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Ms Trudie Wykes
Senior Advisor – Financial Services Unit
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

E-mail: Trudie.Wykes@TREASURY.GOV.AU

Dear Trudie,

Consultation: operational arrangements for the Asia Region Funds Passport

The Property Council of Australia welcomes the opportunity to further participate in the consultation on the Asia Region Funds Passport (**Passport**).

The Property Council represents the \$680 billion property investment industry in Australia. The Property Council's 2,000 member firms and 55,000 active industry professionals span the entire spectrum of the property and construction industry. Our members operate across all property asset classes - including office, shopping centres, residential development, industrial, tourism, leisure, aged care, retirement villages and infrastructure.

The property industry by numbers:

- pays about \$34 billion p.a. in real estate-specific taxes;
- manages direct and indirect investments of almost 12 million Australians through their retirement savings;
- provides 1.3 million jobs (12.8 percent of the total workforce);
- contributes \$148 billion in direct economic activity;
- generates \$219 billion in GDP through supporting industries;
- represents 11.5% of Australia's GDP - one ninth of the country's total economic activity.

The industry is deeply supportive of an Asia Funds Passport to enhance the flow of capital within the region and help Australia to become a leading funds management hub.

We note that the recommendations made in our prior submission on 10 July 2014 should be read in conjunction with this further submission.

We maintain that it is important for the Asia Funds Passport to timetable the inclusion of property as an asset class and property funds in particular. Property is a well-established asset class that is in demand around the world and its inclusion will help solidify the Asia Funds Passport as a necessary and critical investment regime.

We understand that this will happen by degrees and we welcome the first steps made in this Asia Funds Passport stage 1. It is an essential opportunity for fund to fund property and infrastructure investment.

The Asia Funds Passport is also capable of becoming an effective vehicle for attracting capital into critical industries through corporate bonds. These bonds should be available to institutional and retail investors under the current proposal, which will cement the Passport as a fundamental tool for business that enables growth.

In the light of stalled domestic CMBS markets, the Passport has the opportunity to reinvigorate and diversify the capital markets without cost to Government nor industry. With infrastructure capital demands set to rise over the next decade, the Passport is a very efficient way to deliver capital where it is needed. The Passport will create a fairer market by giving retail investors an opportunity to safely invest in market sectors that they would otherwise be unable to access.

We are keen to make sure the current rules enhance rather than prejudice the full integration of all these opportunities and our submission is aimed in part, at highlighting necessary provisions that cannot be negotiated away with the other Passport countries.

It is critical to ensure that the Passport restrictions and limitations are balanced and reasonable otherwise the rules will be of limited commercial value and discourage investment. Where possible we have suggested solutions to minimise this risk.

The key industry concerns are to ensure the passport rules:

1. interact appropriately with the Corporations Act and do not generate a second unnecessary and conflicting legal structure for managed investment scheme operators;
2. create simple structures that can be easily implemented and expanded in the future – the restrictions on both investments and asset classes cannot impede the capacity of Operators to diversify their investor base and sources of funds; and
3. align, adopt and absorb current accounting, tax and corporate finance standards - the technical aspects of the Rules cannot conflict with existing accepted practices within the market (such as valuation of instruments and taxation regimes).

We have highlighted a number of circumstances throughout the document where we believe there are important and potentially adverse impacts to the Australian regulatory environment and the key MIS regulator, ASIC. To help resolve these issues, we have suggested alternate drafting or a potential solution to preserve the integrity of the Australian regulatory environment.

In particular, we consider that the rules need to acknowledge mutual recognition of the managed investment regulations, in line with the current memorandum(s) of understanding between the regulators. This will take care of a lot of issues we have identified, such as financial adequacy tests and help make the rules simpler and easier to use.

Importantly, we recognise the necessity to protect the domestic legal and investment environment for those who might only operate within Australia, and ensure those operators are not disadvantaged by the structure of the Passport Rules. We recognise that it is critical we do not end up with a two speed regulatory environment in an attempt to offer Australian investors broader choices.

We are keen to talk further with you in order to resolve the issues we have raised. Please do not hesitate to me if you have any queries.

Yours sincerely



Andrew Mihno
Executive Director
International & Capital Markets
Property Council of Australia
0406 45 45 49

Operation of the Asia Region Funds Passport

April 2015

A. SUMMARY OF SUBMISSIONS AND COMMENTS

A1. General submissions and comments

1. The Property Council of Australia supports the Asia Region Funds Passport regime and welcomes its development.
2. APEC, including representatives from the Australian government, should strive to extend the Asia Region Funds Passport regime to the economies of Hong Kong, Japan and China. Broadening the reach of the Passport regime will add to its attractiveness and success whilst supporting intra-regional investment diversification.
3. The interplay between the Draft Rules, once enacted as law in Australia and the current Australian corporations laws is not clear, and may lead to the imposition of additional regulation and regulatory complexity.
4. While we consider that it is appropriate that the Passport regime in its earliest iteration contain restrictions on investment (such as concentration limits and caps on certain types of assets), the rules are on our view so restrictive as to result in only a very limited range of funds being made available to consumers and as such will discourage fund operators from using the Passport regime. In our view, some of the investment restrictions may be contrary to good public policy, particularly, imposing restrictions on any investment in registered schemes (which are highly regulated) and imposing no restrictions on investments in listed companies.
5. The Draft Rules unnecessarily impose restrictions in Part 6.3 of Annex 3 on Passport Funds being established to invest in direct real estate and in property securities. Such restrictions are contrary to the interests of consumers seeking to diversify their investment portfolio, especially given that investments in such asset classes is well understood by the Australian retail market.
6. While Passport Funds that invest in direct real estate and property securities may be on the agenda for a second or further stage of the development of the Passport regime, we submit that the Draft Rules should be amended to facilitate the passporting of such funds.
7. The prohibitions on lending money and giving guarantees in section 43 of Annex 3 are unreasonable and unduly onerous where a Passport Fund forms part of a stapled group.
8. Please consider including a transition period so that a Passport Fund has up to 24 months to meet all of the investment restrictions set out in Part 6.3 of Annex 3 and that the Operator be required to use its reasonable endeavours to achieve compliance as soon as practicable.

A2. Some drafting suggestions

9. In terms of drafting, the following key terms or sections should be amended as follows:¹
- (a) section 20 of Annex 3 refers to section 23(2) (dealing with partly paid transferable securities), however, paragraph 50 of the Arrangements for an Asia Region Funds Passport: Feedback Statement and Consultation on Draft Rules (Feedback Statement) refers instead to section 23(1). This discrepancy is important because it imposes a geographical limit on investments in transferable securities;
 - (b) section 23 of Annex 3 defines transferable securities by reference to a 'security', which is defined in section 55 of Annex 3, but then lists a number of securities that look similar to (but not identical with) the list set out in the definition of 'security'. The definition in section 23 is confusing and circular;
 - (c) the various restrictions set out in section 30 could be modified to make clear the cumulative effect set out in the 'Explanatory note' under section 30(3). Further, the various restrictions set out in section 30 could cross-refer to other restrictions – for example, section 30(1) could be expressed to be subject to section 30(8);
 - (d) the concept of 'same entity' as it is used in Annex 3 should be defined to exclude funds operated by the same responsible entity. This is because, in Australia, managed investment schemes are typically operated by a single responsible entity, the assets of which are segregated from the assets of each other scheme and from the assets of the responsible entity. The relevant policy principle should be to treat each registered scheme as a separate and unrelated 'entity'. Similarly, the concept of 'same group of entities' in section 31 of Annex 3 should be amended to take into account this concept;
 - (e) the definition of 'financial asset Regulated CIS' be amended to refer to the ability of an investor to exit via (a) redemption generally (whether or not on a financial market) or (b) sale (whether or not on a financial market, and whether or not the price is materially different from the NAV per interest);
 - (f) section 46 of Annex 3 (dealing with member's liability) could be re-drafted to make it clear that the member is not liable to not only the Passport Fund, but also the Operator or the Passport Fund's creditors, except to the extent of any unpaid amount on subscription;

¹ This is not an exhaustive list.

- (g) the use of 'and' and 'or' at the end of the paragraphs in section 51(3) of Annex 3 makes it unclear what the intended redemption restrictions are; and
 - (h) paragraph (a) of the definition of 'Regulated CIS' in section 56 of Annex 3 refers to a 'scheme' (which is not defined), however, it would appear the reference should instead be to 'CIS' (or 'Collective Investment Scheme') so as to pick up the foundational definition of 'Collective Investment Scheme'.
10. We also assume that there will be a general review of the drafting of the Draft Rules to correct typographical errors², or to define undefined terms³, or remove defined but unused terms⁴.

B. GENERAL COMMENTS ABOUT THE ASIA REGION FUNDS PASSPORT AND THE DETAILED RULES AND OPERATIONAL ARRANGEMENTS

The Property Council of Australia supports this initiative as it considers this the first step towards creating a collective investment scheme that will enable funds established in one of the Home Economies to be marketed in Host Economies in the Asia Pacific Region.

The Asia Region Funds Passport regime is intended to achieve a number of goals, including to enhance liquidity in the financial markets in the region, increase the competitiveness of this region against other global trading zones, and provide increased consumer choice of fund offerings under a regime which promotes and supports consumer trust and confidence. We support these goals.

B1. Participating economies

The Asia Region Funds Passport should continue to work towards the inclusion of other Asia Pacific economies such as Hong Kong, Japan and China. Given the global significance of the economies in these jurisdictions, the inclusion of these economies will enable the goals outlined above to be better achieved. In particular, the attractiveness of the regime as one in which to participate will be significantly increased by the expansion of the regime to these key Asian economies. Further, consumers will welcome the opportunity to further diversify their investments into collective investment schemes that are operated in a broader group of participating economies.

It is the view of the Property Council of Australia that the Asia Region Funds Passport regime will be seriously impeded if it does not, at inception, have a sufficient number of participating economies so that the operator of a collective investment scheme will consider that it is attractive for it to seek to rely on the Passport. If there are insufficient participating economies at inception, then there is a high risk that few collective investment scheme operators would be prepared to establish a new scheme which meets the stringent requirements of the regime and then notify or apply for that fund to

² For example, 'financial asset Regulated CIS' is sometimes referred to as 'Financial Asset Regulated CIS'.

³ For example, the term 'Part A' as used in Annex 2.

⁴ For example, the term 'Interest' in section 55 of Annex 3 does not appear to be used.

obtain Passport status. Early and consistent establishment of Passport Funds is critical to ensure additional economies will sign up to participate. It is important for the future success of the regime that some care is taken to appropriately time the launch of the regime and avoid adversely affecting its future success.

B2. Relationship with Australian corporations laws

The interplay between the Draft Rules, and the current Australian corporations laws (or equivalent laws in a participating economy) is not clear. While the introductory clauses in each Annex in the Draft Rules set out some guidelines about the enactment of laws consistent with the Draft Rules⁵, (and while it appears to be the intention that additional regulation in the areas set out in section 2 of Annex 1 is voluntary), it is not clear whether such laws, once enacted, will either:

- (a) be deliberately harmonised with existing Australian corporations laws, and ASIC's class orders and regulatory guidance, such that Australian laws and ASIC policy will be amended accordingly; or
- (b) constitute a separate regime applicable to Passport Funds that will operate alongside existing Australian corporations laws and ASIC policy. Further, if this is to be the case, then the Draft Rules do not contain an anti-overlap provision (i.e., a provision to the effect that (presumably) the Draft Rules override any inconsistency with Australian laws and ASIC policy).

This issue is important because the Draft Rules prescribe requirements relating to the following, among other things, each of which has a bearing on current requirements applicable to registered schemes:

- (c) the content of scheme constitutions – see, for example, the meaning of a 'compliant' scheme constitution⁶ but also the requirements with respect to winding up⁷ and suspending redemptions⁸ which, in an Australian context, should be set out in a scheme constitution;
- (d) Australian financial service (**AFS**) licensing requirements – see, for example, proposed licensing relief for Operators where a 'qualified distributor' is utilised⁹; a new regime dealing with 'eligible entities' that deal with such matters as competency to be an Operator and provide the financial services (human,

⁵ In this regard, while assume that section 1 of Annex 2, which states that that Annex is not designed to be directly incorporated into the law of a Participant, is not intended to operate so as to avoid it having legal effect, but rather that a Participant may enact laws consistent with the broad common regulatory arrangements.

⁶ Section 4(3) of Annex 3.

⁷ Section 16 of Annex 2.

⁸ Section 51 of Annex 3.

⁹ Section 2(2) of Annex 1.

technological and financial) associated with being an Operator¹⁰; and breach reporting requirements¹¹;

- (e) disclosure requirements – see, for example, the power to made laws in relation to disclosure and annual and periodic reporting¹²;
- (f) requirements in relation to the nature of a registered scheme and the powers of ASIC in that regard – see, for example, the provisions about deregistration and winding up¹³ and the proposed requirements with respect to redemptions¹⁴. Further, the circumstances in which redemptions may be suspended appears to be expressly limited to those set out in the Draft Rules¹⁵;
- (g) requirements that affect a registered scheme's compliance arrangements, including potentially the compliance arrangements set out in the scheme's compliance plan – see, for example, the annual compliance review requirements¹⁶; and
- (h) requirements in relation to holding 'legal or equitable interests' in 'votable transferable securities' of an entity – see section 36 of Annex 3. This restriction would presumably apply in addition to the takeovers provisions of the *Corporations Act 2001 (Corporations Act)*, and would include the holding of interests in a Passport Fund (as 'entity' is not defined).¹⁷

Further, Host Economy regulators appear to be at liberty to impose additional requirements, such as:

- 1) additional requirements on a Regulated CIS that is not a Passport Fund¹⁸;
- 2) powers to request additional information about Passport Funds applying for registration¹⁹ or offering interests in a Host Economy²⁰;
- 3) extensive supervisory and investigative powers²¹; and

¹⁰ See Part 3 of Annex 3.

¹¹ See Part 4 of Annex 3.

¹² Section 2(1)(b) of Annex 1.

¹³ See Part 7 of Annex 2.

¹⁴ Part 7 of Annex 3.

¹⁵ Section 51(4) of Annex 3.

¹⁶ Section 15 of Annex 3.

¹⁷ This would be relevant to listed funds, which are subject to takeovers provisions in Chapter 6 of the *Corporations Act 2001*.

¹⁸ Section 3 of Annex 1.

¹⁹ See section 3(2)(b) of Annex 2.

²⁰ Section 4(2)(c) of Annex 2.

- 4) powers to issue additional guidance²².

If these powers are enacted in law, then ASIC may have additional legislative options to impose additional requirements on certain registered schemes. This will lead to additional regulation and regulatory complexity, contrary to the intention of a single financial services regime.

We note finally in respect of the Operator, the Draft Rules are proposing a financial resources test, again not acknowledging any existing Home Economy capital adequacy arrangements such as those in Australia under the general AFSL provisions administered by ASIC. We do not agree that there should be any requirement for such a test – other than the requirements of the existing Home Economy regulatory regime. Part of the first hurdle for passporting a fund will be a clearance from the Home Economy regulator and that should include a regulatory “clearance” in respect of the overarching Operator having met its Home Economy obligations.

Further, financial resources under the Draft Rules that would otherwise exceed the Home Economy capital adequacy requirements may lead to excess capital being held, which results in an inefficient use of capital and locks it out of the market. In real terms, this is an economic impact that should be avoided and particularly in circumstances where it drives no change in risk to retail investors. We highlight that the Draft Rules do require a minimum % of investment from the Home Economy prior to a fund being available under the Passport - additional financial resources only being applicable once a fund is passported also potentially creates inequity in the protections afforded to retail investors in different countries.

B3. Asset classes and investment restrictions

It is appropriate that the Asia Region Funds Passport regime in its earliest iteration contain restrictions on investment (such as concentration limits and caps on certain types of assets). These are appropriate to ensure that, when launched, the Asia Region Funds Passport regime supports and facilitates collective investment schemes which are robust. It will ensure the highest degree of consumer confidence in the structure.

However, it is also important that its most early iteration, the regime does not adopt Passport investment rules that are so restrictive that the measures result in:

- 1) only a very limited range of funds being made available to consumers under the Passport arrangements; or
- 2) discouraging fund operators from using the Passport regime because of concerns that they cannot lawfully operate a regime within the restrictions of the new rules.

At present, the investment limitations are too restrictive and will likely result in many Operators ignoring the regime because they may operate funds which also invest in asset classes or types which cannot be brought within the Draft Rules. If Operators do

²¹ For example, see sections 9 to 12 of Annex 2.

²² Section 5 of Annex 1.

not establish eligible funds within the Passport rules, it is likely that the other major Asian economies will delay or decline to participate in the Asia Region Funds Passport regime.

The Property Council of Australia has analysed the investment restrictions and consulted with its members, including operators of collective investment schemes that invest in property and property securities. Unfortunately, the expert view is that it is almost impossible to establish a Passport Fund that has significant exposure to either of these asset classes.

Property represents a significant class of investment which will not be available to investors. We are concerned this will mean the Passport regime will not offer the best investment and diversification opportunities.

Some exposure to these asset classes could be achieved if the investment restrictions in Annex 3 were altered as follows:

Section	Description	PCA comments
Section 30 single entity limits	<p>No more than 5% of the adjusted value of the assets of the Passport Fund may be held in assets or arrangements that relate to the same entity (that is not an assessed clearing party or subject to BASEL regulation); and</p> <p>(b) are of any one or more of the following types:</p> <p>(i) transferable securities other than</p> <p style="padding-left: 40px;">(A) interests in financial asset Regulated CIS or UCITs; and</p> <p style="padding-left: 40px;">(B) risk-assessed government securities;</p> <p>(ii) money market instruments other than risk-assessed government securities;</p> <p>(iii) securities lending arrangements</p>	<p>To ensure that an Operator has the ability to invest in more than one Regulated CIS with the same Operator, the Property Council proposes that the concept of 'same entity' be modified so that an asset is not taken to relate to the same entity simply because it has the same responsible entity. In Australia, it is common that a responsible entity will operate multiple funds, and diversification and risk management can be achieved by investing in different funds (even if operated by the same entity).</p> <p>In addition, to ensure that investors are able to obtain exposure to property as an asset class and to listed property funds, the Property Council proposes that:</p> <ul style="list-style-type: none"> • section 30(1)(b) be modified so that the Passport Fund can invest in assets other than financial assets only; and • the 'financial assets Regulated CIS' definition be modified to refer to the ability of an investor to exit via a (a) redemption generally (whether or not on a financial market) or (b) sale (whether or not on a financial market, and whether or not the price is materially different from the NAV per interest). <p>The Property Council is supportive of this investment limit being raised to 10% as outlined in the detailed comments section below (see Section B of this submission).</p>

Section	Description	PCA comments
<p>Section 31 group limit</p>	<p>No more than 20% of the adjusted value of the assets of a Passport Fund may be held in assets that relate to the same group of entities and are of one or more of the following types:</p> <p>(i) the types mentioned in paragraph 30 (1)(b); and</p> <p>(ii) deposits</p>	<p>As above – the changes which are made to accommodate multiple funds operated by a single entity should also apply to enable multiple fund investments where those funds are operated by a single group. Again, from an Australian perspective, asset segregation and trust operation serve to ensure that each fund asset exposure is ring fenced from each other. It should not matter from a risk or diversification perspective if a Passport Fund gains exposures through investing in multiple funds operated by a single company or two or more companies from the same group of companies.</p>
<p>Section 34(1)</p>	<p>No more than 10% of the adjusted value of the assets of the Passport Fund may be held in any financial assets Regulated CIS or sub-fund of financial asset regulated CIS that is not a Passport Fund.</p>	<p>The Property Council considers that there should not be a restriction on the investment of Passport assets in the regulated funds of a jurisdiction, which, in Australia's case, means registered managed investment schemes subject to regulatory oversight and detailed laws and guidance. In other words, the Property Council would like to see the limitations on investments in a financial asset Regulated CIS be removed entirely.</p> <p>It notes that an investment in a listed company, such as a listed investment company, is not subject to this restriction.</p> <p>However, if there must be such a restriction to launch the Asia Region Funds Passport, then Property Council considers that a limit of 40% would be more appropriate and would encourage the establishment of Passport Funds without jeopardising the importance of diversification or undermining the robustness of the regime.</p>
<p>Section 34(4)</p>	<p>No more than 30% of the value of the assets of a Passport Fund may be held in assets that are:</p> <p>(a) financial asset Regulated CISs that are not Passport Funds; or</p> <p>(b) UCIT funds</p>	<p>This section puts an over-arching limit on the total value of Passport Fund assets that may be held in financial asset Regulated CISs which are not Passport Funds and UCITS funds.</p> <p>This means that it would not be possible to establish a Passport Fund that was intended to invest 100% of its assets in Australian registered managed investment schemes that were not Passport Funds but which invested in financial assets. The cap on such investment is 30%. The balance of the fund's investments would need to be made into other permitted assets such as interests in Passport Funds, deposits, etc.</p>

Section	Description	PCA comments
		<p>Given that at least initially there will be few if any Passport Funds, this condition will make it very difficult to establish any Passport Fund which is a fund of funds that meets the investment restrictions.</p> <p>It also creates an unlevel playing field, given that the same restrictions do not apply to investing in quoted securities.</p> <p>This will create an imbalance, limiting investment in listed funds but not listed companies. Given the level of regulation which applies to each of these types of entities (which in Australia, is higher for a listed managed investment scheme (which is also subject to Chapter 5C of the Corporations Act) than a listed company), then there should not be an overarching limit on investment in Regulated CISs which are listed.</p> <p>Further, it is the Property Council's submission that limitations on investment in Regulated CISs should be removed entirely, as stated above.</p>

While Passport Funds that invest in direct real estate and property securities are likely to be on the agenda for a second stage of the Passport regime, the Draft Rules should be amended to ensure these funds can be easily added in when appropriate.

In particular, we strongly recommend the list of asset classes in section 19(2) of Annex 3 should be extended to include assets to which all Participants may agree, and similarly section 56 of Annex 3 should be amended so that the definition of 'Regulated CIS' should be extended to include a type of fund to which all Participants could agree. In respect of the meaning of 'Regulated CIS', the Feedback Statement suggests that this flexibility appears to have been intended.²³ While we appreciate that detailed rules for these assets and funds would need to be worked out, our recommended amendments would ensure participating countries treat the Passport as a "living document" that is intended to adjust as markets and participants demand.

B4. Other restrictions

Section 43(1) imposes an absolute restriction on Passport Funds lending money to any person. This restriction is unreasonable and unduly onerous. For example, it would unreasonably prohibit a Passport Fund that is stapled from lending money to the entity to which it is stapled. Intra-group loans are a typical, necessary and commercial reality for stapled groups. The Corporations Act and ASIC policy, in particular Chapter 2E of the Corporations Act as modified by Part 5C,7, sufficiently regulates the giving of financial

²³ See the first box entitled 'Outcome' on page 7 of the Feedback Statement, which states the following: 'Eligible economies may nominate other types of Regulated CIS to be listed in the table in section 56 as long as it is regulated broadly in accordance with the IOSCO Principles and Objectives relating to CIS.'

benefits to a related party, and as such a blanket prohibition on loans to related parties is not warranted.

Further, loans on an arm's length terms, whether to related parties or third parties, should not be prohibited as such loans are investments of a fund, just like any other asset class. In other words, there is no reason why investment loans should be a prohibited asset class, particularly secured loans on arm's length terms.

Similarly, the absolute restriction in section 43(3) on giving guarantees would disentitle a Passport Fund that is stapled from providing a guarantee to the entity to which it is stapled (which would be relevant, say, where the stapled entity obtains financial accommodation for the benefit of stapled group investors as a whole). For the same policy reasons set out above with respect to intra-groups loans, this blanket restriction is unreasonable and unduly onerous.

B5. Implementation of the regime

Finally, as an overarching comment, there does not appear to be any leeway on the very tight limitations which will take into account the time necessary to establish a Passport Fund. Generally, when a fund is established there is a period when the fund will contain cash or liquid assets, generally held with a single financial institution, and then the fund will invest those amounts as market opportunity arises. The Fund will typically be in breach of the Passport rules immediately and fail the eligibility requirements.

The rules need a transition period to ensure a Passport Fund has up to 24 months to meet all of the investment restrictions. The Operator should also be required to use its reasonable endeavours to achieve compliance as soon as practicable.

C. RESPONSES TO CONSULTATION QUESTIONS IN THE DRAFT RULES

Consultation Question		PCA comments
Annex 1		
Q1 Section 2(4) –	<p>For certainty, the Working Group intends to provide a table which will specify who is a qualified distributor in a Participant. This will reflect the approach identified in subsection (3) above, although there will be some differences.</p> <p>For Singapore, a qualified distributor may be restricted to certain entities such as banks and holders of a capital markets service licence. For Australia, a qualified distributor would be the holder of an Australian financial services licence authorised to deal in interests in managed investment schemes.</p> <p>The Working Group is seeking feedback on whether, in relation to each economy, there are adequate avenues through which an Operator is able to market a Passport Fund without obtaining a licence in that economy.</p>	<p>We consider that it is appropriate that in Australia, distribution be made available through a person who holds an AFS licence or who has the benefit of an exemption.</p> <p>However, there are a range of exemptions from licensing under Australian legislation available to persons who may distribute financial products such as interests in a collective investment scheme.</p> <p>The Property Council considers that, to best ensure a level playing field, the persons who can lawfully distribute interests in registered managed investment schemes in Australia should also be able to distribute interests in a Passport Fund.</p> <p>That may include persons acting as authorised representatives of the holders of AFS licensees.</p>
Annex 3		
Q2 Section 7 –	<p>The financial resources test is set with reference to a specific currency, USD. Is it appropriate to set the currency as USD for the purposes of the requirements, given the possible fluctuations in currency?</p>	<p>If there is a need for a common currency denominator, then we agree that USD is applicable in the absence of a widely used Asia-Pacific regional base currency; and that it would be pegged to a specific reference point.</p> <p>We recommend that the capital adequacy should be confirmed once per year, on balance date of the Operator, in USD (using the spot rate at the close of trade in the Home Economy market).</p> <p>For example, in Australia for an Operator with a 30 June financial year end, that would be the AFSL capital adequacy value in AUD at the close of business 30 June, converted using the AUD/USD spot rate as at 5pm EST. This approach is then replicable in each other Home Economy on the same basis without generating administratively burdensome calculations that offer no risk reduction to an investor.</p>

Consultation Question		PCA comments
<p>Q3 – Section 25(3)</p>	<p>The Passport Rules currently do not allow Passport Funds to short sell, both synthetically and physically. Nevertheless, the Working Group acknowledges the importance of using financial derivative instruments for hedging and netting off existing exposure. Exceptions are therefore provided for a Passport Fund to take a short position in derivatives that are subject to hedging or netting arrangements.</p> <p>The Working Group notes this proposed Passport Rules may be stricter than some existing cross border frameworks for retail CIS and is considering the conditions and what additional safeguards should be introduced to ensure short selling will not result in the Passport Funds taking excessive risks.</p> <p>The Working Group would like to seek industry input on whether physical or synthetic short selling should be restricted, and if so, what safeguards would be appropriate to mitigate risks associated with physical or synthetic short selling:</p> <p>(1) Synthetic short selling – Are the current safeguards relating to derivatives, such as global exposure limit (section 39), cover rule (section 42), quality of counterparty to derivatives (section 27), and general requirements for derivatives (section 25) sufficient to mitigate the risk of synthetic short selling? What other safeguards should be considered?</p> <p>(2) Physical short selling – Some existing cross border frameworks for retail CIS jurisdictions do not currently permit retail CIS to carry out physical short selling, citing increased settlement risk involved in and absence of requirements governing such transactions. Should Passport Funds be permitted to engage in securities borrowing and physical short selling transactions? Accordingly, what requirements and safeguards should be</p>	<p>Members of the Property Council regularly enter into derivatives for hedging purposes. We understand that the restriction in section 25(2) does not apply to hedging arrangements (because of s.25(3)(b)).</p> <p>In relation to the Working Group question on prohibiting short selling, whether for synthetic or physical derivative instruments, we note that under the current arrangements in the Corporations Act (s1020B and correspondingly s764A(1)(g)), derivatives are not on the prohibited list for short selling purposes.</p> <p>Whilst the Property Council acknowledges that not all member economies of the Working Group might have consistent rules, we believe the appropriate response is that the Home Economy rules should prevail, subject to the appropriate level of disclosure being made in product documentation for investors.</p> <p>The appropriate level of short selling restriction is at the Passport Fund level itself. By way of example, Australia currently prohibits through the Corporations Act, shorting in respect of securities, managed investments and superannuation funds. We do not believe there is any change to the risk level of a Passport Fund by individually excluding synthetic or physical derivatives shorting in the proposed manner.</p> <p>Additionally, the Passport Fund Rules need to take account of the significant body of work relevant to derivative instruments and trading through IOSCO and other bodies. This work includes substantive global reforms to both the clearing and settlement of derivatives and the trade reporting of derivatives.</p> <p>If there is a concern as to “increased settlement risk” and “absence of requirements governing such transactions” the appropriate means to redress that would be through the peak body policy mechanisms, such as IOSCO, ESMA, the CFTC and similar bodies responsible for the global derivatives reform agenda.</p> <p>As a solution to the Passport Rules, we recommend that short selling of synthetics and/or physicals is restricted only where there is no Home Economy regulation of such activity – this preserves the legal rules of each Home Economy, its regulatory mandate and certainty for the Operators, whilst maintaining flexibility for product offerings and business models.</p>

Consultation Question		PCA comments
	introduced to ensure that Passport Funds minimise the risks arising from securities borrowing and physical short selling transactions, if such transactions were to be allowed? For example, what are some of the safeguards available to ensure that a Passport Fund's short positions in such transactions are fully covered at all times?	
Q4 Section 30(1)	– Should the single entity limit be 10% in all cases, as opposed to the graduated approach as drafted under section 30? Would this significantly reduce the extent to which diversification is used in Passport Funds to reduce risk? Does the wording in the text give rise to practical problems?	<p>The Property Council considers that the investment restrictions are very limiting at present and would welcome any change which would make a fund more able to meet the conditions for the Asia Region Funds Passport.</p> <p>Property Council considers that a 10% limit would not significantly reduce the extent to which diversification is used in a fund to reduce risk.</p>
Q5 Section 30(2)	– The Working Group is seeking feedback on whether the proposal in subsection 30(2) to increase the single entity limit to 15% for banks regulated under Basel Guidelines is preferable to having a separate limit for derivatives from other forms of counterparty exposure.	<p>The Property Council considers that the investment restrictions are very limiting at present and would welcome any change which would make a fund more able to meet the conditions for the Asia Region Funds Passport.</p>
Q6 Section 30(8)	– Should the acceptable risk assessment apply even if the total of holdings that exceed the limit in subsection 30(1) was less than 40%? Would this significantly reduce the risk of such exposures? What, if any, costs or practical problems would arise?	<p>The Property Council does not consider this assessment will have a material impact on risk. In Australia, with an obligation to act in the best interest of members and as an AFS licensee to maintain appropriate risk management processes, an Operator would be assessing the risks of the portfolio on an ongoing basis. The risk assessment would be more complicated than simply assessing exposure to certain percentages of an individual asset or type of arrangement.</p>
Q7 Section 31(1)	– For the entity limits (subsection 30(1), 30(2), 30(4), 30(8) and 31(1)), the Working Group has taken the approach to disregard the offsetting effects of derivatives as this is a more conservative approach. Would this be unduly restrictive for industry?	<p>The Property Council views the entity limits as unduly restrictive and not reflective of the manner in which managed investments are operated and offered at present under existing Australian law.</p> <p>Additionally, such restrictions on grouped entities with higher credit ratings might lead to increased risk in portfolios as a result of Operators having to utilise instrumentality from lower credit rated and smaller organisations – this would potentially increase investor risk (this may be an unintended</p>

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		<p>consequence of such limitations being imposed).</p> <p>Specific to section 30(4) we do not consider that a 35% cap on government securities relating to same government entities is practical as this may give rise to index products being unable to achieve index itself; and fails to recognise government repayment guarantee on such issues. This would, for example, limit to a maximum of 35% of a portfolio the inclusion of US treasuries, which we do not believe would reduce portfolio risk.</p> <p>If the inclusion of a maximum threshold for government entity securities is critical to the Working Group, we recommend that there be credit rating rules put in place for the % cap limits to actually manage risk. For example, this may be unlimited investment into AAA-grade government securities, to not more than 10% of BBB-grade government securities. This would recognise the globally accepted practices within markets for the holding of government securities; and be a better mechanism to manage risk to retail investors in such products.</p>
Q8 – Section 47	<p>Would the proposed Passport Rules on the charging of performance fees be unduly burdensome? What impact, if any, would this have on current commercial arrangements?</p>	<p>The Property Council considers that the restrictions on performance fees are unduly burdensome and not warranted. Performance fees are a means by which an Operator will achieve some alignment with the interests of an investor. A fund that carried a performance fee will often have a reduced ongoing management fee to reflect the potential upside that will be delivered to the Operator in the event of the Fund's success.</p> <p>In Australia, the Board or compliance committee is not currently involved in analysing the application of policies to performance fees or verifying their calculation (this latter task being typically a task undertaken by the auditor which undertakes compliance reviews annually).</p>
Q9 – Section 51	<p>Would the proposed Passport Rules over suspension of redemptions be too restrictive? What impact, if any, would this have on current commercial arrangements?</p>	<p>The Property Council welcomes the inclusion of a reference to possible redemption suspension in the Draft Rules.</p> <p>The Property Council notes that the Draft Rules require that an Operator to suspend redemptions if directed to do so by the Regulator. The Property Council notes that to introduce such a requirement, which would override the Operator's duties under the terms of the Passport Fund's constitution with</p>

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		<p>members, would require a legislative amendment.</p> <p>The use of 'and' and 'or' at the end of the paragraphs in section 51(3) mean that it is not clear what the intended redemption restrictions are.</p> <p>In Australia, a fund's constitution generally spells out the circumstances in which the Operator can suspend redemptions. The challenge here is that the wording in the Passport rules will not align with the constitution of a domestic managed investment scheme. With legislative amendment it would be possible to establish a fund which reflected this wording only. However, in practice, no existing registered managed investment scheme established in Australia would be able to meet this requirement.</p>
<p>Q10 – Appendix B, Section 1(1)</p>	<p>Should the value referred to in subsection (1)(b) above be market value or notional value of the equivalent position in the underlying asset, whichever is the more conservative?</p>	<p>Derivative valuation is based typically on the gross notional value outstanding, irrespective of the instrument.</p> <p>In the Australian context, the most common practice for derivative use in a scheme is that these instruments are used to hedge a total portfolio of assets referable to the derivatives, not individual underlying assets within a portfolio – this is for two primary reasons, one being to not encumber any individual asset within a portfolio; and secondly it is operationally more efficient and cost effective (purchasing power by undertaking less transactions for whole portfolio). This results in less cost to investors.</p> <p>The valuation of derivative instruments should instead recognise the applicable Accounting Standards of the Home Economy as being the appropriate means of valuation.</p> <p>Importantly, this is the measure used by the external auditors of managed investments, and will be reflected on that basis in financial statements, with flow-through into both unit pricing and distribution values ongoing for any managed investment vehicle, so the Rules should not exceed or otherwise seek to replace the accounting standards that are relevant in the Home Economy. This is relevant for both unlisted managed investments and those listed on a stock exchange, so must be consistent for markets and trading, as well as to meet the generally accepted valuation standards.</p> <p>The Property Council also notes that the valuation</p>

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		mechanisms for derivatives in Australia are effected through the tax system, particularly in the event of a profit or loss being made on such instruments, and any inconsistency to the Home Economy valuation mechanism is likely to also intersect with local tax agency rulings (that could also lead to regulatory arbitrage within the region across the different tax regimes).