INVESTMENT FUNDS BILL, 2019

Parliamentary Address By:

The Hon. K. Peter Turnquest, M.P.

Deputy Prime Minister and Minister of Finance

Presented At:

The House of Parliament

Wednesday 6 March 2019

As prepared for delivery

Good morning, Mr. Speaker:

I rise to address this House on the Investment Funds Bill, 2019, tabled in the Parliament last week. This piece of legislation proposes to modernise the vital investment funds industry in The Bahamas by introducing an overhauled legal and regulatory framework that is compliant with international standards and best practices, and is replete with improved provisions to protect investors and lay the foundation to attract new and increased business to The Bahamas.

Mr. Speaker,

Investment funds form a critical component of The Bahamas' financial services toolkit. At 31st December 2018, there were Seven-hundred and forty-nine (749) licensed investment funds and Sixty-two licensed investment fund administrators in the jurisdiction. The investment funds industry has been exemplary of Bahamian innovation in financial services, giving birth to the world-leading Specific Mandate Alternative Regulatory Test Fund product in 2003, known by the industry as the SMART fund and, more recently, the Investment Condominium, a ground-breaking, bespoke legal structure for Bahamian investment funds.

Despite the industry being a centre for Bahamian financial services innovation however, the legislation and regulations governing the sector have become outdated, and now pose a risk to the reputation of the jurisdiction as a world-leading international financial centre.

Mr. Speaker,

Allow me to provide some background behind some of the key events leading to the need to overhaul the existing legislation and briefly discuss the development of the Bill.

The legislation currently governing the investment funds industry is the Investment Funds Act, 2003, along with its subordinate Regulations and Rules. The legislation is administered by the Securities Commission of The Bahamas. I note that, in its function of regulating and overseeing investment funds, securities and the capital markets, the Securities Commission also administers the Securities Industry Act, 2011. The Securities Commission is also the duly appointed Inspector of Financial and Corporate Services and in this capacity administers the Financial and Corporate Service Providers Act, 2000.

When the current investment funds legislation was introduced, its provisions were, largely, suitable for the regulation of the industry at the time. The legislation provided for the supervision and oversight of investment funds in an environment where the majority of the consumers of the investment funds product in The Bahamas were sophisticated investors, or the trustees, private bankers and wealth managers that represented them. The regulatory framework was in line with the structure and needs of the Bahamian financial services industry at the time and sufficient to satisfy the international standards and best practices of the day.

By the time The Bahamas underwent its peer review under the International Monetary Funds' Financial Sector Assessment Programme in 2012 however, the world of financial regulation had become a very different place. The global economy had suffered through the financial crisis of 2008, and Governments and international standards setters were ratcheting up regulatory standards, transparency expectations, and genuine pressure to conform with espoused principles at a previously unprecedented pace. Although the jurisdiction received generally good results for the overall

compliance of its securities regulation with international standards, when it came to investment funds in particular, The Bahamas failed four of the five principles. To summarise these very broadly, there were deficiencies related to:

- the fact that only the investment fund administrator, and not the fund operator, manager or custodian, were subject to full assessment of its governance, organisation and operational conduct;
- specific requirements regarding the operational conduct of custodians and the segregation of client assets were not in the Investment Funds Act,
- there were insufficient obligations regarding conduct in the valuation, pricing and redemption of underlying securities, and
- managers/advisers of hedge funds were not subject to appropriate oversight.

This, of course, was and is, unacceptable for an international financial centre purporting to be a regional leader in wealth management. So the process to develop a modern piece of legislation, compliant with international standards and conducive to a globally competitive industry, commenced.

The Bill before you now is the culmination of those years of development and the Securities Commission was responsible for the development of the legislation. To accomplish the task, the Commission relied on its own regulatory experience and its understanding of the local industry and international regulatory expectations, augmented with expertise of technical and drafting consultants from the private Bar. The provisions of the draft Bill were benchmarked against the legislation of various jurisdictions, including the United Kingdom, the Cayman Islands, the British Virgin Islands, Luxembourg, Singapore, Jersey and Guernsey. The Securities Commission also established an Investment Funds Act Technical Team, comprised of industry professionals, to ensure the voice of the industry was represented throughout the project by reviewing and providing comment on the Bill at various stages of its drafting. On the 27th of November 2017, the Securities Commission submitted the draft Bill for public consultation, which concluded on 28th February 2018. Subsequent comments received as a result of the consultation were considered and where appropriate are reflected in the Bill.

Mr. Speaker,

With some understanding of the impetus for the overhauled legislation and of the process used to develop it, allow me to discuss the major changes the Bill will introduce:

Licensing triggers

Among the more fundamental of the changes the Bill proposes, is to rewrite what an investment fund is for the purpose of licensing and regulation, and what it means to carry on investment fund business in or from The Bahamas". The result is that the conditions that would require or trigger a fund or its various operators, managers, related parties, etcetera, to be licensed, have been changed in the proposed legislation. The definition of an investment fund in the new Bill is a "unit trust, company, partnership or investment condominium that issues or has equity interest, the purpose or effect of which, is the pooling of investor funds with the aim of spreading investment risks and achieving profits or gains from the acquisition, holding, management or disposal of investments." Unlike the previous definition, there is no other requirement for a connection or 'nexus' to The Bahamas built into it. Under the provisions of the Bill, licensing as an investment fund is triggered by an entity that fits the definition of an investment fund carrying on, or attempting to carry on business in or from The Bahamas.

Regarding what it means for an investment fund to be carrying on business in or from The Bahamas, the definition has been expressly included in the proposed Bill and now applies to an investment fund that is incorporated in The Bahamas, or offered for sale to non-accredited investors in The Bahamas. Mr. Speaker, by non-accredited investors, I refer to individual investors, rather than institutions such as banks and insurance companies, who do not meet specified wealth criteria, such as having a net worth in excess of one million dollars, or making an individual income of two hundred thousand dollars annually, for example. This provision ensures that the triggers for licensing and regulation are oriented to the protection of those most vulnerable, and needing perhaps the greatest protection from a regulatory perspective – ordinary persons for whom an investment gone wrong as a result of misconduct or other infractions of securities laws will have the greatest financial impact. Also of note, these new definitions mean that investment funds are eligible for licensing based on the activity they conduct or intend to conduct and who will be impacted by those activities, and not on whether or not certain service providers to the fund are located or licensed in The Bahamas.

The new definitions provide the wealth management industry some new flexibility. To give an example of this, if an International Business Company, or IBC, was deemed an accredited investor, its decision to invest in an investment fund would not trigger the need for that investment fund to be licensed in The Bahamas—opening many more investment options for the Bahamian wealth management service provider.

While on the subject of key definition changes, I wish to also highlight the change to the definition of a Non-Bahamas based investment fund. Under the prevailing Act, any investment fund that is not a Bahamas-based investment fund, but is being sold in The Bahamas, or had 'any' other nexus to The Bahamas, such as having appointed a Bahamian manager or advisor, was deemed to be a non-Bahamas based investment fund, and hence was subject to the regulatory regime for non-Bahamas based funds. This meant, amongst other things, that the fund would be required to appoint a representative in The Bahamas. Therefore, if an investment manager in The Bahamas wanted to invest in, for example's sake an American investment fund for his high-net worth clients, that fund would have to appoint a representative in The Bahamas just to allow the manager to invest in that fund.

I think we all can quickly understand how such provisions needlessly complicate business and reduce the competitiveness of investment managers from this jurisdiction. This requirement was deemed to be needlessly burdensome, particularly considering that the regulatory risk that would arise from selling a foreign security to accredited investors within the Bahamas was properly the responsibility of the regulator in the fund's home jurisdiction. Therefore, the Bill proposes that Non-Bahamas based investment fund is to mean an investment fund that is incorporated, registered or established in a jurisdiction other than The Bahamas but has a nexus to The Bahamas through it being administered or managed in or from The Bahamas.

Rationalising responsibilities, righting regulation

Mr. Speaker,

You will recall I indicated that a primary impetus for the overhaul of the legislation was related to the jurisdiction's performance under the IMF's Financial Sector Assessment Programmes (FSAP) 2012 peer review in the matter of investment funds regulation. Several of the key deficiencies in the investment funds legislative framework revolved around the regulatory approach of the previous bill, which placed an inordinate emphasis on the investment fund administrator as a touchpoint to trigger

licensing and oversight, rather than the activities being conducted and the regulatory risk those activities pose.

This shift away from a focus on the investment fund administrator will be among the more notable for the investment funds industry, but is fundamental to rebalancing the regulation and oversight of the industry. It goes hand-in-hand with some of the provisions I am about to discuss, such as regarding the regulation of investment fund managers and custodians. Together, they will result in improved investor protection, as key functions and responsibilities are realigned to the proper parties and the regulator is able to fully assess their governance, organization and operational conduct.

Under the proposed Bill, a Bahamas based fund is no longer required to appoint an investment fund administrator in The Bahamas to provide its principal office. Further, to act as an investment fund administrator, a firm must be licensed under the proposed Bill, or established and operating in a prescribed jurisdiction. Mr. speaker, for those not familiar with financial services regulation allow me to note that by prescribed jurisdiction I mean a jurisdiction which the Commission has formally identified as having comparable regulatory standards and practices to our own, such that the Commission may rely on or defer to the other regulator in certain instances.

I note the legislation also will not allow business structured as international business companies to be licensed as investment fund administrators and will subject directors, officers and senior managers to fitness and propriety standards. The investment fund administrator will also be required to appoint a compliance officer and must have two senior officers residing in The Bahamas to meet new physical presence requirements under the new Bill.

Investment Manager

Proper oversight of the investment fund manager has been a glaring point of non-compliance under the current Act, compared against international standards and best practices for modern investment funds regulation. Under the new Bill, all Bahamas based investment funds must appoint an investment manager, except where the investors are the fund manager itself, the parent or subsidiary of the fund manager, or a feeder fund that invests one hundred percent of its assets in a master fund. If the fund is being sold to accredited investors, then the fund manager would only need to be registered, but when selling to non-accredited investors, licensing would be required. So long as investment fund management services are being offered in or from The Bahamas, the investment fund manager would need to be licenced or registered under the proposed Bill, regardless as to whether or not the fund is a Bahamas based fund.

Conversely, Bahamas based funds would be free to appoint investment fund managers that are licensed or registered in prescribed jurisdictions. Licensed fund managers of course, would be subject to capital and fitness and propriety requirements under the proposed legislation, closing regulatory gaps and contributing to protect investors and ensure fair and efficient markets.

Custodian

The Bill also introduces a requirement that an investment fund appoint a custodian, unless it has been exempted from the requirement by the regulator – the Securities Commission. Under the proposed legislation, the custodian will have to be independent of the investment fund administrator, fund manager, and operator of the investment fund, and is obliged to segregate the cash and other assets of the fund from those of the custodian itself. Again, while addressing regulatory deficiencies these provisions will bring about greater protections for investors. I note that the Securities Commission took measures to ensure these provisions would satisfy the regulatory principles for investment funds

espoused by its primary standards setter-the International Organisation of Securities Commissions, or IOSCO.

Operators

As a part of the realignment of duties and responsibilities under the proposed legislation, the Bill requires each fund to appoint operators. The required appointments are based on whether the fund is structured as a company, partnership, trust or Investment Condominium. The responsibility for the operation of the fund will be placed on these appointees, though in limited circumstances certain fiduciary responsibilities will fall to the fund manager. The operators will, of course, be subject to fit and proper assessment, and generally will be required to be independent of the administrator unless exempted from this requirement, or structured as an investment condominium.

AIFMD

In crafting the new Bill, one of the primary objectives was to ensure that the legislative and regulatory framework it ushered in would not preclude Bahamian funds and investment managers from conducting business with the European Union, or EU. This means the legislation had to allow for compliance with the European Union's Alternative Investment Fund Managers Directive, which I will refer to as AIFMD or the Directive.

The directive entered into force on 22 July 2011, creating a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers within the European Union, as well as establishing certain regulatory requirements for non-European Union alternative investment fund managers that provide services to EU investment funds. The AIFMD also applies to non-EU alternative investment funds managers that manage or market alternative investment funds in the European Union.

The Securities Commission of The Bahamas has already engaged with and executed 28 Memorandums of Understanding with the securities regulators of EU Member states in order to facilitate participation in their respective countries. The Commission advises it is working now to conclude the Memorandum with the Italian securities regulator, who is currently the final eligible securities regulator in the EU.

While the Directive does not require that the non-EU country where an alternative investment fund is established must have AIFMD-equivalent rules, the non-EU alternative investment fund managers must be able and willing to operate in the EU in compliance with rules established in relation to the AIFMD. Under the Directive, non-EU alternative investment fund managers may seek a 'passport' that would enable them to enjoy the same rights, and be subject to the same obligations, as their EU based counterparts. It became a requirement for non-EU industry participants beginning in 2016.

The draft Bill is seeking to address the qualifications for EU Passporting. As a result, the proposed legislation includes extensive AIFMD provisions, which have been reviewed by a prominent U.K. law firm-- Charles Russell Speechlys.

Conclusion

Mr. Speaker,

The investment funds industry is a vital component of the financial services industry in The Bahamas, and the jurisdiction's reputation as an international wealth management centre. Investment funds provide business opportunities for persons seeking to provide investment fund products or investment funds related services to clients locally and internationally. It provides a structure for new securities products for investors in the local capital markets.

The investment funds industry has been the home of internationally notable innovations, such as the Specific Mandate Alternative Test, or SMART Fund, and the Investment Condominium. However, for the many reasons already presented, the 2003 Act governing misses the mark on key regulatory provisions required to oversee the industry at current internationally acceptable levels, and the underlying investor protections and market conduct provisions they encapsulate are absent from the prevailing legislation.

This bold piece of legislation seeks to fill those regulatory gaps with a framework of rationalized definitions of fundamental terms and the realignment of fundamental, though critical functions and responsibilities. It proposes to open the industry in key ways that will allow Bahamians greater access to international service providers to enhance their operations and client offerings. Simultaneously, it announces that Bahamian investment fund professionals and the industry are ready to compete internationally. It aims to ensure market access, both to the investment products of other jurisdictions, such as the European Union, but also of those jurisdictions to Bahamian markets. I note its rationalization of responsibilities will also improve the ease of doing business in the sector and sets the foundation to attract new business, such as greater institutional business as the responsibilities of investment fund administrators and managers, operators and custodians are clarified.

The Investment Funds Bill, 2019 before us for debate represents the introduction of a new chapter in Bahamian Financial Services. Its strong compliance with best practices and international standards, comprehensive and inclusive development process, and forward looking approach to market growth and development, promise that it is the right legislation to ensure this chapter is one in which the investment funds industry continues to flourish in The Bahamas.