CONTENTS

1 REGULATORY OUTLOOK 2019

2 INTERBANK OFFERED RATE

3 FUND REGULATION
   3.1 Asian Region Funds Passport
   3.2 Australia Corporate Collective Investment Vehicle
   3.3 Singapore Variable Capital Company
   3.4 Hong Kong Open-ended Fund Company

4 GOVERNANCE
   4.1 The Australian Royal Commission into misconduct in the banking, superannuation and financial services industry (The Final Report)
   4.2 The Australian Securities and Investments Commission (ASIC) – Fee and Cost Disclosure - Regulatory Guide 97 (RG 97)
   4.3 Portfolio Holdings Disclosure for superannuation funds
   4.4 Hong Kong Unit Trust Code Revision

5 FOREIGN INVESTMENT INTO ASIA PACIFIC (APAC)
   5.1 Deregulation of QFII/RQFII
   5.2 Critical infrastructure

This booklet outlines our thinking about recent regulatory changes, and how they might affect your programs. It summarizes recent developments impacting the financial industry and how we anticipate supporting our clients through this period. For more information, contact your Northern Trust representative or visit northerntrust.com
1. REGULATORY OUTLOOK

Northern Trust’s commitment to understanding the evolution of our clients’ needs motivates us to track global developments to identify regulatory trends. Although there are country specific nuances, there is similarity across a number of global themes. It will come as no surprise that the topic we see most prevalently dominating the current regulatory agenda is climate change.

Carbon dioxide emissions reached an all-time high in 2018. Governments continue to face pressure to drive investment into infrastructure, transport and energy in an effort to limit global warming to below two degrees. Given that the Organisation for Economic Co-operation and Development estimates this will require US$6.9 trillion per year over the next 15 years, this is a necessity rather than token gesture.

There is worldwide acceptance that this level of spend cannot be met by public funds; the need to push private investment into sustainable projects is apparent to all, and requires legislative action from financial services. The European Union (EU) continues to advance rapidly in this area, but Asia Pacific is close behind, and the US also continues to pick up pace.

On 29 March 2019, the Hong Kong Securities and Futures Commission (SFC), as part of its Strategic Framework for Green Finance, issued an ESG survey to asset management firms for mandatory completion. Furthermore, they have already confirmed they will now conduct a similar survey of the asset owner community. The results will form the basis of future policies, codes and guidance. In particular, work will be undertaken to enhance companies’ environmental disclosures, not simply from a pure operational perspective but including the risk and opportunity presented by climate change.

The Australian Prudential Regulation Authority (APRA) published an Information paper in March 2019, containing the results from a similar survey on regulated entities they undertook last year. The paper confirms APRA’s intention to increase its scrutiny of how risks related to climate change are managed.
How to embed climate change disclosures into enforceable rules with meaningful output continues to be the unsolved conundrum for regulators across the world. In the EU, efforts are being furthered to create a taxonomy of sustainable investments, limiting the so-called green washing of products that have no underlying basis for labelling themselves as benefiting the environment. The rules underpinning the provision of financial advice are being amended to mandate the need to take account of clients’ appetite for sustainable investment, and national green fund vehicles are being developed. Given the ongoing nature of the challenge, we can expect this to continue influencing the direction of regulatory change.

Safeguarding the future of our planet aside, the political uncertainty that has developed over the last few years shows no sign of settling and continues to have implications for our industry. The push for internationally agreed and harmonised financial standards is waning; individual economies seem increasingly intent on driving inconsistent agendas. The long-term implications of the United Kingdom’s departure from the EU and the Trump administration’s push against agreements made in international fora remain to be seen, but there will inevitably be consequences for organisations within financial services.
Work is underway throughout the global financial services industry to prepare for the transition away from interbank offered rates (IBORs). The diminishing volume of underlying transactions that support panel banks' IBOR submissions is considered less preferable in the long run by global regulators than those based less on judgement. Target dates have been set to replace the use of IBORs as reference rates, and market participants have been advised to prepare for the transition.

The UK’s Financial Conduct Authority (FCA) continues to reaffirm that after 2021 it will no longer compel panel banks to submit the rates required to calculate the London Interbank Offered Rate (LIBOR). Regulators have convened working groups comprised of industry participants to develop alternatives to IBORs and recommendations for transitioning to new reference rates. The International Swaps and Derivatives Association (ISDA) has confirmed that it will amend standard documentation to implement fall backs for key IBORs to alternative risk-free rates.

Regulators have convened working groups comprised of industry participants to develop alternatives to IBORs and recommendations for transitioning to new reference rates. The ISDA has confirmed that it will amend standard documentation to implement fall backs for key IBORs to alternative risk-free rates.

In November 2018, the Financial Stability Board (FSB) issued a progress report on new rate benchmarks, setting out the progress made on the development of overnight, nearly risk-free rates. A further progress report is to be issued by the FSB towards the end of the year. The International Accounting Standards Board (IASB) has also now added IBOR Reform and the Effects on Financial Reporting to its standard agenda.

In April 2019, The Bank of Japan’s Cross-Industry Committee on Japanese Yen (JPY) Interest Rate Benchmarks published the main points of their public consultation on the same topic. The outcome of the consultation is not yet known, but the expectation is JPY denominated LIBOR and the Tokyo Interbank Offered Rate (TIBOR) will be replaced with term reference rates based on the uncollateralized overnight call rate (TONA), which is a risk-free rate.
3. FUND REGULATION

3.1. ASIAN REGION FUNDS PASSPORT (PASSPORT)

Background
The Passport is a multilateral agreement between Australia, Japan, New Zealand, Republic of Korea, and Thailand, intended to establish a regional market for collective investment schemes. The Passport aims to reduce regulatory duplication by establishing a standardised set of requirements for fund operators, and benefit investors through broader and more diverse fund offerings while maintaining investor protection.

The Passport provides an agreed framework to facilitate the cross-border marketing of managed funds across participating economies in the Asia-Pacific region. The framework document states one of the founding principles to be the creation of better connections between their financial markets.

There is scope for other countries in Asia to become party to the Passport, with criteria for becoming a member economy including: International Organisation of Securities Commissions (IOSCO) membership, assessment by the International Monetary Fund as having broadly implemented IOSCO principles, and not being listed on the Financial Action Task Force’s list of high risk countries.

3.2. AUSTRALIAN CORPORATE COLLECTIVE INVESTMENT VEHICLE (CCIV)

Background
Currently, Australian fund management tends to be conducted through a Managed Investment Scheme, which has a trust-based structure. Like Undertakings for Collective Investment in Transferable Securities funds, the corporate structure of CCIVs will provide the legal form of a company limited by shares with most of the powers, rights, duties and characteristics of a public company. The hope is that the CCIV will increase the competitiveness of Australia’s managed fund industry through the introduction of internationally recognisable investment products.

Recent developments
On 17 January 2019, the Australian Government issued bills to implement CCIV tax and regulatory topics. The consultation on the new bills implementing CCIV completed on 28 February 2019; we now await direction from Treasury on the next steps in this legislative process.
Key features
The key features of the CCIV proposed legislation include:

- A company may register as a CCIV provided it is a company limited by shares and operated by a single corporate director.
- The corporate director must be a public company that holds an Australian financial services licence authorising it to operate a CCIV.
- A CCIV must not have any officers or employees other than the corporate director.
- The corporate director owes duties to the members of the CCIV, which take precedence over the duties owed to shareholders.
- A CCIV must have at least one sub-fund at all times and may be open or closed-ended.
- A retail CCIV is subject to the full regulatory framework whereas a wholesale CCIV is subject to minimal requirements.
- A retail CCIV has prescribed content requirements and must have a compliance plan.
- A retail CCIV must appoint a depositary; a wholesale CCIV may choose to appoint a depositary.

3.3. SINGAPORE VARIABLE CAPITAL COMPANY (VCC)

Background
The Singapore VCC is a new legal entity structure for investment funds, which can be used for traditional and alternative fund strategies (whether open or close-ended) and set up as an umbrella entity with multiple sub-funds. The VCC also facilitates re-domiciliation of foreign corporate funds to Singapore.

Recent developments
The Variable Capital Companies Act 2018 was passed by the Singapore Parliament on 1 October 2018. It is not yet in force but is expected to come into force in the second half of 2019. The Ministry of Finance (MOF) carried out a consultation on the goods and services tax (GST) and stamp duty treatment of VCCs, in particular, the treatment of sub-funds within a VCC. It is proposed that for these purposes sub-funds will be treated as if they were separate entities in respect of supplies and transactions made. MOF will publish a summary of the main comments and responses by May 2019.

MOF has also carried out a consultation on the proposed legislative amendments for the Corporate Income Tax treatment of VCCs. The public can access detailed consultation documents for the proposed
changes to the Income Tax Act which will be incorporated into the Variable Capital Companies (Miscellaneous Amendments) Bill 2019.

On 30 April 2019, MAS announced two consultation papers on (i) the proposed new regulations for the VCC framework; and (ii) other amendments to existing rules and regulations, such as the SFR (CIS), CIS Code and AML/CFT notice for VCCs, to provide the operational framework to facilitate the implementation of this new regime.

**Key provisions**

Similarly to the CCIV, the VCC legislation is expected to enhance Singapore’s competitiveness as a domicile for investment funds by introducing:

- A customised corporate structure suited to investment funds.
- A corporate form fund that could be:
  - Managed by a fund manager licensed by the MAS (unless exempted).
  - Set up as an open-ended or as a close-ended fund.
  - Used for mutual fund type strategies meant for retail investors, and as alternative investment fund strategies meant for sophisticated investors.
- An approved custodian must be appointed instead of a trustee for Authorised and Restricted Schemes under the VCC legislation.

The tax framework for VCC will be introduced to complement the VCC legislation and it will take effect on or after the effective date of the VCC legislation.
3.4. HONG KONG OPEN-ENDED FUND COMPANY (OFC)

Background

The Hong Kong SFC Open-ended Fund Company (OFC) structure that will allow funds to be established in corporate form is now live. The aim is that this new structure, along with proposed tax exemptions, will position Hong Kong as an attractive domicile for asset managers and a successful fund-service centre.

The detailed requirements are set out in the Securities and Futures (Open-ended Fund Companies) Rules and the Code on Open-ended Fund Companies, which supplement the basic OFC framework to be introduced via amendments to the Securities and Futures Ordinance.

Key features

Currently, Hong Kong's open-ended investment funds are established in unit trust form. An OFC is a collective investment scheme structured as a corporation with limited liability, which will be capable of being either publicly or privately offered. Key features of the OFC will include:

• A variable share capital structure to allow flexibility in meeting subscription and redemption requests.

• The ability to distribute out of share capital subject to solvency and disclosure requirements.

• The investment scope of the OFC will be aligned with the type of investment activities subject to licensing and regulation by the SFC: securities, futures and over-the-counter (OTC) derivatives (once legislative amendments are made for OTCs).

• The ability to be established as an umbrella fund with separately pooled sub-funds and segregated liabilities (similar to a Cayman Islands segregated portfolio company). Each sub-fund will be able to have a pool of assets that is managed in accordance with the investment objective and policy of that sub-fund.

• The need to comply with seven ‘General Principles’ in the OFC Code: (1) acting fairly; (2) diligence and competency; (3) proper protection of assets; (4) managing conflicts of interest; (5) disclosure; (6) regulatory compliance; and (7) complying with constitutive documents.

Northern Trust Action

Northern Trust is monitoring the developments around the Singapore Variable Capital Company, Australia Corporate Collective Investment Vehicle, Hong Kong Open-ended Company and the Passport closely. We continue to actively participate in industry discussions related to these various initiatives. Once further certainty has been reached, we will look to assess the requirements to support the new vehicles where they may differ from the existing services provided to our clients today.
4. GOVERNANCE

4.1. THE AUSTRALIAN ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY (THE FINAL REPORT)

The Final Report, published on 4 February 2019, contains 76 specific recommendations to address misconduct identified. The recommendations are expected to have a significant impact on the operation and provision of financial services in Australia, increasing the compliance requirements and corresponding costs for many entities.

Changes in corporate governance and policy follow an increasingly global trend to enhance accountability within financial services entities. While both the Government and the Opposition party have committed to adopting all of the Royal Commission’s recommendations, the form may vary radically depending on the outcome of the 2019 Australian Federal election, to be held on 18 May 2019. It is unlikely that the recommendations within the report will be baked into finalised legislation before the end of this year.

Recommendations

The Final Report contains analysis on what were deemed to be the key four observations resulting from the inquiry into the behaviour of financial services entities: the connection between conduct and reward; the asymmetry of power and information between financial services entities and their customers; the effect of conflicts between duty and interest; and holding entities to account. The key recommendations include:

- Restricting the roles of superannuation trustees to avoid conflicts of interest
- Prohibiting the deduction of advice fees (other than intra-fund) from MySuper accounts
- Imposing civil penalties for breaches of trustees’ and directors’ covenants
- Banning all forms of unsolicited offering of superannuation arrangements
- Subjecting ongoing fee arrangements for financial advice to annual renewals
- Requiring express disclosure of a lack of independence when providing advice to retail clients
• Reducing the cap on commissions received in the provision of financial advice

• Banning unsolicited offers or sales of insurance products

• Giving legal enforceability to industry codes

Principles based recommendations are also included to address observations surrounding remuneration, culture, accountability and governance:

**Remuneration:** ‘remuneration and incentives tell staff what the entity values’

Prudential standards and guidance should be revised. All financial services entities should review the design and implementation of their remuneration systems to focus on how staff do what they do.

**Culture:** ‘It is evident that culture can drive or discourage misconduct’

• Basic behavioural norms should be adhered to, including: obey the law, do not mislead or deceive, act fairly, provide services that are fit for purpose, deliver services with reasonable care and skill and act in the best interests of others.

• Entities should identify, assess, develop and improve problematic aspects of their culture, and if they are ineffective at doing so, regulators should identify flaws and decide what an entity should do to change.

**Governance:** ‘By shaping how the business is run, governance shapes the culture’

• Directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose.

• Non-financial risks are of equal importance, including compliance, conduct, regulatory and operational risks, with consideration of the same to be made more prominent in prudential standards.

**Accountability:** ‘It is accountability that determines what consequences must follow when things go wrong’

The Banking Executive Accountability Regime should be extended to include an additional accountable person’s responsibility for the end-to-end management of product design, delivery, maintenance and remediation.

‘Misconduct will be deterred only if entities believe that misconduct will be detected, denounced and justly punished’

ASIC’s enforcement culture should be changed as deterring misconduct is dependent on visible public denunciation and punishment.
4.2. DISCLOSING FEES AND COSTS IN PRODUCT DISCLOSURE STATEMENTS AND PERIODIC STATEMENTS - REGULATORY GUIDE 97 (RG 97)

The RG 97 was initially issued by ASIC in November 2011 and was met by a great deal of industry discussion. Numerous amendments were made before the most recent iteration (released in March 2017) was subjected to an independent review. The review was released in July 2018, identifying a number of proposed changes. In response to this, ASIC released a consultation paper on 8 January 2019. Submissions were welcomed until 2 April 2019; with ASIC expected to respond in turn within the second half of the year. The paper identifies recommendations that ASIC proposes to adopt, with changes made to RG 97 including:

- Revisions to fee templates to increase comparability between products and reduce complexity.

- Removal of implicit cost disclosures other than in relation to counterparty spreads.

- Revisions to disclosure of performance and performance related fees; performance and performance related fees to be combined and disclosed on a five year average basis.

A further recommendation that was supported by ASIC but has not yet been adopted within the legislation due to resource constraints, is the creation of a central data repository to facilitate consumer comparison. The presumption being that this may become a longer term aim of ASIC’s.

4.3. PORTFOLIO HOLDINGS DISCLOSURE FOR SUPERANNUATION FUNDS

The portfolio holdings disclosure obligations were introduced as part of the Australian government’s Stronger Super regime, requiring trustees of all registrable superannuation entities to publish information about the fund’s portfolio holdings on the fund’s website.

The first reporting date was originally set as 30 June 2014 however ASIC had previously deferred the commencement date under Class Order CO 14/443 Deferral of choice product dashboard and portfolio holdings disclosure regimes to 31 December 2019.

In April 2019, The Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No.1) Bill received Royal Assent amending section 1540 of the Corporations Act 2001 made by Schedule 6 of the Bill so that the Portfolio Holdings Disclosure requirements will apply to reporting days that occur on or after 31 December 2019. As a result of the legislative amendments deferring the
first reporting date to 31 December 2019, superannuation trustees no longer need to rely on the relief provided by CO 14/443.

Key aspects of the requirements include:

- Application date is on or after 31 December 2019 and frequency of reporting is twice yearly as at 30 June and 31 December, to be published within 90 days.

- Non-disclosure provisions have been included whereby the trustee may determine up to 5% of the assets of the fund that are commercially sensitive in nature be excluded from reporting on an individual investment item basis. This is subject to the total weighting or exposure of these commercially sensitive assets needing to be disclosed.

- Look through is only required for associated entities and Pooled Superannuation Trusts.

- Certain kinds of disclosable items may be grouped with only the kind of disclosable item reported, and the total value or weighting of the kind.

- The data required to be reported must include sufficient information to identify each item held and the value and weighting or exposure. Sufficient information will include but is not limited to investment item name and may include for example, ASX codes.

- Total Value and Total Exposure of all investment items must be reported and organised in accordance with Regulations.

4.4. AMENDMENTS TO THE HONG KONG CODE ON UNIT TRUSTS AND MUTUAL FUNDS

On 6 December 2018, Hong Kong’s SFC released the consultation conclusions on proposed amendments to the Code on Unit Trusts and Mutual Funds (the Code). The amendments to the Code are supplemented by frequently asked questions, published on 14 March 2019. Key amendments include:

- Increasing the minimum capital requirement for management companies of SFC-authorised funds from HKD 1 million to HKD 10 million.

- Flexibility for fund management groups with a multinational presence to enable the same to leverage group resources and expertise; two full-time staff were previously needed to meet the key personnel requirement. Whereas now this will be satisfied if the management company belongs to a well-established group and can demonstrate that on a group basis they possess requisite resources and oversight.

Northern Trust Action

Northern Trust is actively working on developing solutions to support clients with their reporting obligations and also remains actively engaged in ongoing discussions with ACSA in its’ efforts to produce a ‘best practice’ guide to support the portfolio holdings disclosure.
• Codifying the eligibility requirements for trustees and custodians and enhancing their obligations in order to meet the standards set by IOSCO.

• Broadening the core investment requirements to allow for securities lending, sale and repurchase and reverse repurchase transactions.

Although the Code became effective on 1 January 2019, existing funds and operators benefit from a 12-month transition period before needing to comply with the revisions.
5. FOREIGN INVESTMENT INTO APAC

5.1. AMENDMENTS TO RULES GOVERNING FOREIGN INVESTMENT IN CHINESE CAPITAL MARKETS (QFII/RQFII)

The Qualified Foreign Institutional Investor (QFII) scheme and its yuan-denominated alternative, the RMB Qualified Foreign Institutional Investors (RQFII) scheme, allow overseas institutional investors, banks and asset managers to make capital account investment under Chinese law and trade Chinese domestic securities. Although the aim of both is to attract foreign investments and promote the development of Chinese capital markets, the schemes have seemingly lost their attraction over the years, something attributed to their complicated approval process and limited investment scopes.

To address this, at the end of January 2019, the China Securities Regulatory Commission published a consultation paper and supporting rules aiming to ease foreign institutions’ access to capital markets. The draft legislation looks to lower the threshold for overseas applicants and simplify the vetting process they face upon investment into Chinese capital markets. The scope of investment is broadened under the proposal, with new products including bond repurchases, private investment funds, financial and commodity futures now considered as applicable investments within both schemes. The restriction on the number of custodians appointed by a QFII will also be removed should the proposal progress to legislative change, and specific penalties for breaches of the regulations imposed.

5.2. SECURITY OF CRITICAL INFRASTRUCTURE ACT 2018 (THE CRITICAL INFRASTRUCTURE ACT)

Whilst there are economic advantages of foreign involvement in critical infrastructure, the same also presents exposures from a national security perspective, opening a theoretical gateway for sabotage, espionage and coercion.

To address this, the Australian Government published the Critical Infrastructure Act, which applies to specific assets in the electricity, gas, water and ports sectors. Three key measures are now in place with the aim of managing national security risks related to critical infrastructure:
• Register of Critical Infrastructure Assets: direct interest holders (with more than 10% direct interest in the asset) and responsible entities must report on ownership by 11 January 2019, and subsequently within 30 days of any notifiable event.

• Greater regulatory powers to request certain information from direct interest holders, responsible entities and operators of critical infrastructure assets.

• Ministerial directions power to enable the Minister to issue a direction to mitigate national security risks (there are safeguards in place limiting the ability to utilise this power).

All source documents referenced within this newsletter can be directly accessed using the hyperlinks contained within the electronic edition of the newsletter. To access the electronic edition please go to: www.northerntrust.com/insights-research/publications/regulatory-development-newsletters