Offshore mutual fund regulation in Taiwan – An overview

In their overview of offshore mutual fund regulation in Taiwan, Dr George Lin and Ross Darrell Feingold of *Lin & Partners* discuss recent developments in the market, divulge how to obtain registration approval and explain the measures they feel will enhance the attractiveness of Taiwan as a market for offshore fund products.

Taiwan continues to have an active mutual funds industry, based on its high GDP per capita (US$20,900 in 2014), investor appetite for a range of wealth management products and a large number of industry participants that ensures innovation and competition in the market.

According to the main industry trade group, the Securities Investment Trust & Consulting Association (SITCA) at end-2014, investors in Taiwan held US$107bn in offshore mutual funds, and US$105bn in onshore local funds.

Taiwan's past reputation was that the market had significant regulatory hurdles to entry, including its own library of abbreviations such the Financial Supervisory Commission (FSC), securities investment trust enterprises (SITEs), and securities investment consulting companies (SICEs).

However, with appropriate collaboration from external counsel and distribution partners, offshore mutual funds can enter the market with no greater difficulty than neighbouring jurisdictions. Regulations are transparent even if the regulatory decision-making process may sometimes be slowed due to market conditions. This article discusses the offering of offshore funds to retail investors in Taiwan. Private placement of offshore mutual funds to high net worth individuals and institutional investors are governed by additional regulations outside the scope of this article.

Legal & regulatory overview

The primary applicable regulation is the Regulations Governing Offshore Funds (Regulations) (as last amended on 29 May 2014). Banks, securities brokers, insurance firms, SICEs and SITEs are subject to laws and regulations that govern their respective businesses, which range in scope from customers facing procedures such as know your client (KYC) to back office functions. Regulatory circulars issued by the FSC and its predecessor agencies also apply to the industry. Self-regulatory organisations also play a significant role as the initial application window for offshore fund approval registration, and have issued numerous voluntary guidelines for best practices in business conduct.

The master agent

Under the Regulations, the offshore fund manager must appoint a master agent. As of December 31, 2014, 45 firms are registered as master agents for 1025 offshore funds managed by 81 offshore managers.

The master agent's legal obligations include submission of regulatory approval applications, serving as onshore recipient of investor and regulatory correspondence, and operational processing of sales and redemptions. The master agent requirement did not initially exist when the market was opened to offshore funds, and was implemented in 2006 to provide comfort that an offshore fund manager has an onshore point of contact for investors and regulators.

SITEs, SICEs and securities brokers may act as master agents. Master agents are subject to capital, clean regulatory record, performance bond, staffing and other operational requirements, which entities associated with Taiwan's largest financial groups are easily able to satisfy. The master agent will mandate the sub-distributors such as banks, SITEs, SICEs, mutual funds and insurance companies.

A master agent is not restricted to acting on behalf of a single offshore fund manager, although the parties may agree to this by contract. The amount of the master agent's compensation is subject to commercial negotiation between the fund manager and master agent, though the amounts, types (sales-linked, marketing budget, etc.) and basis (e.g. AUM) must be disclosed to investors per guidelines issued by SITCA. The master agent agreement is based on a format common in the market with little possibility to negotiate bespoke clauses. Some offshore managers have elected to establish their own master agent in Taiwan rather than work with third parties.

Distribution channels

Offshore mutual funds may be distributed via banks, SITEs, SICEs securities companies, insurance companies and other financial advisers. Banks with their large branch networks are often the favoured distributor for offshore funds, as banks offer significant resources scale. However, banks in turn have the leverage to limit the number of funds that they distribute and extract greater commissions. Insurance companies are also an increasingly important distribution channel.

A distributor is not restricted to acting on behalf of a single offshore fund manager, although the parties may agree to this by contract. The amount of the distributor's compensation is subject to commercial negotiation between the fund manager and distributors and master agent, though the amounts, types (sales-linked, marketing budget, etc.) and basis (e.g. AUM) must be disclosed to investors per guidelines issued by SITCA. The distributor agreement is based on a format common in the market with little possibility to negotiate bespoke clauses.

Fund types & investor preferences

Taiwan's retail fund investors' preference for equity or fixed income funds varies with global market conditions. The FSC will generally approve offshore equity or fixed income funds, subject to the restrictions below. Funds established as Undertakings for Collective Investment in Transferable Securities (UCITS) in Dublin or Luxembourg may be registered, and are favoured by fund managers for operational efficiencies, as well as for the FSC's history of approving UCITS funds.

Key regulatory restrictions are:
Derivatives: The non-offset 'long' position may not exceed 40 percent of the offshore fund's NAV, and the non-offset short position may not exceed the fund's holding of the asset.
China: For equities, the securities must be listed on either the Shanghai or Shenzhen exchange and may not exceed 10 percent of the fund's NAV. For fixed income issued in China, equities issued in Hong Kong by Chinese companies (e.g. red chips), and fixed income issued in Hong Kong by Chinese companies, there is no NAV-linked limit.
Physical Commodities and Real Estate: No holdings are permitted.
Denomination: Major currencies are permitted; renminbi and Taiwan dollar are not permitted.
History: Prior to the regulatory application in Taiwan, the fund must have existed for one year, and be publicly offered in its home market.
Custodian: The offshore fund's custodian bank must be rated BBB- or above.
Hedge Funds: Offshore hedge funds may not be registered for sale to retail investors.

Registration approval

The master agent, rather than the offshore fund manager, files applications with SITCA. Subsequent to SITCA's review, the application is forwarded to the Financial Supervisory Commission, Securities and Futures Bureau, Securities Investment Trust and Consulting Division, for approval. In reality, the offshore fund manager will, together with its external counsel, prepare the applications on behalf of the master agent.

Especially for new entrants to the market, preparation of applications, legal documentation and investor fact sheets takes one to two months. Experienced fund managers are able to condense this period.

The SITCA review typically takes one month, and the FSC review six months.

Registration withdrawal

The offshore fund may apply to withdraw its registration and cease sales in Taiwan. In such cases, the master agent must con-

"With appropriate collaboration from external counsel and distribution partners, offshore mutual funds can enter the market with no greater difficulty than neighbouring jurisdictions"

Dr George Lin

Ross Darrell Feingold

"The Financial Supervisory Commission is receptive to industry suggestions especially those that expand onshore product availability and the knowledge base of the financial services workforce"

tinue to ensure that investors in Taiwan are able to redeem their holdings and continue to receive statements and other information in a timely manner. Failure to maintain sufficient support onshore following a registration withdrawal may result in regulatory actions by the FSC and substantially impact the offshore manager's ability to register funds in the future.

Cross listing Exchange Traded Funds (ETF)

Taiwan and Hong Kong allow ETFs to be cross-listed, which offers hope for future cross-listing agreements between Taiwan and exchanges in other jurisdictions. Currently, only Taiwan financial institutions have cross-listed ETFs in Taiwan and Hong Kong. Thus, it remains to be seen whether fund managers from outside Taiwan will seek to cross-list an ETF.

White labelling

The regulatory structure for an offshore fund manager to act as a sub-advisor to a local fund established by an onshore fund manager is well developed. The use of a white label product may be of interest to fund managers who are new entrants to the Taiwan market.

Taxes

Offshore funds continue to be an attractive option for retail investors, as income earned from an offshore investment product is not taxed unless the investor's total offshore income (from all income sources) exceeds a minimum threshold of NT$1 million. The income will be added to the investors total taxable income and taxed at applicable income tax rates.

Recent developments

On February 6, 2013, the FSC announced a series of long term measures to encourage the offshore funds industry to conduct more business from onshore and to otherwise improve service quality. In addition to a relaxation in staffing rules for the master agents, the FSC committed to speedier reviews for new fund registrations and waivers to derivatives limits, and increase to three the number of new registrations a master agent may concurrently submit. We believe successful implementation of these measures will enhance the attractiveness of Taiwan as a market for offshore fund products.

Scheduled to be implemented on January 1, 2016 is a reduction in the amount of Taiwan securities that may be held in a registered offshore fund to 50 percent, from the current 70 percent, of NAV, and a reduction in the percentage of NAV of an offshore fund that may be held by Taiwan investors, to 50 percent from the current 70 percent. Although these may be viewed as additional restrictions, the FSC takes the view that they will encourage offshore fund managers to bring more diverse products to the market.

Conclusion

The FSC is receptive to industry suggestions, especially those that expand onshore product availability and the knowledge base of the financial services workforce. Recent initiatives outside the funds space include the expansion of offshore banking and securities unit services, the liberalisation of renminbi product offerings and raising the daily stock trading fluctuation limit to 10 percent from seven percent. For offshore funds and global fund managers, Taiwan offers a market with a large, wealthy and knowledgeable customer base. The participants in the distribution channels, such as master agents, SICEs, and SITEs, have over two decades in the registration and marketing of offshore fund products. Although the regulatory infrastructure is unique and may differ significantly from other markets in Asia, it is not a barrier to entry, and the many fund managers who have successfully registered their funds in Taiwan attest to this.

The authors would like to thank associate Tsai-Ling Wu for her assistance in the preparation of this article.