on a passport fund holding assets which are interests in regulated CIS:

- a limit on the proportion of the assets it can hold in interests issued in one regulated CIS (the single CIS limit); and
- a limit on the proportion of the assets it can hold in all regulated CIS that are not passport funds (the total CIS limit).

Single CIS limit: A passport fund must not acquire an interest in a regulated CIS if it results in the passport fund holding or holding to a greater extent more than 10 per cent of the value of its assets in that regulated CIS, or 25 per cent for an index fund or a benchmark fund meeting the requirements in the exception to the single entity limit.

To accommodate feeder funds, the single CIS limit will not apply where:

- the passport fund has disclosed an investment strategy of investing at least 85 per cent of the value of its assets in another passport fund (that is, it is a feeder fund); and
- the passport fund in which it holds at least 85 per cent of the value of its assets is itself not a feeder fund.

Total CIS limit: A passport fund must not acquire an interest in a regulated CIS if it results in more than 30 per cent of the value of its assets being in interests in regulated CIS that predominately invest in transferable securities and money market instruments but are not passport funds. This is to prevent avoidance of the passport rules.

Limit on unquoted shares, stocks and interests in investment schemes

A passport fund must not acquire a share, stock or interests in investment schemes, other than regulated CIS, if it results in the passport fund holding, or holding to a greater extent, more than 10 per cent of the value of its assets in shares, stock or interests that are not:

- quoted on a financial market regulated by an ordinary or associate member of IOSCO; or
- approved for quotation on such a regulated financial market.

Limit on investments conferring significant management influence

A passport fund other than a feeder fund must not acquire any securities carrying voting rights that would enable it to exercise significant influence over the management of an entity (including a regulated CIS). Voting rights exceeding 25 per cent of the votes that may be cast would generally be significant.

Limits on share of securities or money market interests on issue

A passport fund must not acquire more than:

- 10 per cent of the non-voting securities of an entity other than a regulated CIS;

- 10 per cent of the debt securities of an entity; or
- 10 per cent of the money market instruments for which an entity is or may be liable.

The purpose of this rule is to ensure that there are sufficient other investors to provide a basis for liquidity.

Depository receipts over gold

A passport fund must not acquire depository receipts over gold if it would result in the passport fund holding or holding to an increased extent over 25 per cent of the value of the assets of the passport fund in depository receipts over gold.

Derivatives

The passport rules will require passport funds to limit their exposure to derivatives. The purpose of this requirement is to ensure members of passport funds have a reduced exposure to the risk of loss associated with the use of derivatives.

For this purpose, the passport rules will include four key requirements:

- rules to ensure the requirements relating to portfolio allocation are not avoided by use of derivatives;
- a limit on passport funds' global exposure to derivatives;
- a requirement that exposures are covered by assets available to perform obligations; and
- requirements to manage counterparty risk.

Spread of underlying assets

The exposure of a passport fund to the underlying assets of derivatives should be sufficiently diversified on a portfolio basis taking into account exposure through derivatives and otherwise in accordance with the section on investment restrictions – portfolio allocation, page 26.

Limited global exposure

A passport fund must not acquire a derivative or enter into a securities lending transaction if it would cause the global exposure of the passport fund to derivatives and securities lending to exceed or exceed to a greater extent 20 per cent of the value of its gross assets. This may be increased to 100 per cent in the case of an index fund which uses derivatives traded on a financial market regulated by an ordinary or associate member of IOSCO for the purpose of index replication. In coming to these limits, signatory economies considered the limits applicable under UCITS and the ASEAN scheme for cross-border public offers of CIS.

The global exposure of a passport fund is to be calculated as the sum of:

- the absolute value of the exposure of each individual derivative or securities lending transaction not involved in netting or hedging arrangements;
- the absolute value of the net exposure of each individual derivative or securities lending transaction involved in netting or hedging arrangements, after taking into account any netting or hedging arrangements; and

- the value of any collateral provided to the passport fund where there may be an obligation to return the collateral or equivalent assets unless the passport fund has available that collateral. Money held in a deposit account and payable by no later than the time the collateral may be repayable is treated as available where the collateral provided is money.

Commitment approach

The individual exposures that are aggregated to determine global exposure must be calculated based on the commitment approach. Under the commitment approach, the exposure of the passport fund to a derivative is determined by converting the position in the derivative into an equivalent home currency position in the underlying assets. This reflects an approach applied under UCITS. The methods for determining a passport fund's exposure for particular types of derivatives are set out in Schedule B.

Q3.24 To what extent does Table 2 in Schedule B appropriately measure exposure of a passport fund? To the extent it does not, what other measuring standards should apply?

Netting arrangements

Netting arrangements may be taken into account to reduce a passport fund's exposure to derivatives when calculating the global exposure limit. However, passport funds may only net positions between:

- derivatives with the same underlying assets or index (disregarding any difference in the maturity dates of the derivatives); or
- derivatives and the relevant underlying assets or assets that are components of the relevant index.

Hedging arrangements

Hedging arrangements may be taken into account to reduce a passport fund's exposure to derivatives when calculating the global exposure limit. Hedging arrangements are defined as one or more transactions in assets that a passport fund is permitted to hold which are concluded with the sole purpose of offsetting risks linked to positions taken through other such assets.

In determining the exposure for a passport fund, the exposure arising from one or more derivatives, that are the subject of a hedging arrangement, can be offset against other gains that the passport fund reasonably expects would arise, based on documented reasons, when the exposure under the derivatives would arise. This applies only where the passport fund reasonably expects, based on documented reasons, the set of transactions subject to the hedging arrangements will reduce both:

- the general market risk for a class of assets held by the passport fund defined by the passport fund; and
- specific risks arising from holding particular assets in that class.

The transactions under the hedging arrangement must be for the sole purpose of offsetting those risks.

Exposures must be covered

Where the acquisition of a derivative gives rise, or may give rise, to a future commitment of the passport fund, the exposure must be covered as set out below.

In the case of derivatives which will, or may at the option of the counterparty, be cash settled, the passport fund must hold, at all times, available assets that the passport fund reasonably believes will be available and able to be readily converted into sufficient assets to cover the exposure under the derivative.

The term exposure in this context refers to an actual or potential future commitment by the passport fund to make contractually required payments calculated in accordance with Schedule A. As such, an exposure would include, for example, any cash settlement of contracts, margin calls, and interest payments.

In the case of derivatives which will, or may at the option of the counterparty, require physical delivery of the underlying assets, the passport fund must:

- hold the underlying assets in sufficient available quantities to meet the delivery obligation at all times; or
- hold, as coverage, other assets that the passport fund reasonably believes will be available and able to be readily converted into sufficient assets to be delivered as required to meet the actual or potential delivery obligation.

Counterparties to derivatives

The following applies to derivatives which are not cleared by a CCP (non-centrally cleared derivative).

The counterparty of a non-centrally cleared derivative should:

- be subject to prudential supervision by a financial supervisory authority in its home jurisdiction broadly under the guidelines of the BCBS; or
- be authorised by a regulatory authority which is a member or associate member of IOSCO to be a party to derivatives and subject to obligations in relation to holding financial resources and having adequate arrangements to manage risk.

The exposure to a counterparty of a non-centrally cleared derivative for the purpose of the single entity limit (5 per cent of passport fund assets or 10 per cent if the passport fund is satisfied with the additional credit assessment of the counterparty as set out above) and the group limit (20 per cent) should be measured based on the maximum potential loss that may be incurred by the passport fund if the counterparty defaults as set out in Schedule A and not on the basis of the notional value of the non-centrally cleared derivative. Cash collateral that is kept in a deposit account can be used to lower the exposures to the counterparty of a non-centrally cleared derivative to which it relates.

Q3.25 To what extent does the calculations required by Schedule A, including in respect of what collateral may be considered, appropriately measure the maximum potential loss of a passport fund due to a counterparty failing? To the extent it does not, what other measuring standards should apply?

When the derivative is centrally cleared, the passport fund must believe, on reasonable grounds, having regard to independent sources of information, that there is very low risk of the CCP defaulting in any of its obligations over a five year period and has documented in writing its reasons for that belief.

Netting arrangements of counterparty exposure

Netting arrangements may be taken into account to reduce a passport fund's exposure arising from non-centrally cleared derivative positions with the same counterparty where all of the following apply:

- the amounts are due under a legally effective agreement between the passport fund and another person; and
- under that agreement the liability of each to the other is only the net amount for which they are liable.

Embedded derivatives

Where a transferable security or money market instrument embeds a derivative, the requirements for derivatives generally apply to the embedded derivative including the requirements relating to counterparties.

A transferable security or money market instrument embeds a derivative if it contains a component which fulfils the following criteria:

- the component:
 - results in some, or all, of the cash flows that would otherwise be payable to be modified according to a variable other than, for shares or stock, the discretion of the corporation as to payment of dividends or repayment of capital or amounts payable on its winding up (for example, the variable could include a specified interest rate, price of a financial instrument, foreign exchange rate, index of prices or rates, credit rating, or credit index);
 - has benefits and risks that are not closely related to the economic characteristics and risks of the transferable security or money market instrument;
 - has a significant impact on the risks in holding and the price of the transferable security or money market instrument; and
 - is not contractually transferable independently of the transferable security or the money market instrument or, if it is contractually transferrable, is not treated by the passport fund for the purposes of the rules as a separate asset; or
- the component has been designed to meet the specific needs of a passport fund.

Securities lending

A passport fund must not engage in securities lending (being a transfer of assets subject to an agreement to return the asset or an equivalent asset including a 'repo' and a loan of a non-monetary asset) to generate leverage.

The passport fund also must not reinvest any collateral it obtains or any income earned on that collateral except in case of counterparty default.

A passport fund must not at any time have transferred more than 50 per cent of the value of its assets in securities lending transactions excluding assets transferred where the obligations of the transferee have been terminated including by performance.

The passport rules in relation to limits on global exposures for derivatives apply to securities lending transactions as set out above.

In addition, there will be additional requirements relating to the counterparties to securities lending transactions and the collateral to be provided as set out below.

Counterparties to securities lending transactions

The counterparty to a securities lending transaction should be:

- an entity subject to prudential supervision broadly under the guidelines of the BCBS by a financial supervisory authority in the jurisdiction where it is constituted or established; or
- be authorised by a regulatory authority which is a member or associate member of IOSCO and subject to obligations in relation to holding financial resources and having adequate arrangements to manage risk.

Where the operator engages in securities lending transactions with any of its related parties, the operator must ensure that it has effective arrangements in place to manage potential conflicts of interest specific to this situation.

The agreement between the passport fund and the counterparty, either directly or through its agent, should require the counterparty to provide additional collateral to the passport fund or its agent no later than the close of the next business day in the economy of the counterparty if the current value of the eligible collateral tendered does not exceed the value of the asset to be transferred to the passport fund.

Collateral for securities lending transactions

The collateral provided in securities lending transactions must exceed the value of the asset lent by the passport fund.

As set out above, only cash collateral that is kept in a deposit account can be used to lower the global exposures to the counterparty of a securities lending transaction.

Lending, guarantees and underwriting

The passport rules will prohibit money lending, the provision of guarantees and underwriting by passport funds. The reason for this rule is to minimise additional risk to members from these activities, consistent with the guiding philosophy that risks associated with passport funds should be simple.

This rule does not prohibit a passport fund making an investment that is permitted under the rules on permitted asset classes. For example, it does not prohibit passport funds from loaning money to deposit-taking institutions regulated under the BCBS guidelines, where the loan is in the form of an overnight deposit.

Borrowing and partly paid securities

The passport rules will limit the circumstances in which a passport fund may borrow and prohibit the acquisition of partly paid securities.

Borrowing

In general, a passport fund must not borrow money or other assets or obtain finance. However, borrowing is allowed where all of the following conditions are met:

- the amount raised is no more than 10 per cent of the passport fund's net assets (when calculated together with any previous amount raised and not repaid);
- the purpose of the borrowing is:
 - to enable payment of redemption requests that have been made or are reasonably expected to be made; or
 - to enable payment of expenses (other than expenses in making an investment) properly payable by the passport fund other than fees payable from the fund to an operator; and
- there is a material risk that the fund will have insufficient available assets that the passport fund reasonably believes will be available and able to be readily converted into sufficient assets to enable the redemption requests to be satisfied or for the expenses to be paid by the passport fund (as applicable) without the borrowing;
- the borrowing is in the form of a trade credit, loan or overdraft from a financial institution licensed or regulated in the institution's principal place of business;
- the passport fund intends to repay the borrowing in full in less than 31 days and the repayment will not be made from other borrowings or financed amounts; and
- the passport fund has documented cash flow projections prepared on reasonable assumptions that show that the amount of borrowing or finance will be reduced to nil within that time.

Partly paid securities

A passport fund must not hold securities which are partly paid. Even if there is no legal liability to pay any amount not yet paid, the securities may be liable to forfeiture and to avoid losses arising from forfeiture cash may be needed to pay a call.

Short-selling

The passport rules will prohibit short-selling by passport funds.

The reason for this rule is to minimise risk to members, consistent with the guiding philosophy that the passport should have a strong consumer protection focus. The losses associated with short-selling can be unlimited because the price of the underlying security can rise without limit.

Short-selling will be defined as the sale of passport fund assets which does not meet either of the following conditions:

- the passport fund has a presently exercisable and unconditional right to give title to the assets to the buyer at the time of sale; or

- prior to entering into the sale:
 - the passport fund has an agreement to buy the assets sold which is only conditional on one or more of the following:
 - : payment of the consideration,
 - : the exercise of an option on the part of the passport fund,
 - : receipt of the proper instrument of transfer or receipt of the title documents; and
 - compliance with the agreement would result in the first condition being satisfied before the assets are to be transferred.

When assessing its compliance with the above, the passport fund must allow for any other obligations it has to transfer the assets including an obligation to transfer securities that have been the subject of a securities lending transaction. For example, a right to buy a share cannot support two agreements to sell that share. A short sale is prohibited even if covered by borrowed securities.

Delegation

An operator may delegate any function, as allowed under its home economy laws and regulations, but the operator must:

- remain responsible to members for any delegated functions;
- ensure that the delegate employs at least the standard of care when performing the delegated function that the operator would be required to employ if the function were performed by the operator;
- have in place suitable processes to monitor and control the activities of the delegate and evaluate the performance of the delegate; and
- ensure that it or its delegate is able to provide the home regulator ready access to information related to the delegated functions.

Where the portfolio management function is to be delegated, the passport fund must ensure that:

- the delegate is subject to regulation which, to the satisfaction of the home regulator, following consultation with other passport economy regulators, provides substantially equivalent regulatory outcomes to that applying in the passport economies;
- the delegate is regulated by an organisation that to the satisfaction of the home regulator, following consultation with other passport economy regulators, has co-operation arrangements in place with the home regulator which are comparable to, and as effective as, those in place between the passport economy regulators; and
- the delegate meets the requirements for the eligibility of operators under this framework relating to capital, experience (including of its chief executive officer and executive directors), funds under management (as at the time of their appointment in relation to the passport fund) and good standing.

Q3.26 Are these eligibility requirements sufficient to ensure that the delegates have the necessary experience to perform the delegated functions and are subject to appropriate regulatory oversight? If not, what other measures should apply?

Q3.27 Is it appropriate to apply the same requirements as apply to an operator to a delegate in relation to the experience of its chief executive officer and executive directors? If not, why not?

Valuation for pricing

It is critical that a passport fund properly values all assets in its portfolio as issue and redemption of interests in the fund must be based on its net asset value (NAV). This is especially important for instruments for which market quotations are not readily available (for example, restricted securities and many derivatives). If the assets of a passport fund are incorrectly valued, investors may, for example, unfairly pay more for their interests (or unfairly receive less upon redemption), and members remaining in the passport fund also may be adversely affected.

There are various valuation methodologies that can be used to value assets held by CIS. To ensure consistency in the valuation of passport funds, the valuation of the assets of a passport fund must be based on the following:

- in the case of quoted assets, the market price, which is the prevailing price the asset was last transacted or bid for on a financial market on which the asset is quoted; and
- in the case of unquoted assets and quoted assets where the transacted prices are in the reasonable opinion of the passport fund not representative or not available to the market, fair value, which is the price the fund would reasonably expect to receive upon the current sale of the asset.

In respect of specific valuation requirements, passport funds may rely on the requirements in their home jurisdiction. Valuation must occur at a time after the time an application for issue or request for redemption is made.

Redemption

There will be passport rules in the area of redemptions to ensure each passport fund provides reasonable redemption rights to members.

Specifying the minimum redemption rights means members will be able to assume passport funds provide liquidity in ordinary circumstances, consistent with the requirements for assets to be generally liquid.

Right to redemption

The passport rules will specify that, unless there is a suspension permitted by the passport rules, all passport funds must offer a reasonable opportunity to members to redeem their interests, other than interests in an exchange traded passport fund class, at the usual redemption price.

The passport fund must pay the redemption price in no more than:

- 15 days from the time the request for redemption is received by the passport fund if the request complies with reasonable and published procedures; or
- any lesser period of notice that has been disclosed to members or persons considering applying for interests as the redemption period (except when a different period has subsequently been disclosed and a reasonable period has elapsed since that disclosure).

The passport fund must redeem interests in the passport fund based on a price calculated after the time the redemption request is made. If the redemption price were permitted to be based on pricing from a time prior to the time of the request, redeeming can make profits from arbitrage trading to the disadvantage of the remaining members.

Currency conversion

Interests may be redeemed in the currency of the passport economy in which the member's registered address is located or, if that address is not in a passport economy, the currency of any economy.

If the redemption price is paid in a currency other than the currency of the home economy, the amount paid in the relevant other currency must be:

- determined fairly and in accordance with a reasonable and documented policy relating to foreign currency redemptions disclosed on the passport fund's website;
- based on a reasonable estimate of the market exchange rate applied to the redemption price and any fees payable; and
- reduced to take account of the costs of the currency conversion or a reasonable estimate of the costs generally incurred in such conversion.

Exchange traded passport fund classes

If a passport fund is an exchange traded fund, the passport fund must take all reasonable and lawful steps to ensure that interests in the fund are able to be sold on the financial market at a price that is not materially different from the NAV per interest of the passport fund.

Reasonable steps would generally include making available to some persons who may be expected to actively transact in the interests with the general investing public the opportunity to issue or redeem at a price based on NAV to enable arbitrage, and may, if appropriate, also include engaging an entity with market making obligations.

If the interests are suspended from trading on each relevant financial market for more than five consecutive trading days, the passport fund must also take reasonable steps to ensure interests in the fund are able to be redeemed by members who submit a redemption request. This does not apply if the fund is being wound-up, is prohibited from offering redemption under the laws of the home economy by a direction of the home regulator, or the passport fund has exercised a discretion to suspend redemptions in accordance with the passport fund's constituent documents and the passport rules.

If there is a redemption fee payable during a suspension, the passport fund must ensure that the fee is no greater than the redemption fee that would generally be payable by a person

authorised to redeem while interests in the fund are traded adjusted for the value of interests being redeemed.

In this context, an exchange traded fund means a passport fund that is an index fund whose interests are admitted, and remain admitted, to trading status on a financial market in a passport member economy, under the provisions of the operating rules of the financial market.

Suspension of redemptions

The passport rules will also set out the circumstances in which the redemption of interests in a passport fund may or must be suspended.

The nature of the permitted investments for passport funds supports the fund being liquid. Nevertheless, the circumstances of the fund may change, in particular, the liquidity of the assets of the fund, in which case there should be scope for redemptions to be suspended so as to ensure members remaining in the fund are not unfairly disadvantaged.

A passport fund must suspend or restrict redemptions if, and only if:

- it is directed to do so by the home regulator (the home regulator would be given the power to give such direction if it does not have it for its own regulated CIS); or
- it considers that a suspension is in the best interests of members and fair as between members; and
 - such a proportion of the passport fund's assets are not able to be valued sufficiently reliably that there is an unreasonable risk that the redemption price will be incorrect (except where the scope for error is unlikely to affect the decision of members about whether to redeem); or
 - 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 realised, at the market value of the assets or more, within the period for satisfying redemption requests; or
 - the fund is closed to members and is being wound up.

Publication and distribution of audited accounts

In relation to the publication of financial statements and audit reports, a mix of home economy, host economy and passport rules will apply. Annual reports, other than in relation to the financial statements and audit report, may be required in the host economy and subject to host rules.

Requirement to publish financial statements and audit report

As a baseline requirement, the passport rules will provide that, for each period of 12 months, a passport fund must publish a report with one or more documents containing financial statements and an audit report (the report). The passport fund must publish the report, together with any translations (see below), within three months of the end of the period to which it relates. It must also be provided to the home regulator and any host regulators within the same time frame.

The home regulator would be given power to allow or require that this report be published for a lesser period than 12 months in the case of newly established passport funds, or passport funds that are being wound up.

The audit report on the financial statements and the notes to the financial statements must be prepared by one or more persons allowed to audit financial statements of regulated CIS under the home economy laws and regulations in accordance with the International Standards on Auditing or the prevailing national standards of the home economy provided these standards are substantially converged with the International Standards on Auditing.

The rules may specify requirements about the regulation that must apply to an auditor. No additional requirements are proposed in relation to auditors regulated in economies whose regulation of auditors is assessed as meeting the IOSCO principles and assessment methodology. Additional requirements may apply to economies that are not assessed as such.

The report, together with any translations, must be provided to the home and each host regulator and published and otherwise made available to members of the fund in each host economy in accordance with the host economy laws and regulations.

Content of financial statements and audit report

The content of the report will depend on whether the home economy's financial reporting standards and audit requirements are converged or substantially converged with the International Financial Reporting Standards and International Standards on Auditing.

If the home economy's standards are so converged or substantially converged, then the financial statements and audit report should be prepared in accordance with the home economy laws and regulations. The report should also include any information required to be published in or with the financial statements by the home regulator in the home economy.

If the home economy's standards are not converged or substantially converged with international standards, then the financial statements and audit report must be prepared in accordance with the International Financial Reporting Standards and the International Standards on Auditing, rather than the home economy's national standards. The home economy can elect to require the passport fund to prepare two financial statements and two audit reports (that is, one set prepared in accordance with national standards, and one prepared in accordance with international standards) or may elect to allow passport funds to use international standards only.

For each host economy in which the passport fund is issued, the report must also include (as a wrapper or otherwise) any other information that would not form part of the financial statements but is required in the host economy to be published or provided to members with the financial statements.

Example: In Australia a report is required concerning such matters as a review by the operator of the operations of a regulated CIS during the relevant financial year.

This requirement that statements be prepared and audited in accordance with international standards will ensure they are robust and will facilitate comparison.

Language of financial statements and audit report

For each host economy in which the passport fund is issued, the passport fund must have all reports translated into one or more of the official languages of the host economy if required by the host regulator unless the report was prepared in that language or languages.

Q3.28 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?

Such translations must be certified as a correct translation in accordance with any requirements for certified translations as determined by the host regulator.

DEALING WITH INVESTORS

In general, the host economy laws and regulations will apply in relation to a passport fund's interaction with investors.

A host economy may impose rules on passport funds in relation to their dealings with investors in addition to the host economy laws and regulations that apply to regulated CIS generally. However, any additional rules are not to be unduly burdensome for the passport fund in comparison to regulated CIS in the host economy. Any additional rules also need to be reasonable to promote confident retail investment in passport funds.

For example, a host economy may require the operator to appoint a local representative to interface with the investors in the host economy and to perform certain administrative functions.

The host economy may require that a person, such as an individual resident in the host economy or a local company, or a foreign company registered under the laws of the host economy, be responsible for ensuring that the passport fund complies with any laws and regulations of the host economy. This could include providing information and documents to the host regulator and other matters such as keeping registers of members in the host economy.

Distribution and intermediaries

The passport arrangements do not have any effect on host economy laws and regulations relating to intermediaries or the distribution of CIS in the host economy. This means that passport funds may only be distributed in a host economy in accordance with the laws and regulations of the host economy. If those laws require that CIS can only be distributed through an intermediary which is authorised in the host economy, then passport funds can only be distributed in that manner. In this respect, passport funds are to be treated the same as local regulated CIS in the host economy.

Alternatively, if a passport member economy allows CIS to be directly marketed to investors, then passport funds will also be allowed to do so. However, if CIS operators in an economy are required to have any additional approval or license for such marketing, passport fund operators would also have to obtain such approvals.

Host rules will determine requirements for quotation of interests on a financial market in the host economy.

Example: In Australia there are specific requirements relating to the assets that can be held by an ETF, which would need to be met by a passport fund seeking quotation on the financial market in Australia.

Disclosure

When offering interests in a host economy, the host economy laws and regulations will apply to the disclosures required to be given to investors other than as covered by the rule concerning financial statements and audit reports. A range of different disclosure requirements apply to CIS in different economies. Generally, the following types of disclosure and reporting to members of the public are required to be met by passport funds, where required in the host economy:

- point of sale disclosure relating to the product (for example prospectuses and product highlight sheets) and any obligations to update that disclosure or provide continuous disclosure (for example, of significant changes);
- providing a copy or a consolidation of constitution of the passport fund;
- disclosure about portfolio holdings; and
- periodic reporting relating specifically to the investor's interest in the CIS including matters affecting the taxation position of members.

Marketing

Similar to disclosure, the host economy laws and regulations will apply to the marketing of the fund. For example, the host economy laws and regulations will apply in relation to:

- any restrictions or requirements relating to the advertising of financial products,
- any restrictions or requirements relating to offering interests in the CIS by making unsolicited approaches to investors, and
- any laws and regulations concerning misleading or deceptive conduct in relation to communications with investors.

Complaints

Host economy laws and regulations will also apply to complaints handling including both internal dispute resolution and external dispute resolution, if applicable. This means an operator needs to comply with any requirements which apply in each host economy in relation to:

- the manner in which complaints are received, processed and responded to by CIS operators; and
- if applicable, in the host economy, be a member of an approved external dispute resolution scheme.

CHAPTER 3 CONSULTATION QUESTIONS

For each area of CIS regulation outlined in the framework:

Q3.29 Do you agree with the proposed approach in terms of whether home, host or passport rules apply to this area of CIS regulation?

Q3.30 Do you think that the proposed approach would enable the passport to achieve its key objective of providing a high degree of investor protection? If not, in what way can the approach be enhanced?

Q3.31 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?

Q3.32 What impact would the proposed approach have on competitiveness and investor confidence?

Q3.33 For prospective passport fund operators or current and prospective fund managers, what impact would the proposed approach have on your business? If the proposed approach would result in an increase or reduction in compliance or other costs, please quantify.

Q3.34 Do you require more information about the proposed approach? If so, what?

Other:

Q3.35 Are there any additional requirements you would suggest? If so, what are the rules and why?

Q3.36 Do you have questions about how the passport will work that are not addressed in the proposed framework? What are they?

CHAPTER 4: REGULATORY FUNCTIONS

GENERAL APPROACH

Passport economies will need to undertake a high degree of co-operation founded on trust. The economies agreeing to participate in the passport will act to further the passport's objectives including to ensure that regulatory functions are performed in a way that promotes the passport's objectives.

APPLICATION PROCESS

Home regulator application

Following from the structure of the passport arrangements, the home regulator will assess whether a prospective passport fund meets:

- the home economy's eligibility and registration requirements to be a regulated CIS; and
- the eligibility and registration requirements which apply to passport funds (including whether the prospective passport fund has the capacity to meet the requirements of the passport rules).

As such, the first step for a prospective passport fund operator is to lodge an application with its home regulator. It can do this either after becoming a regulated CIS or as part of its application to become a regulated CIS. The timeframes for the home regulator assessing an application from a passport fund may be different, and in some case longer, from those that apply to regulated CIS in that economy.

Passport economy regulators will explore collaborating in providing guidance material about the requirements to be a passport fund and the operation of the passport to facilitate use of the passport.

The application form will be in two parts:

- Part 1: General information about the fund and operator required by the passport rules and all economies; and
- Part 2: Specific information required by the home economy.

Part 1 will be developed and decided on by passport economy regulators and will contain the general information required by all passport economy regulators in assessing the registration of funds. For example, all passport economy regulators will need information on:

- the operator including its name and authorisation or licence number;
- the fund including the name and any identification number of the CIS, the type of CIS, its investment objectives and so on; and
- the CIS's constituent documents and an electronic address where a copy of the constituent documents will be maintained and can be freely inspected.

As such, all prospective passport funds will complete the same Part 1 or a translated version of it, regardless of their home economy.

Part 2 will be information generally required by only the home regulator as a result of specific laws and regulations in that home economy.

In addition to Parts 1 and 2, a prospective passport fund will also be required to provide:

- a consent to the disclosure of information regarding the passport fund between the passport economy regulators;
- an authorisation for publication by the home regulator on its website or another website approved by the home regulator of the application for registration and any translation of Part 1 that is produced; and
- an application fee.

The mechanism for setting the application fee will be agreed by passport member economies. This application fee is in addition to any fee payable for authorisation of the CIS in the home economy and any fees payable in the host economy to be able to offer the CIS in the host economy.

Home regulator assessment

The home regulator may register a passport fund only if, having considered the application for registration, it is of the opinion that the passport fund is eligible to be a passport fund and is likely to comply with the home economy laws and regulations and the passport rules on an on-going basis.

Once it registers a passport fund, the home regulator will publish Part 1 of the fund's application for registration (save for the fund's constituent documents which can be obtained through the electronic address in Part 1) on the home regulator's website or another single website approved by the home regulator.

If any of the information in the application ceases to be current, the passport fund must notify the home regulator and the home regulator will make any consequent changes to the material published on its website.

Requirements applying on registration

A passport fund must comply, on an ongoing basis, with:

- the passport rules both in the home economy and in each host economy;
- the home economy laws and regulations applying in relation to the fund; and
- the host economy laws and regulations applying in relation to the fund.

Application for entry to the host economy

Once a passport fund has been authorised by its home regulator, it may apply for entry into each host economy in which it wishes to make offers.

An application for entry into a host economy should contain:

- the passport fund's registration number and place of registration;
- Part 1 of the passport fund's application (translated with appropriate certification into one or more of the host economy's official languages if required by the host regulator);
- authorisation for its application for registration and if applicable translation to be published on the host regulator's website or another website approved by the host regulator;
- an address (including an electronic address) for receipt of notices in the host economy and the name of the person to whom notices should be sent;
- an application fee, to be agreed by passport member economies (set in USD and converted into the currency of the home regulator at a reasonable exchange rate at reasonable intervals). However, any fees charged in the host economy to be able to offer the passport fund in the host economy must not exceed the fees payable by comparable regulated CIS in the host economy; and
- other documents that are required to be prepared under the host economy's laws and regulations that apply to the passport fund and would apply to local regulated CIS seeking to offer to the public in the host economy.

Example: Some economies require point of sale disclosure documents to be submitted at the time of application.

If any of the information in the application ceases to be current, the passport fund must notify the host regulator and the host regulator will make any consequent changes to the material published on its website.

Host regulator assessment

There will be two processes for host regulator assessment which passport member economies can elect to implement. Entry into a host economy will either be:

- subject to the authorisation of the host regulator, pursuant to a streamlined process; or
- by way of a notification process.

In some economies, the regulator will need to assess the compliance with a general disclosure test, which typically requires that offer documents state all material information which investors and their professional advisers would reasonably require to make an informed decision about the merits and risks of the passport fund. There may be more specific disclosure requirements.

Streamlined authorisation process

The streamlined authorisation process in the host economy is intended to avoid creating unnecessary additional costs for passport funds or overly delaying passport funds' access to host economies.

A passport fund can offer interests in the fund in the host economy only once the host regulator has authorised the fund. As a matter of practice, the host regulator may also review the offer documents concurrently with authorisation of the fund in the host economy.

However, the host regulator must assess the application within 21 days of having received it, assuming the application is complete, the disclosures meet all requirements of the host economy laws and regulations, and the operator responds satisfactorily to queries reasonably raised by the host regulator in a timely manner.

If the application is not complete, reasonable queries are not responded to satisfactorily in a timely manner or the disclosures in the offer documents do not meet the host economy laws and regulations, the 21 day assessment period does not start until all the required information has been provided to the host economy regulator and/or the deficiencies in disclosure have been remedied. This means that the assessment period can be affected by the time taken by the operator to respond to the host regulator. The 21 day period can be extended for an additional period of up to seven days by either the host regulator or the passport fund.

Notification procedure

If the notification procedure is used, a passport fund can offer interests in the fund in the host economy if 21 days have passed since it has made a complete application for entry into the host economy and the host regulator has not notified the passport fund in writing that it cannot offer interests in the host economy.

The 21 day period can be extended for an additional period of up to seven days by either the host regulator or the passport fund. The period also restarts if the host regulator is not provided any information that the host regulator reasonably requests in a timely manner and the host regulator notifies the passport fund to that effect.

Assessment

In assessing an application under either the streamlined approval process or the notification procedure, the host regulator will not generally reassess the passport fund's compliance with the home economy laws and regulations or the passport rules. This would have already been done by the home regulator. Rather, the host regulator will focus on assessing the documents required to be lodged with the application by the host economy laws and regulations (for example, disclosure documents). The host regulator may consider compliance with the passport rules or the home economy laws and regulations at its discretion where it has a particular reason to doubt that they would be complied with. If the host regulator is concerned about non-compliance with home economy laws and regulations or the passport rules, it would consult with the home regulator so that it and the home regulator can exercise their powers within their areas of responsibility.

An application can only be refused if, after due process (that is, acting with procedural fairness) the host regulator makes a determination that it is not satisfied that the passport fund complies or that it is likely to comply with the host economy laws and regulations covering matters that are to be subject to host economy laws and regulations or the home economy laws and regulations or the passport rules. The laws in certain economies may empower the regulator to refuse an application on public interest grounds (for example, for investor protection reasons). It is expected that the public interest grounds would not be used to exclude passport funds not based in or regulated in the host economy on the basis that there are or may be effects on the competitiveness of local CIS operators. That would not be consistent with the objectives and principles of the passport arrangements.

A host economy that refuses an application will promptly notify the home regulator.

Q4.1 Is the proposed registration and assessment process operationally practicable?

Q4.2 If not, what changes would you propose? What impact would the proposed approach have on competitiveness and ensuring investor confidence?

Stop orders

A home regulator will have the power to notify a passport fund at any time that it must not or must no longer offer interests in the passport fund either indefinitely or for a particular period. Such an order will apply in the home economy, if stated in the order, and all host economies.

A host regulator will have the power to notify a passport fund at any time that it must not or must no longer offer interests in the passport fund in the host economy either indefinitely or for a particular period.

Home and host regulators can use this power if they are not satisfied that the passport fund is complying or is likely to comply with the laws in the host economy covering matters that are to be subject to host economy laws and regulations, the home economy laws and regulations or the passport rules. A passport fund must comply with a stop order.

A passport economy regulator will act with procedural fairness to the passport fund, to the extent that it is practicable while doing what the regulator considers necessary to protect investors in the home or the host economy (as the case may be), before making or extending a stop order.

If the host regulator is of the opinion that the passport fund is not complying or is unlikely to comply with the home economy laws and regulations or the passport rules, it will notify the home regulator. If the host regulator is of the opinion that a stop order is necessary to protect investors in its economy, after considering any action taken or that may be taken by the home regulator, it may issue a stop order.

If a passport economy regulator makes a stop order, the regulator must:

- give the order in writing to the passport fund and to the regulator of any other passport economy (that is the home economy or host economy for the passport fund); and
- as soon as practicable satisfy any request from the regulator of any other passport economy (that is the home or host economy for the passport fund) to provide in writing its reasons for preventing the fund from making offers in its economy.

A regulator may revoke a stop order if it sees fit.

SUPERVISION AND ENFORCEMENT

The home regulator will have primary responsibility for monitoring and enforcing the areas of regulation in which the home economy laws and regulations apply and the areas of regulation in which passport rules apply.

The host regulator will have primary responsibility for monitoring and enforcing the areas of regulation in which the host economy laws and regulations apply.

The home regulator will generally be expected to take any supervision or enforcement action appropriate in relation to the passport rules. However, the passport rules will apply to passport funds in both the host and home economies, meaning that either the home regulator or the host regulator will be in a position to supervise and enforce the passport rules. The host regulator may in particular seek to enforce the requirements of the passport rules concerning the provision of reports to the host regulator or investors in the host economy.

As such, the operation of the passport will require heightened and prompt cooperation, consultation, exchange of information, and mutual assistance between the passport economy regulators. For example if any enforcement action were taken in relation to a passport fund by any passport regulator, this would be notified to other passport regulators.

Powers of investigation and breach reporting

Passport member economies will ensure that passport economy regulators are able to use all their existing investigation and information gathering powers applying to their regulated CIS in relation to passport funds, whether the regulator is acting in their capacity as home or host regulator. This will mean regulators can use these powers both in respect of matters which are governed by their home economy laws and regulations and the passport rules and also at the request of a host regulator to assist it to supervise the host economy laws and regulations. Passport member economies will ensure that their laws and regulations do not materially restrict this co-operation.

A passport fund will be required to notify the home regulator in writing within seven days if:

- it becomes aware of a contravention of the passport rules that might reasonably be regarded as significant or that adversely affects the value of interests in the passport fund by more than one per cent of the net assets of the passport fund; or
- it breaches asset, derivative or securities lending holding limits under the passport rules and after seven days it remains that the limits are or are likely to be exceeded; or
- a notification to a home or host regulator is required under other passport rules.

A passport fund must notify a host regulator in writing within seven days if it becomes aware of a contravention of the laws or regulations of the host economy that might reasonably be regarded as significant or that adversely affect the value of interests in the passport fund in the host economy to more than one per cent of the net assets of the passport fund attributable to members in the host economy.

Administrative action

Banning and other administrative orders

Home regulator

All administrative powers of the home regulator apply to passport funds registered in its economy in respect of matters covered by the home economy laws and regulations and the passport rules. This will include any powers to ban (whether temporarily or permanently) the passport fund operator and key people associated with the passport fund, and to prevent the fund from making offers. The home regulator may exercise these powers in the circumstances provided for in their home economy laws and regulations including where:

- the home regulator has determined that, in its opinion, the passport fund has not complied with or is unlikely to comply with the home economy laws and regulations or the passport rules (including for example the good standing rule); or
- the host regulator has determined and informed the home regulator that, in its opinion, the passport fund has not complied or is unlikely to comply with the host economy laws and regulations and the home regulator has assessed that such non-compliance or potential non-compliance could have a potential impact on the home economy or could affect the members or potential members of the passport fund.

Host regulator

The host regulator may issue an order preventing interests in a passport fund from being offered in its economy (a stop order) as noted above.

Civil and criminal actions

Actions by members

Members of the fund, or any person who has the power to take action on behalf of members and is under an obligation to act in the best interests of members in exercising that power, will have the ability to take civil action against a passport fund and/or its operator:

- under the home economy laws and regulations where there is a breach of the home economy laws and regulations or the passport rules to the extent permitted under the home economy laws and regulations; and
- under the host economy laws and regulations where there is a breach of the host economy laws and regulations or the passport rules to the extent permitted under the host economy laws and regulations;

If such a right of action is not available in the home or host economy laws and regulations, the persons referred to above must have the right to consider civil action under the constituent documents for the passport fund in that economy.

To enable such actions (as well as actions taken by regulators), a passport fund must submit to the non-exclusive jurisdiction of the host economy's courts. Further, its constitutive documents must provide that where a proceeding against the passport fund has been commenced by a member in a court in the passport economy in which the member was offered an interest (the member's home economy), the passport fund must not submit that the court should not continue to hear the proceedings on the basis that proceedings should be taken in another economy. This would be expressed to not apply if a similar action or actions by a member or members has commenced in another passport economy so that in

that case a submission may be made and the court may determine whether to act on the submission.

This will mean that members may generally be able to have an action heard by a court in their home economy, unless they choose to have the action heard in another passport member economy (such as the home economy of the passport fund) or if there are other similar actions being taken in other economies.

A passport fund must not bring an action against a member in an economy other than the member's home economy except with the consent of the member in writing. Note in respect of actions taken by passport funds against members that members are not permitted to have a monetary liability to the passport fund as a member.

Q4.3 Will members of passport funds have sufficient ability to seek compensation in the event of wrong doing by passport funds? Is it appropriate to require the constitutive documents of a passport fund to provide that disputes between a member of the passport fund and the passport fund operator are to be heard by a court in the economy of the member (with the exemptions discussed above)? Are there practical or legal difficulties with these proposals?

Actions by regulators

The home regulator (or the relevant enforcement agency in that economy) will have the ability to take appropriate action including supervisory, enforcement or criminal action where there is a breach of the home economy laws and regulations or the passport rules including engaging in or being knowingly concerned in an intentional or reckless breach.

The host regulator (or the relevant enforcement agency in that economy) will have the ability to take appropriate action including supervisory, enforcement or criminal action where there is a breach of the applicable host economy laws and regulations or the passport rules, including engaging in or being knowingly concerned in an intentional or reckless breach.

In taking action against passport funds for breaches of the passport rules, home and host regulators will coordinate their efforts. Action will be taken by the regulator in the best position to do so, given the circumstances of the case. A passport economy regulator will only be able to commence criminal proceedings in the courts of its economy for breaches of the laws of its economy (this should include the passport rules as they will be incorporated into the law or regulations of each participating economy).

Q4.4 Are the proposed supervision and enforcement arrangements operationally practicable and sufficient?

Q4.5 Please detail any other matters you consider relevant to the supervision and enforcement arrangements that need to be reflected in the passport arrangements.

Exemptions and modifications

A home regulator may exercise any power it has to exempt a passport fund from the home economy laws and regulations or modify those requirements with respect to a passport fund.

Home and host regulators will also have the power to exempt passport funds from the passport rules or modify the passport rules with respect to passport funds. As the passport rules apply to a passport fund in both the home and any host economies, an exemption or modification must be made by both the home and all applicable host regulators to be effective. Passport funds seeking an exemption or modification will need to apply to their home regulator who will then consult with the applicable host regulators.

If all the relevant regulators agree to the exemption or modification of the passport rule, the home regulator will notify the passport fund in writing and both the home and the host regulators will publish a notice of the exemption or modification on their websites or a central website.

A host regulator may exercise any power it has to exempt a passport fund from the host economy laws and regulations or modify those requirements with respect to a passport fund.

Deregistration

Deregistration as a passport fund is a separate process from the passport fund ceasing to be a regulated CIS in its home economy. Deregistration as a passport fund means that no offers may be made in reliance on the fund being a passport fund.

A passport fund may be deregistered as a passport fund by the home regulator if:

- the home regulator has determined that, in its opinion, the passport fund is unlikely to or does not comply with the applicable home economy laws and regulations or the passport rules;
- at the request of the passport fund; or
- to the extent permissible by home economy's laws and regulations, at the request of a host regulator, where the host regulator has determined that, in its opinion, the fund is unlikely to or does not comply with the host economy laws and regulations and has notified the passport fund of this determination in writing.

A home regulator will notify any other host regulator of the passport fund prior to deregistering a passport fund.

A passport fund will cease to be a passport fund if it ceases to be a regulated CIS and the home regulator will update its register as soon as practicable.

If a passport fund is deregistered, it must comply with any requirements of the home regulator to safeguard the interests of members such as for example to offer redemptions or winding up the fund. If there are members in a host economy, the home regulator will consult with the relevant host economy regulator in relation to what requirements are to apply as affecting members in the host economy.

A passport fund that has been deregistered remains subject to the applicable home and host economy laws and regulations and the passport rules as if it were a passport fund, until it no longer has any members who became members when the investment scheme was a passport

fund (other than members that are the operator of the passport fund, any previous operators of the passport fund and any related parties of the current or former operators of the passport fund). Without limiting any other powers of a home regulator, a home regulator will avoid causing an investment scheme to cease to be a regulated CIS if that would result in the fund ceasing to be subject to this requirement.

The deregistration requirements operate to help ensure former passport funds continue to comply with the relevant laws of the passport economies and passport rules. Where this is not the case, the home regulator may deregister the fund to maintain investor confidence.

CHAPTER 5: IMPLEMENTATION

Following this consultation, economies who decide that they want to be passport member economies will finalise the arrangements in late 2014 to early 2015.

It will then be for passport member economies to implement the arrangements domestically. Passport member economies may take different approaches to this depending on their existing legal and regulatory frameworks and the manner of law-making in their economy. However, all passport member economies will have to ensure that:

- as a home economy, the passport economy regulator for the home economy can authorise passport funds and supervise those funds in accordance with the arrangements, particularly with respect to home economy and passport rules. This should include being able to take administrative and, where appropriate, civil or criminal action against passport funds and their officers; and
- as a host economy, the passport economy regulator for the host economy can administer and authorise incoming passport funds and supervise those funds in accordance with the arrangements, particularly with respect to host economy laws and regulations where they apply. This should include being able to take administrative and, where appropriate, civil or criminal action against passport funds and their officers.

It is envisaged that these arrangements should be in place by 2016 allowing passport funds to begin using the passport.

LIST OF CONSULTATION QUESTIONS

QUESTIONS ABOUT THE SUBSTANTIVE REQUIREMENTS

Basic eligibility

Types of CIS

- 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?
- Q3.2** Would the restriction on naming and promotion in relation to MMFs give rise to any practical problems? If so please explain.
- 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?
- Q3.4** There is a risk of retail investors misunderstanding how they can realise their investment in an ETF where the interests are not traded on a local financial market. Is there reason for concern that this risk is not sufficiently addressed by host economy laws and regulations about disclosure and distribution? If so please explain.

Offer in the home economy

- Q3.5** Would the requirement for an offer in the home economy give rise to any practical problems? If so please explain.
- Q3.6** Would the requirement for an offer in the home economy promote investor confidence in the effectiveness of supervision of passport funds by the home regulator? What other possible measures could be applied?

Licensing of the passport fund operator

Operational requirements

- Q3.7** Is the requirement for an audit of certain home economy laws and regulations related to the passport fund operational requirements sufficient to ensure that passport funds are operated in accordance with the prescribed standards?
- 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?
- Q3.9** Would it be clearer or more practical to instead require an audit of whether the passport fund operational requirements are being met?

Track record of operator

- Q3.10** Is this restriction on counting the experience of an operator or related party under different control sufficient to ensure that the operator has the capability to act as a passport fund operator? Would the restriction give rise to any practical problems? If the experience of the operator is permitted to be counted despite a change in control

because it meets the requirements about continuity of staffing and decision making processes, should there be additional documentation requirements? If so please explain.

Q3.11 Should operators be allowed to count experience operating other types of retail investment schemes (for example, pension funds) as the requirement is currently drafted? Are there other types of experience which should be allowed to be counted?

Qualification of officers of the operator

Q3.12 Are the qualification standards appropriate and sufficient to ensure the ability of the passport fund operator to perform its functions?

Q3.13 Should they apply to any other persons involved in the operation of a passport fund?

Q3.14 Should the proposed requirements for there being a qualified person who is an officer or employee of the operator apply to ensure this important function is done in the organisation directly regulated as a passport fund operator? What if any practical problems would arise?

Capital requirements

Q3.15 The European Securities and Markets Authority (ESMA) in its technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive recommended allowing a degree of substitutability between professional indemnity insurance and capital to cover professional liability risks. Should a passport fund operator be able to substitute for capital (in whole or in part) the amount of cover provided by holding professional indemnity insurance which meets specified requirements given that a purpose of the requirement for capital for passport fund operators is to address professional liability risk?

Q3.16 If professional indemnity insurance is permitted as a substitute what requirements should apply? Should there be minimum requirements concerning the terms and level of coverage of the insurance policy and the insurance provider? For example:

Requirements on the terms and level of coverage:

(a) The policy must have an initial term of no less than one year.

(b) Coverage must include liabilities of the fund's directors, officers or staff of third parties for whom the fund has vicarious liability.

Requirements concerning insurance provider:

(a) The insurance provider is a third party entity and subject to prudential regulation and ongoing supervision.

(b) The fund manager must assess that the insurance provider has sufficient financial strength with regard to its ability to pay claims.

Are there any other set of requirements that need to be applied?

Operation of the passport fund

Independent oversight

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.

Compliance audit

Q3.18 Should an independent oversight entity be permitted to conduct a compliance audit?

Q3.19 Should an independent oversight entity be permitted to self-certify its own compliance in respect of its own obligations under the passport rules instead of arranging its compliance to be audited in any circumstances? If so, under what circumstances should such self-certification be allowed and how can the potential conflict of interests be satisfactorily mitigated?

Q3.20 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).

Q3.21 Is this the most appropriate approach to ensure there are adequate standards which are applied consistently?

Investment restrictions

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?

Q3.23 Are there any other assets that have appropriate qualities of liquidity and reliable valuation that should be permitted consistent 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 assets should be permitted and within what limits?

Derivatives

Q3.24 To what extent does Table 2 in Schedule B appropriately measure exposure of a passport fund? To the extent it does not, what other measuring standards should apply?

Q3.25 To what extent does the calculations required by Schedule A, including in respect of what collateral may be considered, appropriately measure the maximum potential loss of a passport fund due to a counterparty failing? To the extent it does not, what other measuring standards should apply?

Delegation

- Q3.26** Are these eligibility requirements sufficient to ensure that the delegates have the necessary experience to perform the delegated functions and are subject to appropriate regulatory oversight? If not, what other measures should apply?
- Q3.27** Is it appropriate to apply the same requirements as apply to an operator to a delegate in relation to the experience of its chief executive officer and executive directors? If not, why not?

Financial reporting and audit

- Q3.28** 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?

General questions about the substantive requirements

For each area of CIS regulation outlined in the framework:

- Q3.29** Do you agree with the proposed approach in terms of whether home, host or passport rules apply to this area of CIS regulation?
- Q3.30** Do you think that the proposed approach would enable the passport to achieve its key objective of providing a high degree of investor protection? If not, in what way can the approach be enhanced?
- Q3.31** 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?
- Q3.32** What impact would the proposed approach have on competitiveness and investor confidence?
- Q3.33** For prospective passport fund operators or current and prospective fund managers, what impact would the proposed approach have on your business? If the proposed approach would result in an increase or reduction in compliance or other costs, please quantify.
- Q3.34** Do you require more information about the proposed approach? If so, what?

Other:

- Q3.35** Are there any additional requirements you would suggest? If so, what are the rules and why?
- Q3.36** Do you have questions about how the passport will work that are not addressed in the proposed framework? What are they?

QUESTIONS ABOUT REGULATORY FUNCTIONS

Registration and assessment

- Q4.1** Is the proposed registration and assessment process operationally practicable?

Q4.2 If not, what changes would you propose? What impact would the proposed approach have on competitiveness and ensuring investor confidence?

SUPERVISION AND ENFORCEMENT

Civil and criminal actions

Q4.3 Will members of passport funds have sufficient ability to seek compensation in the event of wrongdoing by passport funds? Is it appropriate to require the constitutive documents of a passport fund to provide that disputes between a member of the passport fund and the passport fund operator are to be heard by a court in the economy of the member (with the exemptions discussed above)? Are there practical or legal difficulties with these proposals?

Other

Q4.4 Are the proposed supervision and enforcement arrangements operationally practicable and sufficient?

Q4.5 Please detail any other matters you consider relevant to the supervision and enforcement arrangements that need to be reflected in the passport arrangements.

GLOSSARY

'**authorised**' includes registered, approved or licensed.

'**business day**' means each day banks are generally open for business in the relevant place.

'**CIS**' or '**collective investment scheme**' means a scheme with the following features:

- i. at least two persons have or are to contribute money or money's worth for the right to the benefits produced by the arrangement;
- ii. the contributions are pooled to produce financial benefits or an interest in property for the contributors or persons directly or indirectly acquiring their rights from the contributors (members);
- iii. not all the contributors or members take part in day to day management of any activities under the arrangement;
- iv. the pool is managed as a whole for the benefit of the contributors or members collectively; and
- v. during the operation of the scheme, other than during particular periods, members, or in the case where interests in the scheme are to be traded on a financial market some members, are to have a right to withdraw from the arrangement and receive the value of their entitlements within a reasonable time.

'**CIS operator**' means a person who operates a regulated CIS under an authorisation of the passport economy regulator, whether as responsible entity, trustee, management company or otherwise.

'**class**' in relation to a passport fund means interests in a passport fund that confer the same rights and obligations.

'**control**' or '**controlled**' – an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies. If the first entity has the capacity to influence decisions about the second entity's financial and operating policies and is under a legal obligation to exercise that capacity for the benefit of someone other than the first entity's members, the first entity is taken not to control the second entity.

'**custodian**' in relation to a CIS is the person that is engaged by the CIS operator to ensure that assets of the CIS are properly held, whether by that person or another person it directly or indirectly engages to hold the assets on its behalf.

'**derivative**' means an arrangement, other than an asset that a passport fund can invest in if were not a derivative or a borrowing of money, in relation to which the following conditions are satisfied:

- i. under the arrangement, a party to the arrangement must, or may be required to, provide at a time after the day the arrangement is entered, consideration of a particular kind to someone; and
- ii. the amount of the consideration, or, if arrangements of that kind are commonly sold or closed out before performance, the value of the arrangement on sale or close out, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of an asset including an asset that is a right to be transferred securities and any income that would be derived from holding securities to meet an obligation of a

person to whom equivalent securities have been transferred, a rate of interest or an index.

'eligible collective investment scheme' or **'eligible CIS'** means a collective investment scheme that is eligible to be offered as a passport fund under the passport rules.

'feeder fund' means a passport fund that has disclosed an investment strategy of investing at least 85 per cent of its assets in another passport fund.

'home economy' in relation to a passport fund means the economy in which the passport fund is constituted or established, and authorised under the laws and regulations of that jurisdiction for offer to the public in that economy.

'home regulator' is the passport economy regulator in the home economy.

'host economy' in relation to a passport fund means an economy (other than the home economy) in which the passport fund is permitted to be offered, or is proposed to be permitted to be offered, to the public in that economy.

'host regulator' is the passport economy regulator in the host economy.

'index fund' means a passport fund that has publicly disclosed that it has an investment strategy of seeking to achieve returns by following an index that:

- i. predominantly relates to financial assets or commodities that are regularly traded;
- ii. has a clearly defined objective or the market or sector which it aims to represent is clearly defined;
- iii. represents a reasonable benchmark for a market or market sector for which it is widely used;
- iv. has 100 per cent of its constituents that, with the exception of those related to commodity prices, are investments that a passport fund would be permitted to hold;
- v. is defined and calculated by a person that is independent from the operator unless, where the two parties are related parties, there are effective arrangements in place for managing the specific conflicts of interest that might arise in this situation;
- vi. has no constituent exceeding 25 per cent of the index; and
- vii. has information about it (including the composition of the index and the information on the methodology used to construct and rebalance the index) that is readily accessible to the public.

'interest' means a right to benefits produced by the passport fund but does not include any special right of the CIS operator to remuneration for the performance of its duties as the CIS operator.

'investment scheme' means a scheme that meets para i to iv of the definition of CIS.

'IOSCO' is the International Organisation of Securities Commissions.

'IOSCO principles' are the IOSCO Objectives and Principles of Securities Regulation published in June 2010, including any subsequent revisions.

'IOSCO assessment methodology' means the IOSCO Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation published in September 2011, including any subsequent revisions.

'laws and regulations' means the provisions of the laws of a passport member economy, the regulations made, and other regulatory requirements that a passport economy regulator administers.

'maturity date' in relation to a derivative is termination date of the derivative on which obligations no longer accrue and the final payment occurs.

'member' in relation to a passport fund means a person holding an interest in the fund.

'omnibus account' means a pool of securities, derivatives, currency or the right to the balance receivable on an at call deposit account where more than one person has an entitlement in relation to the relevant asset.

'passport' means the Asia Region Funds Passport.

'passport arrangements' means the arrangements governing cross-border offers of CIS under the passport.

'passport economy regulators' means the regulators nominated by each passport member economy as being responsible for the authorisation and supervision of CIS and passport funds.

'passport fund' means a regulated CIS that is authorised as a passport fund by a passport economy regulator in accordance with the rules establishing the passport.

'passport member economies' means economies in the Asia region who have mutually decided to implement and participate in the passport.

'passport fund operator' or **'operator'** means a person who operates a passport fund under an authorisation of the home regulator and such a person includes both the trustee and manager, if applicable.

A **'person'** or **'entity'** includes:

- i. a body corporate;
- ii. a partnership;
- iii. an unincorporated body;
- iv. an individual;
- v. a trust; or
- vi. the trustees of a trust.

'related party' means:

- i. an entity that controls an entity;
- ii. the directors of a controlling entity;
- iii. the persons that comprise the controlling entity, if not a company;
- iv. other entities controlled by any of the above; or
- v. an entity that is reasonably considered is likely to become a related party.

'regulated CIS' means a collective investment scheme that is constituted and authorised in a passport member economy under regulatory arrangements of that economy agreed by the passport member economies, and the operator of which is authorised and has a principal place of business in that economy.

'securities' means shares or stock in a body corporate, rights to take legal action against a body corporate or a government for repayment of a debt or interests in an investment scheme, or any beneficial interest in such shares, stock, right or interest or option to acquire such shares, stock, right or interest.

'significant influence' refers to an entity having the power to participate in the financial and operating policy decisions of the management of a second entity, even if not in control or joint control over such policies.

'UCITS' means undertakings for collective investment in transferable securities, as governed by Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.

'underwrite' means being liable to ensure a certain amount is raised from an offer of securities for issue or sale other than as the issuer or seller of the interests in the passport fund.

SCHEDULE A

The maximum potential loss of a derivative or securities lending transaction is calculated by adding:

- the current replacement cost at market price; and
- for derivatives, the greater of the notional principal amount or the market value of the underlying asset (including assets represented in an index) of the derivative, multiplied by the percentage in Table 1.

... and then deducting the value of any collateral held in relation to the derivative or securities lending transaction by the passport fund that is a sum of money (of any currency) where that amount of money is reflected in a credit in an at call deposit account with a body that is subject to prudential supervision by a financial supervisory authority in its home jurisdiction broadly under the guidelines of the BCBS.

Table 1 Potential loss measures

Residual Term	Interest rate contracts	Currency Exchange rate contracts	Equity derivative contracts	Total return swaps and Credit default swaps	Other contracts
1 year or less	0%	1%	6%	10%	10%
> 1 year and < 5 years	0.5%	5%	8%	10%	12%
> 5 years	1.5%	7.5%	10%	10%	15%

In the case of credit default swaps where the passport fund is entitled to payments unaffected by a credit event of the person liable under the underlying reference asset, the relevant percentage is zero per cent unless the credit default swap contract incorporates a provision on closeout upon insolvency in which case the amount to be added is 10 per cent of any unpaid amount that may become payable to the passport fund at the time of the calculation.

SCHEDULE B

The commitment value of a derivative should be calculated as specified in Table 2 where appropriate. The commitment value should be converted into the currency of the passport fund's home economy by using the spot rate.

For a derivative not covered in Table 2 or where the value does not give a reasonable relative estimation of the risks, the passport fund must:

- determine a value with appropriate relativity to the values of other derivatives calculated under Table 2 and taking into account the market value of the equivalent position in the underlying asset;
- document why that value is appropriate; and
- keep a copy of any relevant document for seven years after it has been used by the passport fund for determining the value is appropriate.

Examples of when Table 2 might not give a reasonable estimation are certain binary options or where the notional contract value is determined in an unassumed manner.

Table 2: Calculation Methods

Types of derivatives	Commitment value
Plain vanilla options (including bought/sold puts and calls)	
Bond option	Notional contract value x market value of underlying reference bond x delta
Currency option	Notional contract value of foreign currency leg(s) x delta
Equity option	Notional contract size x market value of underlying equity share if the contract size is determined by the number of underlying shares x delta
Index option	Notional contract value x index level x delta or point value x index level x delta if appropriate
Interest rate option	Notional contract value x delta
Warrant and Rights	Number of shares/bonds x market value of underlying referenced instrument x delta
Futures	
Bond future	Notional contract size x market price of the cheapest-to-deliver reference bond
Currency future	Number of contracts x notional contract size
Equity future	Notional contract size x market price of underlying equity security

Types of derivatives	Commitment value
Index future	Notional contract size x index level
Interest rate future	Number of contracts x notional contract size
Commodity future	Notional contract size x market price of underlying commodity
Swaps	
Contract for differences	Number of shares/bonds x market value of underlying referenced instrument
Credit default swap	Protection buyer: market value of the underlying reference asset Protection seller: the higher of the market value of the underlying reference asset or the notional value of the credit default swap
Currency swap	Notional value of foreign currency leg(s)
Interest rate swap	Market value of underlying (the notional value of the fixed leg may also be applied)
Total return swap	Market value of underlying reference asset(s)
Forwards	
Forward rate agreement	Notional value
FX forward	Notional value of foreign currency leg(s)

In Table 2 delta means the proportionate amount that the passport fund operator reasonably believes the value of the derivative to the passport fund would fall if there was a marginal adverse change in amount of the underlying for that derivative.