ASSET MANAGEMENT

The Committee notes that the Financial Supervisory Commission (FSC) made certain important policy changes last year aimed at creating a more flexible regulatory environment for the asset management industry. The measures included aligning the definition of high-yield bonds for onshore fund with global standards, permitting local industry personnel to serve a regional role, increasing the investment ratio of Rule 144A securities for onshore funds, allowing onshore funds' fee rebate to the discretionary investment mandate (DIM), etc. These policy changes were in line with the Committee's expectations and will ultimately benefit investors. We look forward to seeing more policy reforms, and recommend that the FSC undertake further regulatory relaxation so as to increase the Taiwan asset management industry's competitive advantages and broaden Taiwan's exposure in the Asian region.

In addition, the Committee expresses its appreciation to the FSC for responding to the proposals set out in the 2015 White Paper. In particular, the Committee is grateful to the FSC for the time and effort it devoted to collaborating with the U.S. Securities and Exchange Commission to work out arrangements for the outsourcing of Taiwan onshore funds' investment-management function to a U.S. entity. We also appreciate the effort of the FSC and the Central Bank of the Republic of China to allow a foreign currency DIM to invest in the foreign-currency share class of NTD-denominated onshore funds.

The Committee looks forward to cooperating with the FSC to further grow the onshore-fund business and enhance the cultivation of local talent to work in the industry. The Committee heartily supports the FSC's efforts to build a better regulatory framework for Taiwan's asset management industry by increasing the competitiveness and operational efficiency of onshore products and assuring a level playing field for onshore and offshore funds.

In addition, the Committee notes that the Hong Kong-China mutual fund recognition scheme became effective last July, which will bring great opportunities for the growth of Hong Kong's asset management industry. Considering the trend of regional integration in Asia and the benefits of first-mover advantage, the Committee strongly encourages the FSC to pursue a Mutual Recognition of Funds (MRF) agreement between Taiwan and China so as to broaden the Taiwan onshore fund market.

Suggestion 1: Continue to relax the regulatory restrictions on onshore funds and DIM accounts, and align policy with global practice.

1.1 Delegate non-core functions of portfolio management in the best interest of investors. Cash management is deemed a non-core function of portfolio management but cannot be delegated to a third party. However, the FSC allows onshore funds to delegate foreign currency conversion and FX hedging management to third parties, although this provision does not apply to discretionary investment management (DIM) accounts.

The centralization of cash and FX management in the hands of specialists would enable portfolio managers to focus on their core functions: investment research and decision-making. Furthermore, it could reduce transaction costs and help to prevent errors through integrated models using the latest FX trading and FX management technology. To achieve this centralization, the Committee proposes that cash management for onshore funds and DIM accounts be allowed to be delegated to a dedicated team, along with the delegation of FX management for DIM accounts.

We also suggest permitting use of a broader range of FX strategies and tools, such as outright long positions between foreign currencies, non-delivery forwards (NDF), and swap between NT dollars and foreign currencies. These approaches would increase the efficiency and flexibility of FX and cash management.

1.2 ***Encourage the healthy development of multi-asset products.*** As proposed in the 2015 *White Paper*, the Committee supports the addition of a new type of fund type, "multi-asset," in the overall fund classification mix in line with the global trend for greater flexibility in fund investments.

Under the current regulations, pool funds are categorized under such classifications as equity, fixed-income, balanced, money market, and fund of funds. The allowable proportion of securities investment is specified for each type of fund. According to feedback from the FSC, multi-asset funds are categorized as balanced funds. Ordinarily, however, balanced funds are considered to follow a benchmark, although still framed by investment restrictions. An alternative way to introduce multi-asset funds is through special approval. Currently the Securities Investment Trust & Consulting Association (SITCA) is studying global practices with regard to multi-asset funds. Due to market demand internationally, multi-asset funds have been growing rapidly in recent years, reflecting a shift in investors' preference from traditional benchmark products to more innovative products. The Committee believes that investment restrictions should not present an obstacle to the development of these products, and the Committee therefore endorses the introduction of multi-asset funds as a new classification. This approach would provide local investors with more investment options and follow the global trend of allowing greater flexibility in fund investments. Eventually, the Committee suggests removing the investment restrictions on other asset classes, including equity and fixed-income funds, in line with global trends.

1.3 ***Enable investment-linked DIM accounts to invest in derivatives for currency-hedging purposes.*** The FSC has been actively promoting development of the onshore fund industry. Given the recent upward trend in the investment-linked policy (ILP) DIM market, the Committee believes that creation of a sound and flexible regulatory environment for this business would help boost the volume of onshore assets under management. For ILP DIM accounts managed by asset managers, the underlying investments currently cannot include derivatives. If investment in derivatives for currency-hedging purposes could be allowed for ILP DIM accounts, as it is for onshore funds, it would give asset managers greater flexibility to effectively manage ILP DIM accounts to their full potential and thus serve the best interest of investors. In addition, insurance companies would be more willing to engage asset managers to manage ILP DIM accounts.

1.4 ***Allow NTD-denominated ILP DIM accounts to invest in foreign-currency-denominated securities.*** The strong market demand for ILP DIM has provided asset managers with scalable and relatively stable insurance assets as compared with retail money through mutual funds. But certain investment restrictions still hinder the performance of ILP DIM accounts. Although asset managers are no longer required to obtain separate approvals from the Central Bank when NTD-denominated DIM accounts invest in foreign securities, this provision does not include NTD-denominated ILP DIM accounts for which insurance companies have appointed asset managers. The Committee requests that the FSC facilitate communication with the Central Bank to enable NTD-denominated ILP DIM accounts to receive the same treatment as other NTD-denominated DIM accounts: the ability to invest in foreign securities without separate approvals from the Central Bank. A more flexible regulatory environment for the ILP DIM business by relaxing the relevant investment restrictions would benefit both the asset management industry and investors over the long term.

1.5 ***Allow onshore Funds of Funds to trade derivatives in the interest of investment efficiency.*** The use of derivatives can bring several benefits to the portfolio management of onshore funds. In Taiwan, however, onshore Funds of Funds (FoF) are restricted from using derivatives for any purpose other than hedging, resulting in investment inefficiency. An onshore FoF is in fact not significantly different from any other type of onshore fund, as they all face various investment risks and opportunities and have the same needs for trading derivatives. Countries such as Luxembourg, Singapore, and Korea do not distinguish between different types of onshore funds when regulating derivatives trading. As investment constraints can be obstacles to product innovation, the Committee believes that allowing onshore FoFs to engage in derivatives for both hedging and investment-efficiency purposes will benefit investors by providing more investment options.

1.6 ***Allow delegation of the investment management function of existing onshore funds without approval.*** The Committee suggests that the delegation of the investment-management function by an existing onshore fund to an affiliate of the fund's management company should not require approval by a beneficiaries' meeting, as the change will not materially impact the interest of the investors. The management company is still obligated to exercise its oversight duties and take responsibility for any actions or omissions on the part of the delegated entity. Investors would benefit from the enhanced investment efficiency under the delegation model.

Suggestion 2: Promote the application of "AUM-based" methodology for calculating distributors' commissions on fund sales.

In various jurisdictions, including the United Kingdom, Australia, Canada, and many Asian countries, one of the authorities' main focuses in recent years has been to seek the optimum policy governing the calculation and payment of commission on fund sales. Generally, the controlling principles include an obligation for statutory fee disclosure, a prohibition on claims by fund distributors and financial advisors for commission from the asset management companies (instead, fees should be charged to and paid directly by the investors); consideration of setting a ceiling on the commission that distributors may receive within the first year of a fund's operation; and restrictions on the payment of fee-based commissions by asset management companies. However, so as to prevent abuse, such as situations in which distributors induce investors to engage in excessive trading in order to gain higher commissions, commissions would be allowed if calculated on the basis of the amount of assets under management (AUM).

The inherent risk in commission payment is the potential conflict of interest. Although the distributor has a fiduciary duty to provide clients with the products that best serve their needs, there is also a financial incentive for the distributor to sell the client the fund with the highest commission. In the Taiwan asset management market, the current fee-based commission design may cause certain distributors to influence clients to conduct extensive trading so that they can earn both sales charges and fee-based commission. Several real cases have shown dramatic increases in a fund's AUM within a month, generated by a large amount of subscriptions from a specific distributor, followed by a significant outflow the next month as the result of redemptions from the same distributor. For the asset management industry, significant fluctuations in a fund's AUM present challenges for portfolio managers in making investments, and the extensive short-term trading deviates from what should be the long-term investment concept behind mutual fund products. For investors, the additional costs caused by the extensive trading impose an unfair burden and dilute their investment results.

To avoid the risks and disadvantages associated with fee-based commissions, the regulators have been considering a change in the commission calculation structure from a fee-based to an AUM-based model – for example, one basing the commission on a six-month average as long as the AUM is above the certain threshold. The Committee believes that this change will not only contribute to expanding funds' AUM, but will also lower the sale costs borne by asset management companies and prevent investment results from been diluted by higher sales charges resulting from overly frequent trading.

Suggestion 3: Implement a member-choice labor pension scheme as soon as possible.

Under the current labor retirement plan, all employees are subject to an identical portfolio and return model. There is no opportunity for customization based on the individual's actual needs and risk profile so that employees might either choose to invest aggressively in hopes of gaining higher returns for their retirement income or to invest conservatively to minimize risks. The current pension scheme fails to consider various factors that might cause individuals to select different types of investment plans – factors such as the employee's amount of contribution, retirement age, risk tolerance level, and preferred investment management vehicle.

As a result, employees lack control over their investment risks and returns, which is inconsistent with the purpose of "defined contribution" plans. The Committee therefore urges the FSC to work together with the Labor Pension Fund Committee and the Council of Labor Affairs to transform the current retirement scheme into a "member-choice defined contribution plan" similar to those implemented in such advanced economies as the United States (401K), Australia (Superannuation), Hong Kong (MPF), and Singapore (CPF). Employees would then be able choose a retirement plan based on their individual needs – either to stay in the current scheme where the pension fund is managed by the government with a minimum guaranteed earning or to select appropriate investment objects through member choice platform according to their risk appetite. Considering the continuing low interest-rate environment and employees' need for diverse retirement plans, the Committee strongly encourages the government to expedite the process for implementing member-choice labor pension scheme.