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Will fund passport catch on widely in Asia also?

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Executive Summary

Asian countries are preparing to launch the Asia Region Funds Passport (ARFP) scheme to allow funds registered in ARFP-participant countries to be sold in other participant countries. Although the AFRP faces hurdles, it is expected to invigorate markets by facilitating cross-border fund sales among participating countries.

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ARFP overview

The Asia Region Funds Passport (ARFP) framework establishes common fund registration standards among participating countries in the aim of facilitating and expediting cross-border offerings of ARFP-compliant funds within the bloc of ARFP-participant countries. To participate, countries, fund operators (fund sponsors) and funds all must meet certain requirements[1].

For countries, the requirements include obtaining the consent of the other participating countries and being a signatory of the International Organization of Securities Commissions' Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information[2] (IOSCO MMOU). As of the time of this writing, the ARFP has five participating countries: Japan, Australia, South Korea, Thailand and New Zealand. The Philippines has announced its intention to participate but, having yet to sign the IOSCO MMOU, is not officially an ARFP participant.

Requirements for fund operators include minimum capital requirements and minimum experience requirements for their CEOs, other officers and employees.

Passport funds are required to be publicly offered in their respective home countries and their asset holdings are limited to "plain vanilla" products such as equities, bonds and short-term instruments. They are also subject to a prohibition against short selling and restrictions on lending, borrowing and derivatives trading.

To obtain a passport for a fund, the fund operator must apply for one from the securities regulator in the fund's home country. Upon approving the application, the home country regulator requests approval of the fund from its counterparts in other ARFP-participant countries. Regulatory authorities are supposed to approve

NOTE

1) For more details, see the ARFP Memorandum of Cooperation at http://fundspassport.apec.org/files/2016/04/Asia-Region-Funds-Passport-Memorandum-of-Cooperation.pdf.

2) The IOSCO MMOU provides for international cooperation to prevent market abuses amid growth in cross-border securities trading. Its signatories are listed at https://www.iosco.org/about/?subSection=mmou&subSection1=signatories.

or reject such requests within 21 days as a general rule.

ARFP benefits and challenges

How will the ARFP benefit investors, asset managers and fund distributors once it has been implemented? In Japan, investors wishing to purchase a fund domiciled in another country, including any of the ARFP-participant countries, currently have two options. One is to directly purchase the fund in its home country. The other is to purchase a domestically domiciled fund that owns the foreign-domiciled fund. All else equal, buying the fund directly is generally less costly for investors. The ARFP could reduce the costs of cross-border investing.

The ARFP may also enable investors to invest in funds hitherto unavailable to them. To the extent it does so, investors would benefit from a more diversified investment universe. Additionally, the uniform requirements that passport funds and their operators must meet should give investors more confidence to purchase passport funds, including those offered by overseas asset managers with which they are personally unfamiliar.

Japanese asset managers should benefit from growth in both AUM and revenues by exporting their funds overseas. Japanese fund distributors should be able to increase their commission revenues by becoming local distributors of passport funds from other countries.

Meanwhile, the ARFP potentially faces a number of challenges. The current status of two similar initiatives that already exist in Asia–the ASEAN Collective Investment Scheme (CIS) and Mutual Recognition of Funds (MRF) between Hong Kong and mainland China–offers insight into what might lie ahead for the ARFP.

The ASEAN CIS and MRF frameworks are both new, respectively launched in August 2014 and April 2015. The former has three participants: Singapore, Malaysia and Thailand. Thailand is an ARFP participant also. The MRF framework enables cross-border fund sales between mainland China and Hong Kong. It is similar to China and Hong Kong's Stock Connect program for equity trading. ASEAN CISs and China-Hong Kong mutually recognized funds have yet to widely catch on. While their lack of progress to date partly reflects that neither has been around for very long, other factors such as the following may also be at play.

(1) Language barriers

The ASEAN CIS application form is in English. ASEAN CIS prospectuses for investors also must be in English. The use of English is a barrier to widespread investment in ASEAN CISs. Language differences among ARFP-participant countries could likewise prove to be an impediment.

(2) Sales channel difficulties

Asset management companies wishing to offer their funds overseas reportedly often face difficulty gaining access to local fund distribution channels. Such difficulty impedes widespread distribution. In Thailand, for example, the fund distribution market is dominated by a few major banks that rarely distribute funds of asset management companies unaffiliated with themselves. Their dominance constitutes a formidable barrier to market entry by non-Thai asset managers. In fact, only one ASEAN CIS fund is available to retail investors in Thailand as of December 2016.

Additionally, Hong Kong asset managers' sales of mutually recognized funds in mainland China have been disappointing, reportedly because they have failed to promote their funds persuasively enough to the mainland banks that sell funds.

(3) Cannibalism of preexisting funds

Feeder funds that invest in Singapore are already available in Malaysia and Thailand. If Singaporean master funds become available directly to investors in Malaysia and Thailand, they would cannibalize sales of the existing feeder funds. Asset management companies will consequently have to rethink their sales strategies.

(4) Tax treatment

Given international differences in tax laws, another issue is arrangements to ensure equitable tax treatment among participating countries[3]. Such tax considerations prompted Singapore, initially a party to the ARFP discussions, to opt out of signing the ARFP Memorandum of Cooperation (MOC). According to media reports, Singapore did so because preliminarily agreed-upon tax provisions were omitted from the final MOC.

In sum, the ARFP scheme faces quite a few hurdles to achieving widespread success. The first key to success is for ARFP-participant countries to set rules that will draw existing ASEAN CIS-participant countries, including Singapore, into the ARFP. The next step is to recruit many additional countries and their asset management companies to participate. If ARFP funds end up spreading beyond Asia like UCITS[4] have spread beyond the EU, the ARFP would be a resounding success.

3) For example, such arrangements may involve differences between Country A and Country B's respective taxation of income from ownership of funds domiciled in Country A (equitable tax treatment at the investor level) and/or differences in how Country A-domiciled funds and Country B-domiciled funds are taxed on their income from investments in stocks listed in Country A (equitable tax treatment at the fund level).

4) UCITS (Undertakings for Collective Investments in Transferable Securities) is a European fund passport framework.

However, UCITS took many years to gain widespread popularity. The newly launched ARFP scheme's progress is presumably being monitored by numerous countries still undecided about whether to participate. Given such hesitancy among other hurdles, the ARFP scheme will likely take a while to broadly expand geographically. Its participants need to patiently nurture it to maturity.

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