Launching a Hedge Fund

As an existing hedge fund manager, whenever you launch a new hedge fund, you will need professionaladvisers who have extensive experience in advising similar organisations and individuals in structuring, establishing and operating hedge fund strategies and products. Our partners and managers possess the practical experience as well as the technical expertise to provide responsive, timely and value-added advice to you as you grow.

PricewaterhouseCoopers can bring significant value to our clients in the launch phase of a hedge fund. We have extensive expertise in advising on structuring complex alternative investment products for the full range of target investors. We coordinate closely with our offices in all relevant jurisdictions to ensure that both local and cross-border matters are addressed.

Issues which you face will include the following:

- The choice of an appropriate domicile (specifically whether in Europe or an offshore jurisdiction and taking into account the impact of recent FATF and other initiatives).
- The most appropriate structure whether umbrella, master/feeder, corporate, limited partnership, trust fund, OEIC and other structures.
- Minimising any potential taxation borne by the fund on its strategies and ensuring that investors do not pay unnecessary taxation (in particular what will you be able to state in the prospectus?).
- Should the fund be listed and if so whether on Dublin, Luxembourg, or Channel Islands Stock Exchanges.
- The marketing restrictions in the markets you wish to access.
- Performance fee structuring, equalisation, share classes, internal hedging and associated accounting issues.
- The record-keeping and reporting processes you will need to accomplish your specific needs and objectives and to meet the needs of demanding high net worth and institutional investors (e.g. K1 tax forms or controls reports).
- The selection of service providers e.g. prime broker, fund administrator, transfer agent, listing sponsor, etc., and the selection of systems.
- Leveraging our considerable experience with accounting software and third-party administrators to assist you in building an appropriate back office infrastructure.
- Assisting with the selection of legal advisers in the jurisdiction of the hedge fund and coordinating the incorporation of the fund with them.

Launching a Hedge Fund

PricewaterhouseCoopers and its correspondent law firm, Landwell, provide a full range of services to assist both emerging and institutional clients in addressing all these issues. Our services are “menu” based enabling clients to select the services that will best achieve their objectives, and can range from:

- Full coordination of the establishment of the fund, liaising throughout with you and the service providers selected.
- Creation of all documents necessary for the establishment and offering of the fund, for example preparing the fund prospectus/private placement memorandum and investment management agreement and reviewing documentation provided by, for example, the prime broker and administrator.
- Commenting on the proposed accounting for the fund as described in the fund’s prospectus.
- The full range of tax and regulatory advice.
- Ongoing audit of the fund’s financial statements.

“PricewaterhouseCoopers provide a full range of services to assist both emerging and institutional clients with the establishment of their funds.”

For further information, please telephone either of our lead European Hedge Fund contacts: Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

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PRICEWATERHOUSECOOPERS

Buying a Hedge Fund Manager

Given the rapidly increasing demand for hedge funds, many financial institutions are considering entering, or expanding their presence in, the hedge fund market via the acquisition of a hedge fund manager. Using the wealth of specific hedge fund expertise available within PricewaterhouseCoopers, we are uniquely placed to provide insight and views on the strengths and weaknesses and projected revenue performance of the target business.

We can provide a full range of services to support your acquisition including:

Strategic review/target search

Using our industry knowledge and connections, we can help you decide whether now is the right time to pursue an acquisition and assess the alternatives open to you. We can also perform a market analysis to identify targets that meet your initial acquisition criteria, and approach targets on your behalf.

Valuation advice

Understanding valuation issues will not only permit you to demand the best price but also allow you to set the agenda when developing the strategy of negotiating a purchase. Using our knowledge of comparable transactions, PricewaterhouseCoopers' specialised valuation experts will ensure that you have the best information and arguments on your side of the table.

Deal structuring

Working with your team, PricewaterhouseCoopers Corporate Finance can advise you on structuring a transaction to maximise value. This will include mechanisms and structures to ensure retention of the key personnel within the acquired business – the most valuable assets of a hedge fund operation are its people.

Negotiation

PricewaterhouseCoopers' experienced Corporate Finance professionals can advise and support you in securing the best deal.

Acquisition due diligence

The purpose of acquisition due diligence is to ensure that the acquirer fully understands the key risks in the target business, by assessing and validating the assumptions that underlie a deal and giving the acquirer a coherent overview of the operations of the hedge fund business. Effective acquisition due diligence also ensures that the purchaser fully understands the drivers behind the revenue stream and profitability of the business and that areas are identified which may require costs to be incurred in performing post-deal rectification.

A comprehensive knowledge of these matters and an assessment of their impact on the valuation of the business provide the acquirer with valuable information that can be used to support downward negotiation of the purchase consideration.

Buying a Hedge Fund Manager

Our due diligence expertise is focused on gaining a detailed understanding of the target, its products and its strategic plan and of the impact of the specific risks associated with the market in which the hedge fund manager operates, for example:

- Compliance risks associated with the offshore domicile of the funds, for example the risk of non-compliance with anti-money laundering and regulatory requirements.
- Risks of non-compliance with local market restrictions on the sale of unregulated hedge fund investments.
- Risks associated with the funds' trading strategies, for example non-compliance with investment restrictions, inappropriate gearing, and capacity constraints.
- Taxation risks associated with inappropriate structuring or the ongoing management of the manager and of the funds it manages, including inappropriate transfer pricing arrangements.
- Risks of significant volatility in the projected revenue stream due to the impact of performance fees and "high watermarks".
- Risks associated with the investor profile, and the pattern of subscriptions and withdrawals from the funds.
- Risks associated with the difficulty of evaluating the past performance of the hedge fund manager when the manager is relatively new and has a short trading record.
- Risks associated with the errors in the fund valuation and administration process, for example pricing errors leading to reputational issues and the need to compensate investors.
- Operational risks associated with the quality and reputation of the service providers to the funds: prime broker, administrator, fund accountant, transfer agent, research providers, custodian etc.
- Risks associated with the dependence of the hedge fund manager on a small number of key individuals.
- Risks associated with buying a rapidly growing, owner-managed business, such as a lack of defined financial reporting structures and operational procedures.

Project Management

High quality project management significantly increases efficiency and reduces your time commitment. Using our experience, we can help you plan and run the transaction.

Integration

There are unique risks associated with combining a hedge fund business with an existing long-only business, for example, how to retain long-only managers alongside highly rewarded hedge fund managers, and how to appropriately segregate the two types of trading to overcome insider trading risks.

Similarly, a financial institution buying a hedge fund manager will need to integrate the entrepreneurial culture of an owner-managed business into the defined processes that exist in a larger organisation. Building on our understanding of the target obtained during the due diligence process, we can work with you to identify and quantify the business opportunities and assist with the implementation of the integration plan.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Selling a Hedge Fund Manager

You have worked hard to build a profitable business – now you want to cash out. The owners of a typical hedge fund business will be faced with three options:

1. Sell the business and continue within the business post-sale.
2. Sell the business outright.
3. Wind down the fund and close the business.

The first option is becoming more common. The rapid increase in demand for hedge fund product means that many financial institutions are considering entering, or expanding their presence in, the hedge fund market via acquisition of an existing hedge fund manager.

Using the wealth of specific hedge fund expertise available within PricewaterhouseCoopers and our experience of advising hedge fund managers in similar transactions, we are uniquely placed to assist existing hedge fund or hedge fund-of-fund managers in preparing themselves for acquisition, identifying and trying to resolve issues before they become negotiation points for the acquirer, and obtaining the best price and most favourable terms for the vendor. Traditional valuation techniques may not work for valuing a hedge fund manager, so it may be difficult to know what your business is worth. How do you realise the maximum value for your business when your contacts, trading skills and technical expertise are not measurable assets on your balance sheet but undoubtedly the most valuable assets in your firm? Do you have a succession strategy or a knowledge diffusion plan? If you are considering retiring, how can you convince a potential buyer that your business is viable without you and that investors will not withdraw their money from the fund following your departure? Even if you are not currently thinking of selling your business, you will still need to plan your strategy to ensure that you maximise value. Specialist valuation advice is needed.

A vendor who is fully prepared for a deal and anticipates the due diligence requests of a potential acquirer, its lawyers, investigating accountants and investment bankers, can control the sales process in a timely manner and should be able to maximise value on the transaction. This should include producing a high quality data-room with basic legal and financial data and commissioning a quality Information Memorandum and a credible Vendor due diligence report. We can provide a full range of services to support the sale including:

Strategic review

Using our industry knowledge and connections, we can help you decide whether now is the right time to pursue a sale of the business and assess the alternatives open to you. We can also perform market analysis to identify potential purchasers that meet your deal criteria.

Deal preparation

Based on our prior experience of hedge fund manager transactions, we can assist you in assembling the information that will be requested by a potential purchaser. Many owner-operated hedge fund managers do not have well-defined systems and procedures in place to demonstrate the financial performance of the business and its adherence to regulatory compliance, taxation and legal requirements, and we can assist you in improving such procedures. For example, audited financial information should be available for the results of the business as a whole, as well as budgets, a documented tax transfer pricing policy and clearly defined regulatory compliance processes.

Information Memorandum and Vendor due diligence

We can produce an Information Memorandum and, additionally, a Vendor due diligence report, which will be of particular value if the sale of your business is likely to be competitive.

Vendor due diligence has a number of benefits:

- It can expedite the sale by moving forward the due diligence process and shortening the exclusivity period, since when bidders receive access to the data-room, the vendor due diligence report should be complete and final bids will not be subject to significant additional due diligence. Access to this report also allows acquirers to submit a relatively advanced sale and purchase agreement, with many of

Selling a Hedge Fund Manager

the disclosures, representations and warranties almost finalised.

- The Information Memorandum is given additional credibility by such a report; an acquirer is provided with an independent review of the target by the accountants which will form an important basis for the purchaser's own due diligence and valuation.
- It tends to cause less management disruption than traditional buy-side due diligence due to the fact that one accountant is providing information to a number of potential bidders. The accountants can work closely with management to develop a timetable for visits by preferred bidders, which allows management to maintain their focus on the operations of the business, neglect of which can often be a significant problem during an acquisition due diligence review.
- It places greater control of the due diligence process, and the interpretation of the due diligence findings, with the vendors and its advisers. This should prevent significant changes to offer prices late in the process as the key issues should have been disclosed prior to the submission of bids.

Valuation advice

Our specialised valuation experts can prepare a valuation of your business based on the forecast profitability of the business and our experience of the valuation models that have been used in similar hedge fund transactions. Understanding valuation issues, such as the drivers of performance fees, will not only permit you to demand the highest price but also allow you to set the agenda when developing the strategy of negotiating the sale.

Using our knowledge of comparable transactions, we can ensure that you have the best information and arguments on your side of the table. We can identify any areas which may require post-deal rectification costs to be incurred by the purchaser, and which may be used by the purchaser to attempt to negotiate the purchase consideration downwards, and can assist you in addressing such weaknesses. In our experience, the cost of rectification by the seller is often less than the reduction in purchase consideration that may be demanded by the purchaser. A comprehensive knowledge of these matters and an assessment of their impact on the valuation of the business to provide the seller with valuable information.

Deal structuring

PricewaterhouseCoopers Corporate Finance can advise you in structuring the transaction to maximise your value creation. This will include mechanisms and structures to ensure that you and the key personnel within the business continue to receive a favourable deal post-acquisition, and that the integration of the entrepreneurial and relatively informal culture of your existing business into the defined processes that exist in a larger institutional organisation is performed in such a way that does not stifle the entrepreneurial spirit which will have been part of the success of your business to date.

Negotiation and Project Management

PricewaterhouseCoopers' experienced Corporate Finance professionals can advise and support you in negotiating the best deal. We can also assist with the management of the sales process; high quality project management significantly increases efficiency and reduces your time commitment, so that you can concentrate on continuing to run the business.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Tax Risks involved in Hedge Fund Structuring

As a hedge fund manager, there are many issues involved in both launching a hedge fund operation and also in managing that operation over successive years. You will therefore need professional advisers who have extensive experience in advising such organisations and individuals in managing the tax risks associated with your particular hedge fund strategy and products. Our partners and managers possess the practical experience as well as the technical expertise to advise you on how the tax risks involved in your structure can be minimised.

PricewaterhouseCoopers provides a range of tax services to assist both emerging and institutional clients with the establishment of their hedge funds. Our services are menu based enabling clients to select the tax services that will best achieve their objectives.

Our menu of services includes:

- Reviewing your business plan to establish whether any potential tax risks may arise within your structure.
- Advising on the tax legislation of the relevant jurisdictions applicable to your structure including the requirements for maintaining central management control where desired.
- Consideration of the most appropriate location of management services both from a business practical point of view and a tax perspective.
- Advising on the taxation matters in relation to the structuring of the investment adviser and the associated personal tax planning for the investment adviser’s principals, senior executives and employees.
- Advising on inter-territory pricing and the impact of the interaction between a variety of local tax and regulatory regimes.
- Drafting agreements between entities in different jurisdictions to confirm the services provided by each and their respective responsibilities.
- Consideration of the target investor profile and tailoring of the fund structure to ensure that no adverse taxation consequences are triggered for certain investor groups. This would include advice on appropriate “wrappers” for different markets.

Following the launch of a fund we can offer several services to monitor and minimise potential tax risks arising, including:

- Assistance in developing operating guidelines or a checklist to manage the residency requirements of entities in different territories.
- Production of a transfer pricing document outlining the pricing policies adopted for each entity and the supporting documentation.

Tax Risks involved in Hedge Fund Structuring

- Performance of a "tax health check" on existing structures to identify any potential issues, or existing tax risks that need to be addressed.
- Detailed briefing for non-tax specialist staff on the importance of compliance with the taxation requirements of various jurisdictions.
- Ad hoc advice on tax risks of specific trading strategies.
- Dealing with all compliance issues in the various management firm and fund locations i.e. filing tax returns and liaising with the local tax authorities to ensure the most favourable tax treatment.
- Calculation of returns to be allocated to investors in the fund where their domestic tax authorities require this information.

"Our services are menu based enabling clients to select the services that will best achieve their objectives. These services are coordinated across various professionals to ensure that tax risks are monitored and effectively minimised."

For further information, please telephone either of our lead European Hedge Fund contacts:
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Hedge Fund Regulation

Key challenges facing management – a fast changing regulatory environment

The regulation of investment managers has become much more prescriptive in recent years. European regulators are increasingly scrutinising the hedge fund industry. The costs of getting regulation wrong are significant – the reputational damage, the financial cost and the management time involved in correcting problems often far outweigh the original issue. Putting the right structure and people in place "first time" has become increasingly important.

The hedge fund industry is growing quickly in Europe. As it is a multi-jurisdictional environment, with national marketing rules, different regulators in each national territory and increasingly sophisticated clients, it is all too easy to make a compliance mistake. Some hedge funds operate within the compliance framework of a large institutional fund manager or bank, where the compliance culture and processes are well established and monitoring is strong. Smaller hedge fund managers do not have the advantage of this support and therefore rely on professional advisers to assist them in meeting their compliance obligations.

The issues faced by hedge fund managers include:

- The increased number of regulatory issues that have to be identified and managed because of multi-jurisdictional investors and entities within the hedge fund group.
- The complicated nature of the products offered by hedge fund groups.
- The conflict of interest that arises when a manager runs both long-only funds and hedge funds and the related segregation of duties.
- Relationships with third parties e.g. outsourcing.
- The quality of customer agreement reporting.
- Security and use of the internet.

Pitfalls are appearing as firms grapple with these issues. Significant system changes have their own challenges but experience has shown that a number of regulatory problems have also arisen. These relate not just to the firm but also to individual risk – clearly evidenced in the UK by the FSA's approach to Approved Persons.

PricewaterhouseCoopers has a team of regulatory consultants blended from the industry, European regulators, the FSA, and from our business advisory practice. Our team is experienced in assisting hedge fund managers to find practical solutions to regulatory problems given the size and nature of the business. We have significant practical experience of helping clients manage the regulatory risks that arise during startup and periods of change. We have assisted many firms to identify solutions that help management in meeting the requirements of both stakeholders and the regulators.

Hedge Fund Regulation

Key challenges facing management – a fast changing regulatory environment

Our Regulatory services

PricewaterhouseCoopers provides the following key services:

- Assisting with the authorisation of new hedge fundmanagement entities.
- Assisting firms identify the correct capital structure for their business.
- Providing tailored advice on European, UK (and overseas) regulations.
- Design and implementation of effective compliance arrangements.
- The design of risk-based compliance monitoring frameworks and programmes.
- Training of compliance staff.
- Assessing and introducing technology-led compliance solutions.
- Implementing structures to demonstrate that senior managers are accountable for compliance and risk management, e.g. meeting the FSA's expectations and rules in relation to senior management responsibilities.
- The provision of interim compliance staff either to manage compliance functions or to carry out monitoring reviews.
- Compliance cost-effectiveness reviews.
- Mock supervision visits.
- Advising on effectively handling regulatory issues, including enforcement actions.
- Undertaking investigations on behalf of clients.
- Liaising with your independent consultants.
- Merger and integration regulatory planning and implementation reviews.

"We have assisted many firms to identify solutions that help management in meeting the requirements of both stakeholders and the regulators."

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UK Investment Manager Exemption

Under UK tax legislation the “trading” profits of a non-resident person which arise through the activities of a UK agent are subject to UK tax. In practical terms, this means that a UK investment adviser to a hedge fund could potentially be liable to UK tax on a hedge fund’s trading profits arising from its activities in the UK, that is, unless the adviser satisfies the UK Investment Manager Exemption. PricewaterhouseCoopers has the practical experience and technical knowledge in structuring operations to ensure that the UK adviser meets the Investment Manager Exemption.

Is an entity trading?

There is no statutory definition of what constitutes trading under UK law, however, factors which may indicate a trading activity include a high frequency of transactions, a short period of ownership, short selling, a short-term profit motive, the use of leverage, etc. Since the majority of these characteristics are often displayed by hedge funds, there is a risk that a proportion of the profits of a hedge fund could become liable to UK tax even though the fund is not resident in the UK.

However, providing the manager satisfies the UK Investment Manager Exemption, profits of the nonresident hedge fund are outside the UK tax net. This means that the UK Revenue only taxes the profits of the agent, the UK investment adviser, rather than the profits of its principal, the offshore hedge fund.

In order to fall within the Investment Manager Exemption, the investment manager/adviser must satisfy, in respect of “investment transactions” undertaken for the non-resident hedge fund, the following conditions set out in section 127(3) FA 1995/Schedule 26 FA 2003:

- the investment manager/adviser must carry on a business of providing investment management services;
- the transactions must be carried out in the ordinary course of that business;
- the investment manager must act in an independent capacity;
- the investment manager and its connected parties must not be beneficially entitled to more than 20% of the profits and gains arising from the transactions carried out by the investment manager/adviser;
- the investment manager’s/adviser’s remuneration must be at a rate which is not less than a customary rate for that class of business; and
- the investment manager must not be an agent of the fund in relation to other income.

It should be noted that the interaction of these conditions can be quite complex, especially where partnerships (for the fund or investment manager/adviser) are used.

1. Investment transactions

For the IME to apply, the investment manager/adviser must be undertaking an investment transaction.

An “investment transaction” is defined to mean:

UK Investment Manager Exemption

- transactions in shares, stock, futures contracts, option contracts and securities of any description but excluding futures contracts and options contracts relating to land; or
- transactions consisting in the buying or selling of any foreign currency or in the placing of money at interest; and
- such transactions as the Treasury may designate by regulations.

It is important that investment managers/advisers review the type of investment transactions they undertake as not all transactions are investment transactions for the purpose of the IME.

2. Investment Manager/Adviser

Where the investment manager/adviser acts as agent of the fund and has the authority to make binding decisions on behalf of the offshore fund, the agent must do this in the ordinary course of an investment management business. The UK investment manager/adviser must not act as agent for the fund in relation to any other income.

3. The Independence Test

The Investment Manager Exemption requires that the investment manager/adviser acts on behalf of the offshore client in an independent capacity, i.e. carries on an independent business that deals with the offshore funds at arm's length. The term 'independent' is itself open to many interpretations, and has led to the Inland Revenue setting out some 'safe harbours' in its Statement of Practice 1/01. The Inland Revenue will accept that satisfaction of any one of the criteria below will satisfy the independent agent test where all of the other tests of the IME are met:

- where the provision of services to the non-resident (and persons connected with the non-resident) is not a substantial part of the investment management business (≤70%);
- from the start of a new investment management business provided the above condition is satisfied within 18 months;
- where the investment manager/adviser intends to satisfy either of the above conditions and fails to do so for reasons outside his control having taken any reasonable steps to fulfil that intention;
- where services are provided to a collective fund, the interest in which is quoted on a recognised stock exchange or freely marketed; and
- where services are provided to a widely held collective fund (50% not held by 5 or fewer people and no one person owning > 20%).

4. The 20% test

This requires that the investment manager/adviser and connected persons intend not to be entitled to more than 20% of the profits of the fund. It is regarded as satisfied if met in aggregate over a period of not more than 5 years. Therefore, if there is entitlement to more than 20% of profits in a particular period, the test will still be met so long as there is a period (up to 5 years) over which the average entitlement is 20% or less. Professional fees are excluded in arriving at the profits provided they would be deductible for UK tax purposes.

5. Customary Rate

The UK investment manager/adviser must receive remuneration not less than the customary rate for that class of business. Problems may arise in relation to this condition where management capital and early investors are charged a discounted fee. Also, where services are provided to the fund from other affiliated entities, it is necessary to establish the appropriate remuneration for the UK investment manager/adviser.

We can use our extensive understanding of the Investment Manager Exemption rules to offer clients a high quality service in evaluating satisfaction of s.127 FA 1995 / Sch 26 FA 2003 criteria and benchmarking the result.We can bring significant value to our clients, when they are establishing a hedge fund or when established hedge fund managers start trading operations in the UK.We have unique expertise in structuring complex arrangements.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Starting a Hedge Fund Manager Business

Setting up and running a hedge fund business can be as challenging as running the hedge fund itself. In the set up stage, you need professional advisers who have extensive experience in advising organisations and individuals with the structuring, establishment and operations of a hedge fund business. Our partners and managers possess the practical experience as well as the technical expertise and cross-border knowledge to provide responsive, timely and value-added advice to you as you grow.

PricewaterhouseCoopers can bring significant value to our clients in the start-up phase, when they are establishing an independent advisory entity or, in the case of an existing financial services organisation, in establishing or expanding an infrastructure to support hedge fund strategies. We have extensive expertise in advising on structuring complex alternative investment products for the full range of target investors. We coordinate closely with our offices in all relevant jurisdictions to ensure that both local and cross-border matters are addressed.

Issues which you face will include the following:

- The choice of the new investment management entities, whether onshore and/or offshore and whether company or partnership.
- The structuring of the investment adviser, and associated personal tax planning for the investment adviser's principals, senior executives and employees especially what flexibility is desirable for the future and what needs immediate implementation.
- Whether to set up management entities to employ staff and provide administrative services, especially with a view to minimising regulatory capital.
- Your inter-territory pricing.
- The differing tax and accounting issues that arise in the UK compared to other financial centres (e.g. US), managing tax asymmetry (e.g. through deferral or foreign tax credits) and reporting timetables.
- Whether to partner with hedge fund incubators, providers of seed capital and other alliance partners to achieve business and tax efficiencies while maintaining flexibility.
- Application for regulatory authorisation for the investment adviser (e.g. FSA in the UK, CSSF in Luxembourg, CBI in Dublin) and how much to outsource your compliance arrangements.
- Developing your business plan.
- Identifying, documenting or assessing regulatory compliance policies and procedures for registered advisers and commodity pool operators (including the new US privacy regulations).
- All aspects of launching your hedge fund (see our separate insert).

Starting a Hedge Fund Manager Business

- Building an appropriate and reliable back office infrastructure covering both the fund and management entities, including determining your information technology needs.
- Implementing risk management, operational and financial processes and systems in a rapidly growing environment.

PricewaterhouseCoopers and its correspondent law firm, Landwell, provide a full range of services to assist both emerging and institutional clients in addressing all these issues. Our services are “menu” based enabling clients to select the services that will best achieve their objectives. They can range from full coordination of the establishment of the fund manager operations, including the fund, to merely giving our necessary opinions on the relevant application forms for regulatory authorisation. We can advise on all aspects of the structuring or just on the complex taxation arrangements to secure personal tax efficiency or on the transfer pricing documentation.

“PricewaterhouseCoopers provide a full range of services to assist both emerging and institutional clients with the establishment of their hedge fund operations.”

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Investment Performance Measurement Services

Market Need

- Competition amongst hedge fund managers is becoming more intense.
- Clients are becoming more sophisticated and more demanding; they want to be able to compare managers.
- Investment performance will remain a key driver for managers to differentiate themselves.
- Global Investment Performance Standards (“GIPS” or “Standards”) have become widely accepted. They help to provide credibility to a performance history, as well as discipline to performance measurement/reporting.

PricewaterhouseCoopers Solution

- PricewaterhouseCoopers is able to provide assistance in identifying and resolving issues facing hedge fund managers in performance measurement and reporting.

Our services include:

- assistance in selecting and implementing performance systems;
- review and assessment of performance measurement and reporting procedures; and
- training and education in all areas of the business.

In addition:

- We offer advice and assistance throughout the process of achieving compliance with GIPS and reporting compliant information.
- We act as an independent verifier of compliance with GIPS.
- We also provide other attestation services on the performance track record of managers.

“PricewaterhouseCoopers is able to provide assistance in identifying and resolving issues facing hedge fund managers in performance measurement and reporting.”

Investment Performance Measurement Services

Why PricewaterhouseCoopers?

PricewaterhouseCoopers has extensive experience in investment performance measurement:

- We offer a globally integrated service, with performance specialists in over twenty countries around the world.
- We are at the forefront of developments in this area, through membership of committees of the Standard-setting body. We also contribute to the development of the Standards by way of detailed responses to draft guidance.
- We are recognised experts in training on the Standards and offer courses, both in partnership with the body that sponsors the Standards, and in our own right.

Understand the standards → Define the reporting entity → Assess readiness → Overcome barriers to compliance → Compliant reporting of performance → Verification

“We are recognised experts in training on the Standards and offer courses, both in partnership with the body that sponsors the Standards, and in our own right.”

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PricewaterhouseCoopers

Hedge Funds
Anti Money Laundering Issues

In light of recent events, members of the financial community can no longer afford to ignore the issue of anti money laundering ("AML") and hedge funds and their managers are no exception. Governments have made their intentions clear: those seeking to move illicit funds – in particular terrorist funds – through the international financial system will have their access blocked at every available opportunity.

Money laundering: the risks

The risk of money laundering to the hedge fund and its manager is two-fold:

- the reputational damage if the fund is associated with money laundering; and
- access to the major financial institutions may become difficult if funds will not, or cannot, provide satisfactory AML information.

Issues to consider therefore include:

Know Your Customer: Increased transparency

Know Your Customer ("KYC") is a central premise of AML regimes around the world. Regulated firms need to be satisfied that they know who they are dealing with, not only their immediate contact, such as the fund manager, or introducer, but any underlying customer on behalf of whom they may be acting.

In the current climate, anonymity is unlikely to be an option. If a fund's adviser or broker is regulated in financial centres such as New York or London, they are likely to require information about both the offshore manager and the underlying investors.

Do you know the identity of all investors in the fund? Would you be able to provide documentary evidence if requested?

Would the provision of information on investors, for example the broker dealers with whom you transact, be particularly commercially sensitive?

The amount and nature of the documentary evidence will depend on the source of the funds and type of entity.

"If a fund's adviser or broker is regulated in financial centres such as New York or London."

Hedge Funds
Anti Money Laundering Issues

Funds and investors from territories without recognised AML regimes, particularly those from offshore jurisdictions, will be expected to provide more information. Corporate entities and trusts will be the subject of even further scrutiny by regulated firms.

Consequently, hedge funds and their managers should expect those parties subject to AML regulations to be asking more questions where funds are located in tax efficient jurisdictions.

Protecting your reputation

Fund managers need to understand the level of money laundering risk they are facing in each of the jurisdictions in which they operate.

Do you obtain the bare minimum of KYC information to meet the local regulatory requirements or move to an international standard of verification of identity procedures?

What impact will such due diligence of your investors have on your competitive position with other funds?

PricewaterhouseCoopers have experts that can advise you on AML rules and regulations, as well as designing AML best practice solutions for your particular circumstances.

“Hedge funds and their managers should expect those parties subject to AML regulations to be asking more questions where funds are located in tax efficient jurisdictions.”

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Transfer Pricing

Transfer pricing is an important issue for any hedge fund manager with cross-border operations where services are provided by connected parties. Tax authorities around the world are focusing more attention on transfer pricing issues.

This is a particularly important issue where a hedge fund uses a hedge fund manager in one jurisdiction who in turn delegates discretionary management to an investment manager or adviser in another jurisdiction. To ensure that the hedge fund is kept outside the tax jurisdiction where the investment manager operates, the remuneration the investment manager receives must be arm's length (e.g. see UK Investment Manager Exemption).

In addition, in many jurisdictions, hedge fund advisers are required to prepare and file tax returns including a declaration that they have submitted a correct and complete return. Thus it is implicit that the entity has used arm's length transfer prices in compiling the return and that the approach to determining the arm's length price is supported by all the available evidence.

PricewaterhouseCoopers can assist you with structuring your operations so that entities are established, and intra-group services are provided and priced, in a tax-efficient manner. We can also assist if you are required to defend your transfer pricing policies to fiscal authorities.

Our menu of services includes:

- Structuring:

  Advising on structures that will achieve the objectives of the company/partnership/fund in a tax efficient way.

  Ensuring that the benefits of the Investment Manager Exemption or the overseas equivalents are available.

- Providing comfort that the transfer pricing obligations of the manager/adviser are being followed.

- Defending transfer pricing policies as a result of fiscal enquiry.

- Preparing or reviewing transfer pricing documentation, especially using our detailed experience and knowledge in:

  identifying relevant commercial or financial transactions engaged in by associated entities;

  identifying any intangible assets utilised;

  ascertaining the price applied in respect of such services;

  determining who performs the key functions, bears the key risks, and owns the key assets;

  obtaining comparable information in respect of the different activities by reference to the results of third parties involved in performing similar types of functions;

  financial modelling to secure a desirable and defensible outcome; and

  mitigating taxation and penalties.

Transfer Pricing

Our transfer pricing expertise can add significant value by ensuring that entities are structured from the outset in a tax-effective way. We also have a proven track record of assisting clients in documenting their transfer pricing methodology, by sharing best practice and providing guidance, questionnaires, templates and a detailed review. We liase across our network of offices around the world, so as to provide you with transfer pricing documentation that meets local requirements and is consistent across your group operations.

"Our transfer pricing expertise can add significant value by ensuring that entities are structured from the outset in a tax-effective way."

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Managing Your Risks

Risk assessment and risk management are critical to any financial services business wishing to protect its market position and to satisfy the demands of regulators and clients. Hedge fund firms are no exception, indeed concern that investors should be better protected against risks associated with less understood instruments impose a need to demonstrate strong risk management capability.

Your business should consider taking advantage of PricewaterhouseCoopers' risk services when:

- you are uncertain of the operational, financial or regulatory risks facing your business;
- your business does not have a complete and robust framework of risk, process and security controls;
- mitigation strategies are required to overcome key risks; or
- regulatory or investor pressure requires increased effectiveness and transparency of your risk management.

PricewaterhouseCooper's Global Risk Management Solutions (GRMS) group works with fund managers, administrators, investment banks and institutional investors, leveraging risk expertise across the full spectrum of market and operations risk. Drawing on a global network of 6,000 risk professionals, we work with organisations to develop and maintain a competitive edge by managing risk at a strategic and tactical level. We can help you identify the critical risks that you face, reduce your risk exposure and develop opportunities for growth and expansion.

Our investment management clients use our services to design and implement controls as part of programmes of change, the introduction of new systems or to provide independent assurance that adequate controls are in place and operating as intended.

A controls framework should first exist to guide the design of internal controls by reflecting your business drivers, the organisation's culture and its attitude to risk. Controls can then be developed in the following areas:

Business process controls: best-practice system and clerical control solutions to mitigate process level business risks;

Application processing controls: ensure satisfactory management and auditability of the transactions and data held and processed by your business systems;

Application security controls: manage user authorisations to provide appropriate information and system access and adequate segregation of duties; and

Technical infrastructure controls: maintain a secure technical platform for the development and operation of business systems.

Managing Your Risks

Trust and security

PricewaterhouseCoopers provides a range of services to help you ensure that your business remains safe and secure from improper use and access to your systems, networks and internet-based operations. We will:

- Identify areas of risk within your internet strategy, business processes and technical architecture;
- Assess the development, deployment and operation of new infrastructures; and
- Design, develop and implement security strategies, eg:

  Identity management: security architecture design, security product implementation, security testing.

  Internet security: penetration testing, cybercrime investigation and penetration.

  Enterprise wide: Enterprise Security Architecture Systems (ESAS), security policies and standards together with security function organisation.

Methods and tools

A wealth of risk management methods and tools provide GRMS professionals with thorough approaches to analysing your business risks and developing your risk management processes.

For example, ORCA (Objectives, Risks, Controls, Alignment) provides a framework for understanding and defining risk. It helps instil an instinctive and consistent consideration of risk and reward in day-to-day planning and the achievement of strategic, business and operational objectives.

The ORCA framework:

- focuses on how organisations, business units, business processes or individuals describe and prioritise their strategies and objectives;
- is founded on the premise that risks must be taken in the pursuit of opportunities;
- helps organisations to plan specific risk management or control processes to respond to potential threats and opportunities; and
- helps organisations to align their strategic objectives with their own risks, controls and processes.

RiskPRiSM software can be used to support the ORCA framework, by providing a tool that helps to define, link and align organisation or business unit objectives, risks, controls, actions and issues. A combined ORCA/RiskPRiSM approach increases the likelihood of long-term risk management success after completion of the project.

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Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Delivering Technology and Business Change

Systems are core to the hedge fund industry. They bring up-to-date global market data to the hedge fund manager’s desktop; manage, exchange, report and analyse the funds, trades and investments; provide the connections between investors, fund managers, administrators, prime and other brokers and custodians; maintain the accounting records; and provide information for owners, investors, regulators and other third parties. Optimal systems must be integrated with sound business operations and proactive risk management to provide systems reliability, product and cost competitiveness and long-term business performance.

Your business should consider taking advantage of PricewaterhouseCoopers’ technology, operational improvement and project management services when:

- your business is starting up or entering a new period of growth;
- regulatory requirements, competitive position or market pressures demand change;
- changes to your business, operational or technology strategy are planned;
- you are not satisfied with the performance or costs of your business operations;
- significant or recurring operational breakdowns are experienced;
- benefits from a major improvement initiative are not realised; or
- multiple improvement initiatives fail to identify or solve the root causes of operational problems.

PricewaterhouseCoopers’ Global Risk Management Solutions (GRMS) group has a global reputation of excellence in the selection, design and delivery of process and system solutions. We work with firms across the investment management community to ensure that their operations are secure, controlled and efficient. Our clients benefit from the creation and implementation of sustainable business models that maximise the performance of today, but not at the expense of tomorrow.

Change and project management

Helping clients control and deliver major business change is a core competency of our GRMS group. Without the necessary specialist skills and resources, there are high risks of failure, and of undue impact to your services and operations. PricewaterhouseCoopers has an excellent reputation in this area, providing project management disciplines to:

- Ensure the delivery of critical business projects;
- Recover failed or failing projects;
- Manage third parties and outsourcers; and
- Plan and manage testing and acceptance of new processes and systems; and
- Plan, measure and manage the delivery of benefits.

We also provide independent project review and assurance of your internal or third party projects, provide advice to the project teams and report the risks and likelihood of project success to management.

Successful change is achieved through people. PricewaterhouseCoopers also provides change management skills to manage or assist in:

- Preparing your organisation for change (change readiness);
- Encouraging a culture that fosters innovation;
- Providing change leadership;
- Stakeholder management;
- Communicating internally and externally to gain support and prepare for implementation;
- Designing and developing learning solutions, including e-learning;
- Creating sustainable improvement in people’s performance.

Technology evaluation

When you need to improve or expand your systems or technology you may need to consider e-systems, bespoke applications, in-house developments, external services, or review your entire systems architecture.

Delivering Technology and Business Change

Our GRMS team will work with you to determine the system applications and infrastructure options appropriate for supporting your specific products, channels, services, volumes, third party relationships, locations, security and control needs. As your business relies upon the continuing and effective support of your IT suppliers; we can provide the procurement disciplines to enable you to assess the suppliers as part of the decision making process and to advise upon the contracts and pricing required to protect and benefit your business.

Operational resilience and disaster recovery

September 11 2001 reminded us all of the importance of recovery planning to ensure the continued operation and performance of your business in an emergency or disaster situation.

Our specialists have helped many clients plan for major disruptions in business operations. Our services range from process-based reviews of your disaster recovery planning and business resumption plans; to detailed assessments of how well the objectives of availability, reliability and data integrity are maintained within your IT environment; and to the planning and management of tests to confirm that your continuity plans work in practice.

Operational improvement

GRMS has proven frameworks and a practical tool-set for delivering sustainable improvement within investment management organisations. By focusing on revenue, cost and controls, we seek to improve the performance of the primary operating processes of your business by identifying, quantifying and realising revenue enhancement and cost reduction opportunities, whilst also minimising your risks.

We can improve the underlying performance of your business by aligning technology and operations to your business strategy; enhancing the effectiveness of technology management; and optimising the use of technology. We can help you consider opportunities for outsourcing IT or operational processes where this may achieve genuine cost reduction, service improvement, or release resources to focus upon other key areas of your business.

We assist clients improve their operational control (ie. to measure and manage operational performance, identify and mitigate operational risk and comply with investment management regulations that impact operations) through services such as balanced scorecard design, management information process design, business intelligence system implementation and the design, building and implementation of operational risk frameworks.

We conduct diagnostics and leverage PricewaterhouseCoopers' extensive knowledge base, to determine where the greatest opportunities for improvement exist, for example:

Management information: Information design & alignment with value drivers, data sources & systems, timeliness & efficiency of information production, relevance & usage of information, performance measurement and presentation & communication of information.

People and learning: Skills & competencies, knowledge management & continuous learning, human performance management, management style, team & group behaviour, organisational culture.

Processes: Design & optimisation, execution & measurement, process integration, continuous improvement, documentation & training and process control & maintenance.

Technology and assets: Technology strategy, technology & project governance, enterprise-wide technology systems, change management & maintenance, technology operations, trust & security and business continuity.

Alliances: Alliance strategy, legal agreement, governance & decision making, staffing & resource requirement, core capabilities & critical knowledge and organisation & culture.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Reports on Controls for Hedge Fund Managers

Recent reports indicate that institutional investors such as pension funds, charities and insurance fundsare allocating more money to hedge funds. Consequently, the control environment at a hedge fund manager is becoming the subject of ever-greater focus by investors and regulators and by the boards of directors of the funds themselves. However, there are no accepted standards for hedge fund operational risk management and the level of outsourcing and cross-border relationships in the European hedge fund industry makes oversight of an entire structure by a single regulator impossible. In this context, the onus is on the hedge fund manager to be able to demonstrate the robustness of its control environment.

Background

Reporting on controls originated in the United States with the introduction of Statement of Auditing Standards (SAS) 70 – “Reports on the Processing of Transactions by Service Organisations”. Guidance for such reporting now exists in several countries, for example in the United Kingdom under a standard commonly called “FRAG21”, which is currently being updated to move to a model very close to the existing SAS70 guidance.

Reports on Controls

Initially, reports on controls in the investment management industry were prepared by service organisations such as custodian banks, fund accountants, transfer agents, benefit plans and payroll providers. However, the SAS70 and FRAG21 frameworks can be applied to any organisation that executes transactions and maintains accountability for them, or records transactions and processes related data, and it has become common practice for “long-only” investment managers to prepare such reports on controls in response to requests from clients (and their clients’ auditors). This reflect the responsibilities of investors such as pension fund and charity trustees to review their controls as part of an increased focus on governance.

Reporting framework

A key element of the SAS70 and FRAG21 reporting frameworks is that they allow for independent attestation of the controls by a firm of independent accountants, and the majority of long-only investment managers in the UK, and increasingly in the rest of Europe, now produce such reports on an annual basis. The advantages to a hedge fund manager of having a report on controls include:

- Informing clients, including the directors of the funds and their auditors, how the operational risks that are most relevant to them are managed and providing them with comfort on the hedge fund manager’s control environment.
- Assisting in demonstrating compliance with the requirements of various regulators regarding regular current review of internal controls.
- Generating feedback on the control environment against best practice

Reports on Controls for Hedge Fund Managers

and identifying potential improvements in control procedures and processes.

- Providing a convenient and cost-effective method of responding to elements of repetitive investor due diligence questionnaires, assisting in the marketing effort to win new clients and reducing the risk of competitive disadvantage as more hedge fund managers move towards the preparation of such reports.
- The ability to demonstrate the robustness of the control environment to a potential third party acquirer, should the need arise in the future.

Preparation

Under the SAS70 and FRAG21 guidance, reports on controls are prepared by the directors of the hedge fund manager entity and describe:

- The control objectives of all or part of the business;
- The control activities that have been put in place to meet those control objectives; and
- The testing of those controls performed by the independent accountants.

The scope of the controls to be included in the document is at the discretion of the directors, but for a hedge fund manager would typically cover the following areas:

- Compliance with investment guidelines and restrictions
- Trade execution
- Transaction processing
- Portfolio accounting and valuation
- Client administration and NAV reporting
- Computerised information systems and business protection

The hedge fund environment is characterised by a high level of outsourcing to third party service providers. The clear articulation of internal control processes surrounding such arrangements is an area of focus of investors and regulators.

Reporting Accountants

PricewaterhouseCoopers is well placed to assist hedge fund managers with the development of their reports on controls:

- We have unrivalled experience in assessing control processes and reporting on SAS70/FRAG21 reports in the investment management industry, including acting as reporting accountants on the first reports on controls to be produced by hedge fund managers.
- Our knowledge of the hedge fund industry allows us to advise on the most appropriate control processes to be included in the report and to assess your control environment against best practices in the hedge fund industry to allow you to obtain maximum benefit from the report on controls process.
- We are also familiar with the common pitfalls encountered in producing such reports and can assist you in managing the project in an efficient and well-controlled manner, so that the process has the minimum impact on your organisation.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719, Robert Mellor (44) 20 7804 1385, Jerry Dawson (44) 20 7804 2624, or your usual local PricewaterhouseCoopers contact.

Corporate Governance: an important issue for Hedge Funds

Changing patterns of demand driving changes in expected behaviours

Europe is seeing a significant increase in the level of demand for hedge funds from institutional investors. In particular, pension funds are showing an increased interest. At the same time, access by affluent and, to some extent, even retail investors to hedge fund products is increasing, reflecting a desire to include alternative products within a diversified portfolio and taking advantage of the changing stance of regulators in relation to the promotion of hedge funds.

However, regulators are naturally concerned to see that:

- assets owned by retail investors are subject to good stewardship; and
- pension fund trustees adhere to their fiduciary responsibilities to scheme members to ensure that scheme assets are adequately protected.

For these reasons, the strength of a fund's corporate governance arrangements will be an increasingly important differentiator for funds that wish to raise and retain subscriptions from sources other than the traditional investors of high net worth individuals, family offices and endowments.

The need for balance

It is important that any system of corporate governance delivers control of the operational risks faced by a hedge fund. However, this must be balanced and should not stifle the ability of the investment adviser to react quickly to market developments or implement innovative investment strategies, provided these are within the scope of the overall investment strategy as determined by the Board of Directors and the Fund's prospectus.

Directors' responsibilities

Hedge funds' Boards of Directors have always had a responsibility for the stewardship of shareholders' assets. Although there are, as yet, no universally accepted standards for corporate governance in the context of hedge funds, Boards of Directors should react to the increased focus on corporate governance by reviewing their current arrangements, particularly in relation to:

- the process for identifying risks associated with the activities of the investment adviser and other key service providers;
- the controls in place at the service providers to mitigate against these risks;
- the procedures by which the Board of Directors monitors the operation of the relevant controls;
- the pricing/NAV methodology, related controls and escalation procedures; and
- the overall effectiveness and transparency of the Board of Directors' oversight over the fund's key service providers

Challenges for hedge fund boards

The starting point for the Board of Directors of any hedge fund is to define a structure for governance

Corporate Governance: an important issue for Hedge Funds

Changing patterns of demand driving changes in expected behaviours

that provides comfort for investors that they have in place a system of internal controls to safeguard shareholders' investments and the assets of the fund.

Hedge fund boards are typically largely or wholly comprised of non-executives who are usually not involved in the day-to-day management of the Fund or any of its delegated activities.

For this reason, it is usually practical for Boards of Directors to discharge their duties in relation to the corporate governance of a fund, by adopting and following procedures which focus on monitoring by the Board of Directors of those parties who are actually responsible for the delivery of services on a day-to-day basis: the investment adviser, the prime broker and the administrator.

Such systems of control should be subject to a regular review of their effectiveness to ensure that controls are functioning properly and that emerging risks are identified and mitigated by establishing new controls where necessary. It is generally accepted that no system of control can be said to exist unless it is properly documented.

The challenge for hedge funds' Boards of Directors is to implement a governance regime that does not overly restrict or hinder the fund's investment activities, but which enables the Board of Directors to discharge its fiduciary duties, taking into account the operational structure of the hedge fund and the important roles performed by the investment adviser, and other key service providers.

Increasingly, we believe that Boards of Directors of hedge funds will be requested to provide more information to both current and potential investors regarding the exercise of oversight within the fund.

Actions to take

In summary, Boards of Directors of hedge funds will need to consider:

- the applicable framework, from a legal, regulatory and tax standpoint, within which the fund operates, as this may dictate certain base-level obligations of the Board of Directors;
- the specific roles and responsibilities of the Board of Directors as distinct from other parties involved in the operation of the Fund, such as the investment adviser, the prime broker and the fund administrator;
- the generic risks applicable to the hedge fund industry and the risks which are fund-specific and how these are mitigated by control activities performed by the Fund's service providers;
- the management information flows from the Fund's service providers and how this lends itself to effective monitoring at the level of the Board of Directors; and
- how the Board of Directors will record the monitoring that it performs in order to document that it has discharged its duties appropriately.

Further Information

PricewaterhouseCoopers has considerable experience in the design and implementation of effective corporate governance arrangements tailored to the specific requirements of hedge funds, drawing on the expertise of specialists in assurance, regulation and taxation and our cross-border hedge fund network.

For further information, please telephone either of our lead European Hedge Fund contacts:
Graham Phillips (44) 20 7213 1719, Roger Turner (44) 20 7804 3249 or Robert Mellor (44) 20 7804 1385, or your usual local PricewaterhouseCoopers contact.

Tax Health Check for Hedge Funds

Who does this affect?

Any hedge fund manager or adviser operating in the UK.

Why should you care?

In recent years the UK Inland Revenue (now HM Revenue & Customs ("HMRC")) has focused considerable attention on the hedge fund industry, which, in its eyes, remains largely obscure and unregulated. This has been driven by perceived tax abuse in instances where management profits are being retained by offshore entities located in tax havens. The HMRC is also alive to the possibility of tax leakage where principals engage in sophisticated personal tax planning, or they and their families co-invest in offshore hedge funds.

Why are tax risks higher for the hedge fund industry?

Privately owned hedge fund managers do not generally have the specialist in-house resource to deal with the often complex tax issues surrounding their operations. Since the principals of the business tend to focus on operational issues rather than tax matters, tax risks may not be managed adequately. The HMRC sees this as fertile hunting ground, and has had success in raising substantial amounts of additional tax.

Which areas are typically investigated?

Transfer pricing

This is a major area of focus. Where offshore companies are included in the corporate structure, there is a need to review and benchmark the level of inter-company pricing against an arm's length standard, and to ensure that robust documentation supports the current pricing. Going forward, this review should also extend to any transactions between UK management entities.

Permanent establishment

Even where offshore management or advisory companies are tax resident outside the UK (see below), great care must be taken to ensure that they are not inadvertently carrying on some, or even all, of their business through a UK permanent establishment – for example, through the agency of an affiliated UK company. The HMRC will actively seek to identify a permanent establishment to bring additional profits into the charge of UK taxation.

Investment Manager Exemption ("IME")

Where an offshore hedge fund is "trading" in the UK through the "agency" of a UK investment manager or adviser, that manager is in principle subject to tax on the fund's behalf in relation to the associated fund profits. This would be calamitous for external fund investors. To prevent independent UK agents and their offshore funds or clients from being penalised, a series of safe harbour provisions exist known as the IME.

Many UK hedge fund managers will rely on these safe harbour provisions to escape such agency liability, but their operation can be complex. The IME provisions should be reviewed on a continuous basis to ensure that a failure does not occur. This is particularly important in cases where a hedge fund pursues non-traditional investment strategies such as loan origination deals.

Dual contracts & remuneration planning

The HMRC has been challenging dual employment contracts, particularly those in the financial services sector. In particular, concerns have been raised as to whether existing contractual arrangements are robust enough to ensure that sums paid by offshore entities to individuals are structured in such a way that they do not fall to be taxable in the UK.

The HMRC is also reviewing the personal tax and remuneration planning adopted by UK based hedge fund managers. It is typical for the opening letter of an enquiry concerning the management vehicle to be accompanied by similar letters to the principals at their home addresses.

Company residence

A company is UK tax resident if its 'central management and control' is in the UK. Should the Inspector succeed in making a case that an offshore company is UK resident, all of the company's profits and gains will become chargeable to UK Corporation Tax. You should note that the Inspector may also seek interest and penalties on amounts not paid, if it is established that there was negligence in filing the annual tax return.

Personal tax liabilities

The HMRC takes a 'holistic' approach to hedge fund enquiries. In some cases it seeks to attach personal tax liabilities to (broadly) the 'owners' of a structure where it can be said that assets, such as shares, cash, property, etc have been moved offshore to avoid tax (Section 739).

Tax Health Check for Hedge Funds

Developing tax issues

Acquisition of securities by employees

HMRC has introduced a new annual reporting requirement for unapproved share related plans. The reporting requirements (captured within Form 42) are now far more extensive than in previous years (the 2004/2005 return is 16 pages) and the HMRC will be more proactive in instigating penalty proceedings for failures in reporting. Reportable events include the acquisition of securities by employees and could include the purchase by employees or their families of shares in a hedge fund. The deadline for submission is 6 July 2005.

EU Savings Directive

The key thrust of the EU Savings Directive, which will be fully implemented on 1 July 2005, is the exchange of information between EU member states on cross-border payments of interest to individuals. Many offshore jurisdictions have traditionally attracted investors who wish to retain privacy. Yet a number of these jurisdictions have acceded to EU wishes and agreed to require local paying agents to report (or to withhold tax on) relevant payments to EU investors, which would include distributions and redemptions from hedge funds that are debt invested. Paying agents located within the EU will have similar obligations. Recent developments in the UK and other jurisdictions suggest more hedge funds than previously thought will fall outside the scope of the Directive. Hedge fund managers need to identify which of their funds are likely to be affected, and the relevant paying agent(s) in their operational structure, to ensure that appropriate steps are taken to address the Directive. This includes communication with investors about the status of the fund under the Directive.

How can we help?

PricewaterhouseCoopers can carry out reviews on each of these important areas and report back our conclusions and recommendations on any relevant documentation, operations or the current corporate structure. The principal objective of each review is to identify any potential tax exposures and to enable you to rectify them before a lengthy HMRC enquiry ensues.

The review will provide you with a risk assessment on current matters and a framework within which to address future operating decisions.

What should I do if a HMRC enquiry has already started?

Contact us immediately!

Our industry knowledge and experience put us in an excellent position to assist you in dealing with a potentially arduous enquiry.

We also have a dedicated Tax Investigation team, who specialise in HMRC negotiations. The tax investigation team consists of individuals who previously worked as Inspectors of Taxes, with considerable experience of dealing with investigations, and are able to use that experience to help minimise the tax consequences of any investigation.

Industry and tax expertise

Our hedge fund tax practice has built a wealth of experience in the following areas:

- The drafting of transfer pricing documentation
- Tax planning for the fund and its investors
- Dealing with a HMRC enquiry or Special Compliance Office negotiations
- Tax efficient remuneration and retention planning solutions
- LLP conversions
- Personal tax planning
- Fund re-organisations
- Assistance with drafting of legal agreements

For further information, please telephone either of our lead European Hedge Fund contacts:
Robert Mellor – Partner (44) 20 7804 1385, Martin Smith – Partner (44) 20 7212 5524,
Elizabeth Stone – Director (44) 20 7804 9678 or Debbie Payne – Senior Manager (44) 20 7213 5443, or your usual local PricewaterhouseCoopers contact.

European Hedge Fund Group

EUROPE

Lead European Hedge Fund contacts: Graham Phillips (44) 20 7213 1719 and Robert Mellor (44) 20 7804 1385

United Kingdom

Graham Phillips (44) 20 7213 1719
graham.p.phillips@uk.pwc.com

Robert Mellor (44) 20 7804 1385
robert.mellor@uk.pwc.com

Jerry Dawson (44) 20 7804 2624
jerry.dawson@uk.pwc.com

Debbie Payne (44) 20 7213 5443
debbie.a.payne@uk.pwc.com

Elizabeth Stone (44) 20 7804 9678
elizabeth.j.stone@uk.pwc.com

Channel Islands/Jersey

David Pirouet (44) 1534 838 302
david.pirouet@gbj.pwc.com

Channel Islands/Guernsey

Simon Perry (44) 1481 719 357
simon.p.perry@gbg.pwc.com

France

Marie-Elisa Roussel (33) 1 56 57 87 86
marie-elisa.roussel@fr.pwc.com

Finland

Tuukka Lahkela (358) 9 2280 1333
tuukka.lahkela@fi.pwc.com

Germany

Robert Welzel (49) 69 9585 6758
robert.welzel@de.pwc.com

Steffen Gnutzmann (49) 69 9585 6474
steffen.gnutzmann@de.pwc.com

Greece

Nicos Komodromos (30) 210 6874 671
nicos.komodromos@gr.pwc.com

Isle of Man

Mike Simpson (44) 1624 689 689
michael.simpson@iom.pwc.com

Italy

Lia Turri (39) 02 7785 356
lia.turri@it.pwc.com

Ireland

Damian Neylin (353) 1 662 6551
damian.neylin@ie.pwc.com

Olwyn Alexander (353) 1 704 8719
olwyn.m.alexander@ie.pwc.com

Ken Owens (353) 1 704 8542
ken.owens@ie.pwc.com

Luxembourg

Didier Prime (352) 49 48 48 2515
didier.prime@lu.pwc.com

Laurent de la Mettrie (352) 49 48 48 3204
laurent.de.la.mettrie@lu.pwc.com

Malta

Joseph Camilleri (356) 25 647 603
joseph.camilleri@mt.pwc.com

Netherlands

Kees Hage (31) 10 4008 414
kees.hage@nl.pwc.com

Sylvie Villoria (31) 10 4008 440
sylvie.villoria@nl.pwc.com

Norway

Petra Liset (47) 95 26 01 52
petra.liset@no.pwc.com

Spain

Antonio Greño (34) 91 568 46 36
antonio.greno@es.pwc.com

Sweden

Sussanne Sundvall (46) 8 555 33273
sussanne.sundvall@se.pwc.com

Switzerland

Thomas Huber (41) 44 630 2436
thomas.huber@ch.pwc.com

Adrian Roth (41) 44 630 2424
adrian.roth@ch.pwc.com

Victor Meyer (41) 44 630 4340
victor.meyer@ch.pwc.com

European Hedge Fund Group

AMERICAS

Lead Global Alternative Investment Management Group contact: Anthony Artabane (1) 646 471 7830

Bahamas

Clifford Johnson (1) 242 302 5307
clifford.a.johnson@bs.pwc.com

John Ranson (1) 242 302 5308
john.r.ranson@bs.pwc.com

Bermuda

Andrew Brook (1) 441 299 7126
andrew.brook@bm.pwc.com

George Holmes (1) 441 299 7109
george.holmes@bm.pwc.com

Cayman Islands

Noel Reilly (1) 345 914 8600
noel.t.reilly@ky.pwc.com

Graeme Sunley (1) 345 914 8642
graeme.sunley@ky.pwc.com

Middle East Region

Ashruff Jamall (971) 4 304 3105
ashruff.jamall@ae.pwc.com

Netherlands Antilles

Cees Rokx (599) 9 430 0000
cees.rokx@an.pwc.com

United States

Boston

Mark Rosenblatt (1) 617 530 7240
mark.rosenblatt@us.pwc.com

Paula Smith (1) 617 530 7906
paula.e.smith@us.pwc.com

Chicago

Christopher Cornwall (1) 312 298 4816
christopher.cornwall@us.pwc.com

Dallas

Robert Collins (1) 713 356 6851
robert.c.collins@us.pwc.com

Denver

Gregory Hinkle (1) 720 931 7344
gregory.hinkle@us.pwc.com

Los Angeles

David Chrencik (1) 213 356 6130
david.g.chrencik@us.pwc.com

New York

Anthony Artabane (1) 646 471 7830
anthony.artabane@us.pwc.com

Gina Biondo (1) 646 471 2770
gina.biondo@us.pwc.com

Gregory Culloo (1) 646 471 7504
gregory.culloo@us.pwc.com

Frank Calabro (1) 646 471 7842
frank.m.calabro@us.pwc.com

Mark Casella (1) 646 471 2500
mark.j.casella@us.pwc.com

Marvin Nagler (1) 646 471 8429
marvin.nagler@us.pwc.com

Michael Greenstein (1) 646 471 3070
michael.s.greenstein@us.pwc.com

Barry Knee (1) 646 471 5898
barry.knee@us.pwc.com

Linda Ianieri (1) 646 471 2400
linda.ianieri@us.pwc.com

Linda McGowan (1) 646 471 7480
linda.s.mcgowan@us.pwc.com

John Reville (1) 646 471 7845
john.reville@us.pwc.com

Thomas Romeo (1) 646 471 8048
thomas.romeo@us.pwc.com

William Taggart Jr. (1) 646 471 2780
william.taggart@us.pwc.com

Philadelphia

William McGinley (1) 267 330 2140
william.c.mcginley@us.pwc.com

San Francisco

Gregory Eckert (1) 415 498 7443
gregory.eckert@us.pwc.com

Lucinda Powers (1) 415 498 6210
lucinda.powers@us.pwc.com

Seattle

Michele Godvin (1) 206 398 3801
michele.l.godvin@us.pwc.com

Hong Kong

Robert Grome (852) 2289 1133
robert.grome@hk.pwc.com

Singapore

Justin Ong (65) 6236 3708
justin.ong@sg.pwc.com

Sydney

David Prothero (61) 2 8266 2916
david.prothero@au.pwc.com

Tokyo

Peter Finnerty (81) 3 5532 2530
peter.finnerty@jp.pwc.com

Stuart Porter (81) 3 5251 2944
stuart.porter@jp.pwc.com