Interim Regulatory Impact Statement

FUNDS DOMICILE INITIATIVE

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development.

It provides an analysis of advice to Ministers on a response to the recommendations of the International Funds Services Development Group (IFSDG) to facilitate the growth of a funds domicile industry in New Zealand. Specifically, this document provides analysis of whether or not Ministers should direct officials to conduct a detailed analysis regarding the IFSDG's tax and regulatory recommendations, and to report back to Cabinet for approval of a complete set of policy decisions by September 2011. At that stage, Cabinet could decide if and how it wishes to proceed with the funds domicile initiative.

The specific regulatory and tax changes required to establish the conditions necessary for New Zealand to become a funds domicile are yet to be determined. Given this, we are unable to produce a comprehensive cost-benefit analysis, as we are unaware of the exact changes and therefore the full range of costs. As such this is only an Interim Regulatory Impact Statement.

The regulatory changes proposed in this initiative may could impose an additional regulatory burden on the domestic industry.

Jo Doyle, Manager, Business Assistance Policy Team

Status quo and Problem Definition

New Zealand currently only has a small domestically focused funds administration industry. An opportunity has been presented to significantly grow this industry by establishing an international funds domicile industry in New Zealand. Analysis from the International Funds Services Development Group (IFSDG) has found this industry could generate significant benefits for New Zealand.

However, the current regulatory and tax environment in New Zealand does not permit the establishment of an internationally attractive funds domicile industry. This regulatory impact statement therefore makes a preliminary assessment of the costs of regulatory and tax changes against the potential benefits of establishing a funds domicile industry in New Zealand.

What is a Funds Domicile?

A domicile is the legal "home" of a managed fund. The domicile also tends to be a centre for fund accounts and administration, including: transfer and registration of the fund's shareholders; trustees performing a caretaking role with respect to the investments; funds administration functions, including calculating daily pricing and other related accounting of the funds; and legal, accountancy and advisory services relating to licensing and domiciling in the jurisdiction.

The International Funds Services Development Group

Much of the preliminary work on this initiative has been done by the private sector group, the International Funds Services Development Group (IFSDG). This group was appointed by Cabinet to report back to Government on what would be required for New Zealand to successfully position and market itself as an international funds domicile. Appendix one contains further information on the IFSDG.

As an input into the IFSDG's report, the international financial consultancy firm Oliver Wyman was also commissioned to produce a report on how New Zealand could develop a funds domicile. Where appropriate, their analysis has been referred to in this document.

Objective

The objective is to establish the conditions necessary for New Zealand to become a funds domicile for the Asia-Pacific region.

Regulatory Impact Analysis

The specific regulatory and tax changes required to establish the conditions necessary for New Zealand to become a funds domicile are yet to be determined. The changes suggested by the IFSDG will be used as a guide but consideration will be given to the practicality of such changes and any wider impacts that they may have. Alternative or new regulatory changes may also be considered if it is determined that they better help to meet the objective.

Given this, we are unable to produce a comprehensive cost-benefit analysis, as we are unaware of the exact changes and therefore the full range of costs. In this section we provide a preliminary overview of the broad costs and benefits of this initiative. We also briefly discuss the prospects of successfully establishing a funds domicile in New Zealand.

If Cabinet decides to further investigate this initiative, a more detailed analysis of these points will be required in order to allow Ministers to make an informed decision on whether or not to proceed.

Why are regulatory and tax changes being considered?

If it is decided to progress with this initiative, significant regulatory and tax reforms would be required.

Regulatory

In their report, Oliver Wyman identified the need for regulatory change through extensive interviews with regulators, fund managers and fund servicers throughout the Asia-Pacific region, and also through their own deep knowledge of the international funds industry. They found that for New Zealand to establish itself as a funds domicile it would be required to at least meet the current "best in class" global standard: the European Union's Undertakings for Collective Investment in Transferable Securities (UCITS) regulatory regime.

The IFSDG agreed with this assessment. For more information on why meeting the international regulatory standard is essential to creating the conditions necessary for New Zealand to become a funds domicile for the Asia-Pacific region, please see Appendix Two which contains an excerpt from the IFSDG's report on established competitors.

Tax

The IFSDG also recommended tax policy changes. These are required to ensure that there is no tax leakage, and to make our tax environment approachable for international fund managers.

Inland Revenue and The Treasury's work on changes to the Portfolio Investment Entity (PIE) tax rules is already addressing the core tax requirement of ensuring that non-resident investors in PIEs are not over-taxed. This will reduce the PIE tax rate to zero for foreign investors investing in foreign assets through a New Zealand PIE. This will bring the PIE rules into line with New Zealand's source-basis taxation system, where residents are taxed on their worldwide income and non-residents are taxed on their New Zealand-sourced income.

Inland Revenue's work on limited partnerships will also address some of the concerns of the IFSDG.

Beyond these changes already progressing irrespective of the funds domicile initiative, the IFSDG's report recommends the following changes:

- providing the international funds industry with the confidence that the changes are enduring in the long term;
- clarifying that multi-layer "funds of funds" are able to qualify;
- ensuring that the changes apply to all sources of foreign income;
- extending the zero per cent tax for non-residents investing in foreign assets to the full range of investment vehicles used by fund managers internationally;
- ensuring that the changes do not unduly disadvantage New Zealand financial solutions providers; and
- ensuring that the PIE structure is able to be readily understood and recognised by international fund managers.

As noted above, while these recommended changes will be considered, further work is needed to assess their exact impact and suitability in the New Zealand context.

Costs

Impact on the domestic industry

There is potential that the regulatory changes could impose a high regulatory burden on the domestic industry. As it currently stands, the review of securities law is unlikely to recommend a regime as rigorous as the UCITS standard for the domestic industry.

The IFSDG, through their industry consultation, received feedback suggesting that the domestic industry is concerned about the potential costs such a regime could impose.

Such a regime may also result in a bias in the regulatory system towards larger managed funds. Larger funds would likely be capable of covering the additional costs that such a regime would impose, whereas smaller funds may find it not feasible to operate under the higher cost structure. This could effectively remove smaller offerings from the domestic industry.

These concerns can be mitigated to some degree by considering a dual regime, where international funds must comply with international standards but domestic funds would be able to comply with a lower standard. If it is decided to progress this initiative, options for a dual regime will be explored.

We currently have no information of the impact on the domestic industry of the tax changes suggested by the IFSDG. Potential costs will need to be considered in the development of the detailed tax policy work.

Opportunity cost

Assessing the changes suggested by the IFSDG would consume significant policy resource. The detailed investigation of both the regulatory and tax recommendations

would require reprioritisation of officials work programmes, delaying the implementation of current work.

Specifically, accommodating the detailed investigation, and potential future implementation, of the regulatory recommendations would delay, for at least six months, the part of the securities review dealing with managed funds.

It is likely that similar opportunity costs would apply to investigating the tax recommendations.

Implementation and Administrative costs

In the first instance it will cost an additional $700,000 per annum to fund the additional regulatory policy resource required to further investigate, and then potentially implement, this initiative. This can be met from within Vote Economic Development; however this funding would not then be available for other purposes.

If an international standard regulatory regime is implemented there will be an additional cost to the proposed Financial Markets Authority to negotiate the necessary recognition agreements with regulators in other countries and to regulate and monitor a more comprehensive regime. If a dual regime is implemented this cost will be magnified. The details of the exact costs of this will be determined in the further detailed work.

As yet we have been unable to determine what implementation and administrative costs there may be for the proposed tax changes.

Benefits

This section considers the potential benefits to New Zealand if a funds domicile industry is established. These benefits should be treated with caution, however, as success in developing this industry is not guaranteed. The factors influencing the likelihood of success are discussed in the next section.

Establishment of a high-value service export industry

The International Funds Services Development Group (IFSDG) estimates that in 10 to 15 years time the funds domicile industry could generate revenue in New Zealand of NZ$0.5 – 1.3 billion per annum, 2,000 – 5,000 high value jobs (such as accountants, lawyers and trustees), and taxes of NZ$150 – 360 million per annum.

Potential flow-on benefits to the wider financial services industry

Beyond the immediate benefits generated from the funds domicile industry, there is potential for positive benefits for the wider financial services industry. The skill base required to service the funds domicile industry may create a skill base capable of providing wider financial services expertise.

However, at this stage it is difficult to tell if such benefits would occur, and if they do, what their nature and size would be.

Likelihood of success

Key barriers to entry

Beyond the already discussed requirement for tax and regulatory reform, the IFSDG identified the following barriers to entry for New Zealand:

- **Brand –** the perception that New Zealand is not an obvious domicile choice for most managers and investors, along with uncertainty over the longer-term government support and coordination. This particularly refers to the incumbent advantage that the UCITS brand holds over any potential competitor.
  - The IFSDG argue that through appropriate marketing in the latter stages of the project this barrier can be overcome
  - Officials consider that this would be a difficult but not insurmountable barrier.
- **Location –** New Zealand's time zone (which is much closer to the time zone of Asian investors than the incumbent European domiciles) is seen at best as a partial advantage by most stakeholders and the distance to Asian centres was highlighted as an inconvenience.
  - This barrier is difficult to address, but New Zealand is likely to be in a better position for Asian funds than the incumbent European domiciles.
- **Labour market capability –** a major concern raised by many of the fund servicing companies is a perceived lack of depth and requisite skills in the local labour market. Local capabilities are currently below requirements, but are expected to quickly increase in the face of new demand.
  - The IFSDG argue that because of the slow ramp-up of services over 10 to 15 years the labour market issue could be overcome with appropriate training and targeting of professionals from overseas (including expat New Zealanders). Officials agree that this barrier can be overcome.

The IFSDG also discussed a further barrier regarding European restrictions on funds not domiciled in Europe. Currently European regulators generally do not allow funds domiciled outside Europe to be distributed to retail investors within their jurisdictions. This would shut New Zealand out of the European market, at least initially. It would also mean that New Zealand could not domicile global funds that wished to distribute in Europe as well as other regions.

Counterbalancing this is an emerging trade protection dispute. This may have the effect of opening up European markets to wholesale, and possibly also retail, funds domiciled in other jurisdictions.

The effects of this restriction will need to be carefully considered when assessing New Zealand's prospects of success.

New Zealand's competitive advantage

The Asia-Pacific region represents the greatest opportunity for New Zealand as an aspirant funds domicile and / or funds servicer. There is currently no established funds domicile in the Asia-Pacific region.

The IFSDG argued that as a small, stable, developed country, New Zealand would be well placed to take advantage of this opportunity.

Officials note the opportunity for a funds domicile in the Asia-Pacific region, but are more cautious about the challenge presented by potential competitors within the region.

Competition

Beyond the established domicile competitors discussed in Appendix Two there are several potential competitors in the region that in some respects are better positioned to play a domicile role than New Zealand, but they also face their own challenges and have not historically emphasised a domicile-driven strategy. Appendix Three contains an excerpt from the IFSDG's report concerning these competitors.

The IFSDG found that strongest competition in the Asia-Pacific region comes from Singapore and Hong Kong. However, they argue that as both countries compete for the role of the Asian wealth and asset management hub, it is likely that each may find it challenging to ensure the cooperation of the other in any attempts they may make to engage in a regional domicile role.

Officials consider that there is a significant risk that Singapore and Hong Kong could dominate this industry in the Asia-Pacific region. These jurisdictions are regional wealth management hubs with strong financial infrastructure and skills base. They also already have many of the regulatory and tax conditions in place and, in the case of Singapore, will offer fund servicing companies generous incentives. However, traditionally funds domiciles have not been located in major funds management centres (such as London or New York). Smaller more nimble and responsive jurisdictions dominate this industry. Again, this will need to be carefully considered in the more detailed analysis.

CONSULTATION

The majority of the analysis of this project so far has been conducted by the IFSDG and Oliver Wyman.

In the development of their advice the IFSDG held varying intensity of engagements with the following groups:

- government agencies, including Statistics New Zealand, Inland Revenue and the Treasury;
- senior managers of local and overseas banks, to get a better understanding of their out-sourcing and in-sourcing decisions;
- professional consultants, to consider relevant tax implications and international regulatory standards;
- funds industry representatives, through workshops in both Auckland and Wellington, where people working in the financial sector were given the opportunity to hear what the IFSDG is doing and to give feedback on potential approaches;
- regulators in Beijing to complement the interviews conducted by Oliver Wyman;
- the New Zealand Foreign Trust industry, captive insurance industry and global superannuation industry experts;
- members of the Kiwi Expats Abroad (KEA) organisation with experience in the funds servicing industry;
- the New Zealand Corporate Taxpayers Group; and
- other research by members of the IFSDG using their extensive local and global contacts.

Oliver Wyman conducted an extensive range of interviews with international fund managers, regulators and other key players in the Asia-Pacific funds management industry.

In conducting the more detailed analysis regarding the IFSDG's recommendations, we will consult widely with both the New Zealand domestic funds management industry and the international funds management industry in the further development of this project.

Conclusions and Recommendations

Given the lack of detailed information a full cost-benefit analysis is not possible. We therefore cannot provide the necessary information for Ministers to make an informed decision on whether or not to proceed with this initiative.

However, given the potential benefits of establishing a funds domicile industry in New Zealand, we believe it is worth further consideration. We therefore propose that Cabinet direct officials to conduct a detailed analysis regarding the IFSDG's tax and

regulatory recommendations and report back to Cabinet for approval of a complete set of policy decisions by September 2011. This will include a full analysis of the implications and prospects of establishing a funds domicile industry. This will allow Cabinet to make an informed decision on if and how it wishes to proceed with the funds domicile initiative.

IMPLEMENTATION

No Cabinet decisions are sought at this stage on implementation.

MONITORING, EVALUATION AND REVIEW

Following the report back to Cabinet in September 2011, monitoring and evaluation requirements will be determined.

APPENDIX ONE – THE INTERNATIONAL FUNDS SERVICES DEVELOPMENT GROUP'S REPORT

Cabinet appointed the International Funds Services Development Group (IFSDG) to report back to Government on what would be required for New Zealand to successfully position and market itself as an international funds domicile.

One of the key inputs into the IFSDG's report was a study commissioned from Oliver Wyman, one of the world's leading financial consulting firms. Oliver Wyman brought a strong "outside looking in" perspective based on extensive experience in the financial services sector. They conducted a range of interviews with participants in the international funds services industry throughout the Asia-Pacific, including fund managers, service providers and regulators.

In their final report the IFSDG proposed a two-stage approach. This would allow the Government to first establish the tax and regulatory environment necessary for a funds domicile. Then, subject to market conditions, the Government could make a decision about what further additional government support would be required to attract fund servicing companies who can perform the domicile functions.

In order to realise the funds domicile opportunity, significant changes to our current securities law regime, in particular managed funds regulation, would be required. The current "best in class" global standard is the European Union's Undertaking for Collective Investment in Transferable Securities (UCITS) regulatory regime. New Zealand will have to at least match the UCITS standard to effectively compete in this space and will likely have to offer something further to differentiate itself from incumbent domiciles.

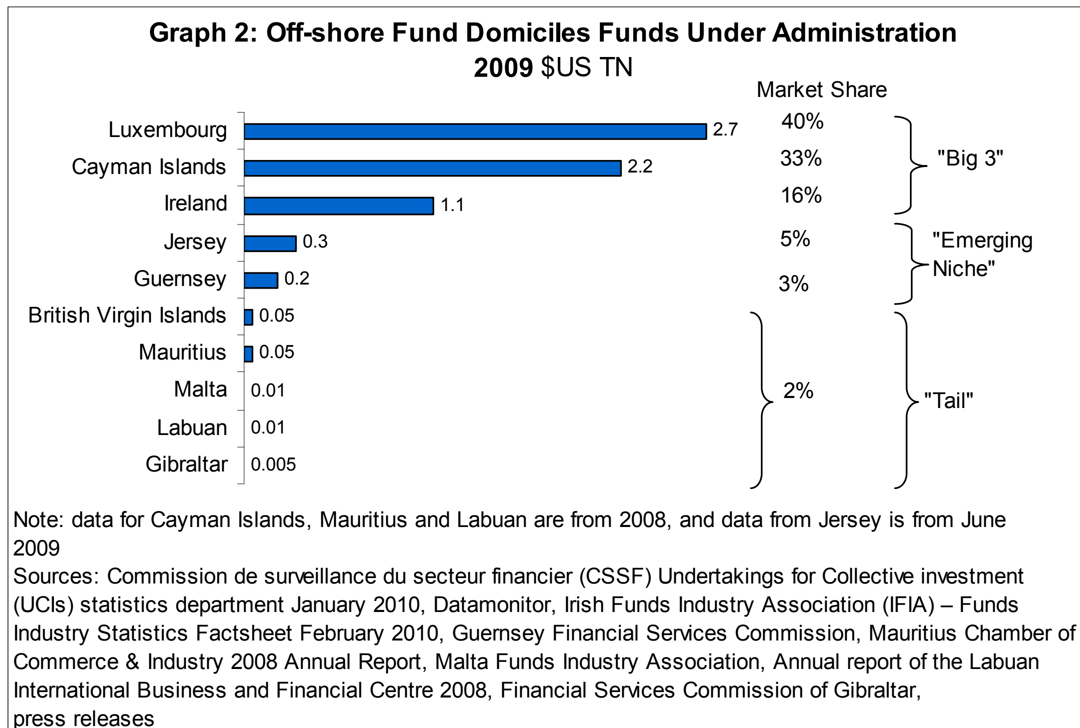
The IFSDG specifically stated that to meet higher international standards, regulatory change – above and beyond what is likely to result from of the current review of securities law – will need to be made in the following areas:

- introducing restrictions on investments, such as the use of derivatives in defined funds;
- ensuring that the "fit and proper" tests meet the standard set by the UCITS;
- regulating all significant entities and individuals that work in senior positions in the funds industry, including the fund itself, fund managers and service providers;
- introducing capital adequacy provisions for custodians / depositories;
- enforcing anti-money laundering and "know your customer" rules;
- regulating wholesale funds, which are indirect recipients of retail funds; and
- requiring full independence between the manager and the assets where a Depository is appointed as the safe-keeper of the assets and to independently value the fund assets and calculate unit prices.

To reduce the regulatory burden on New Zealand's domestic funds management industry the IFSDG proposed a two tier, opt-in system. International funds would be required to conform to a higher international standard regulatory regime. The domestic industry would have a less rigorous regulatory environment as their default, but be able to opt-in to the higher standard offered by the international regulatory regime if they wish.

APPENDIX TWO – ESTABLISHED COMPETITOR ANALYSIS - EXTRACT FROM THE INTERNATIONAL FUNDS SERVICES DEVELOPMENT GROUP REPORT

Currently the global offshore funds industry is dominated by the Big 3 domiciles – Luxembourg (40 percent market share), the Cayman Islands (33 percent) and Ireland (16 percent). However, the landscape is evolving with a range of “niche” domiciles emerging which are positioning themselves as specialist providers for specific areas (especially alternative asset classes). The size of the current domiciles is indicated in Graph 2 below.



Graph 2: Off-shore Fund Domiciles Funds Under Administration 2009 $US TN

Note: data for Cayman Islands, Mauritius and Labuan are from 2008, and data from Jersey is from June 2009

Sources: Commission de surveillance du secteur financier (CSSF) Undertakings for Collective investment (UCIs) statistics department January 2010, Datamonitor, Irish Funds Industry Association (IFIA) – Funds Industry Statistics Factsheet February 2010, Guernsey Financial Services Commission, Mauritius Chamber of Commerce & Industry 2008 Annual Report, Malta Funds Industry Association, Annual report of the Labuan International Business and Financial Centre 2008, Financial Services Commission of Gibraltar, press releases

Successful domiciles have developed over long periods of time by laying the required foundations, responding to market discontinuities, and continuing to invest in marketing and market-driven innovation.

The dominant retail funds domiciles (Luxembourg and Ireland) have:

a international reputations for their regulatory institutions and laws, notably with respect to investor protection and innovation;

b recognition of their jurisdictional framework by the regulators in the major offshore markets, streamlining the distribution process in these markets;

c historical efficiency in terms of servicing and compliance costs;

d labour markets with the depth and capability to support the required funds incorporation and servicing functions; and

e strongly supportive governments encouraging industry growth and development. They have an agile and responsive structure, with one agency responsible to the industry which can deliver a whole-of-

government approach, along with the internationally focused arm of the financial regulator.

UCITS

A key part of the current cross-border funds domicile landscape is the European regulatory standards known as UCITS. The UCITS is an EU directive, first introduced in 1985. Laws and regulations in Luxembourg and Ireland are UCITS compliant, meaning UCITS requirements are applied to funds domiciled in those countries.

The UCITS scheme aims to provide investor protection through strict and prescriptive investment limits and capital, organisational and disclosure requirements, as well as asset safekeeping and fund oversight. The UCITS regulates retail investment products, but not wholesale products. The sole objective of a UCITS regulated fund must be the investment in transferable securities of capital raised from the public.

The UCITS has become recognised as the "gold standard" of cross-border regulatory regimes internationally. Regulators throughout the world have allowed UCITS funds to be sold within their jurisdictions and fund managers and administrators have become accustomed to working within its requirements. In effect, the UCITS is now a global brand for retail fund regulation. This is one of the key reasons that Luxembourg and Ireland are the choice of domicile for retail funds. Appendix Three contains a more detailed description of the UCITS directive.

APPENDIX THREE – EXCERPT FROM THE IFSDG REPORT - POTENTIAL COMPETITORS IN THE ASIA-PACIFIC REGION

Complementarity with Australia

Australia has aspirations to become an Asia-Pacific financial services centre by building on its significant funds industry. In January 2010 the Australian Government released the report *Australia as a Financial Centre: Building On Our Strengths,* the final report from a taskforce of senior financial centre representatives. This report notes that while the domestic industry is strong, managing an estimated AU$1.6 trillion, exporting and importing financial services in Australia are low by international standards. Of the total funds under management, the Australian Bureau of Statistics[1] estimates that only $65 billion (or 4 percent) was sourced from offshore investors. The report argues that there are some policy settings that inhibit a greater volume of cross-border financial transactions occurring through Australia. The report made 19 recommendations in all, including:

- altering the tax environment, to be more condusive to the funds management sector;
- improving and streamlining regulations;
- establishing a regional funds passport, where funds can be freely distributed to any participating jurisdiction; and
- establishing the Financial Centre Taskforce to provide support for effective and ongoing policy reform.[2]

The Australian Government responded to this report on 11 May 2010. They supported most of the taskforce's recommendations, and of particular note was the emphasis put by the Minister for Financial Services Mr Bowen on measures:

- to improve the corporate bond market;
- to enable the Australian Securities and Invesment Commission (ASIC) to perform supervision of real time trading on Australia's licensed markets; and
- to cut the withholding tax rate on certain distributions of income to non-residents by Australian managed funds to 7.5% from 1 July 2010.

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[1] Australian Bureau of Statistics, *5655.0 – Managed Funds*, Australia (December 2009).
[2] All of the recommendations from the *Australia as a Financial Centre: Building On Our Strengths* report are attached as Appendix Two.

It is the view of the IFSDG that Australia will be focusing on positioning itself as a centre for asset management services, as distinct from a funds domicile. International experience indicates that investment managers will cluster close to investment markets and to investors, while domicile and servicing activities will cluster in small, agile jurisdictions with strong regulatory regimes and competitive cost environments. This is why the world's leading funds domiciles are in Luxemburg, Ireland and the Cayman Islands, supporting financial management centres such as London.

The IFSDG believes that there is an opportunity for New Zealand to establish a similar relationship with Australia. Therefore, the IFSDG considers the Australian initiative as complementary to the recommendations in this report, rather than competitive with them.

New Zealand businesses should look to work closely with Australian businesses to develop mutually beneficial approaches. One area of focus should be in jointly pursuing the concept of an Asian Funds Passport, which would help to streamline the process of gaining approval to distribute funds into other jurisdictions.

Other Potential Asia-Pacific Domicile Competitors

There are several potential competitors in the region that in some respects are better positioned to play a domicile role than New Zealand, but they also face their own challenges and have not historically emphasised a domicile-driven strategy. The key potential competitors are Singapore, Hong Kong and Australia, while some smaller niche players have also shown some interest.

Singapore is a regional wealth management centre and a significant funds management centre. It has aspirations to become a key funds servicing centre in the Asia-Pacific, and has captured significant back-office servicing from Hong Kong with heavy incentives. Singapore has the key elements for success in place including regulation, taxation, incentives, aggressive government support, financial infrastructure and a skills base. However, it has had limited success in attracting domiciled funds to date.

Hong Kong is a regional funds management centre with a substantial offshore asset base. It has a strong financial infrastructure and skills base, including front-office and funds servicing skills, as well as good regulation and taxation. Additionally it holds the key advantage of being best placed to access the Chinese market.

Since Singapore and Hong Kong compete for the role of the Asian wealth and asset management hub, it is likely that each may find it challenging to ensure the cooperation of the other in any attempts they may make to engage in a regional domicile role.

Other niche players also operate in this space, such as the Cook Islands and Mauritius. These locations are appealing largely for their attractive tax environments, but in the case of Mauritius the strong connections to India also play a part. However,

they have a weak regulatory infrastructure and limited jurisdiction credibility, financial infrastructure and skills base.