



IMRE News

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The information in this newsletter represents our
understanding at the time of going to press.

Fragile consensus in CCSR over UCITS III

Late in January, the Committee of European Securities Regulators (CESR) issued its final advice on which assets are eligible for use in UCITS III funds. This followed two consultations and comes almost precisely two years after the Directive came into force. The wait has probably been worth it. CESR's advice is now much clearer and means, in short, that the investment strategies in place in current UCITS III can continue.

The main areas of interest are as follows:

Financial indices – derivatives on financial indices would be allowed where the index relates to either eligible or non-eligible assets. Indices must be a representative benchmark of the relevant market, be accessible to the public, and the underlying assets must be sufficiently diversified.

CESR specifically accepts that an index of commodity derivatives could qualify whereas a commodity derivative itself would not. CESR doubts that an index of real estate would meet the tests for an eligible index but accepts the case for an index of shares investing in property. REIT-type vehicles will help here.

CESR offers unconvincing reasons why a hedge fund index would not qualify. This is odd given that most hedge-like strategies can now be achieved directly in the funds themselves.

Derivatives – most derivatives relating to eligible assets or indices are valid. This explicitly includes most collateralised debt obligations (CDOs), including synthetics.

Closed end funds – are allowed in almost all circumstances if constituted as transferable securities. CESR states that this will allow for investment into closed end private equity and property funds.

02

Infrastructure: An attractive asset class for the German market?

Investing in infrastructure is an intriguing investment opportunity which is rapidly becoming a new asset class in the alternative investment universe. This long-term investment has substantial appeal for a variety of German investors, which global and regional firms are keen to cultivate. Meanwhile the German industry is also making progress providing infrastructure product.

Infrastructure businesses involve the management of a wide range of assets that provide essential services to a community. Infrastructure investments may include such ventures as construction or renovation of schoolhouses, universities, roads or highways, telecommunication facilities, utilities, desalination plants or cultural facilities.

Due to their quasi-monopoly position, most infrastructure investments promise consistent and predictable income. However, only some early stage investments (such as toll roads or airports) leave investors with significant flexibility to increase the value of the business in order to allow for a short-term exit. Therefore, most opportunities are attractive for long-term rather than short-term investments.

However, these assets do not tend to be as well suited to outright private ownership because governments are reluctant to cede control. This makes infrastructure an asset class which is very hard to access as a direct investment by a non-specialised investor. Since international demand for the asset class is substantial, an increasing number of globally and regionally specialised asset management firms are in the process of launching sizeable infrastructure funds which look at infrastructure investments from a portfolio perspective.

The opportunities

There could be good opportunities for these players when offering global products to the German investor market. This is for the following reasons:

- **Crackdown on tax shelter products:** Recently, the German tax authorities have restricted the once substantial market for tax-privileged closed ended funds, some of which had exposure to infrastructure assets such as wind farms. Disappointed investors are looking for new investment opportunities.
- **Legislative delay for domestic product:** A recent legislative attempt to make infrastructure an eligible asset class for the German regulated open ended fund industry failed. It is likely that a new attempt will be made but will require some time.
- **Weaknesses of the domestic market:** Infrastructure as an asset class is unfamiliar to most German investors. Even though experts estimate the investment needs for German infrastructure development including Public Private Partnerships will amount to some €700 billion until 2010, there is an expectation that most regional and municipal authorities will be reluctant to open up the domestic market to private equity investors.

Tailoring the product

Given that infrastructure is a relatively new asset class, particular care will be necessary when designing the product. This will be made more challenging by the diverse risk profile of the underlying investments and the resulting blend of yields. Investments in monopoly-like utilities sectors would be expected to deliver reliable low risk income streams while early stage development projects may have a totally different risk profile. Some of these challenges have been overcome in other territories through the development of a secondary market for infrastructure deals.


Furthermore, a choice will have to be made between a regulated and a non-regulated fund vehicle and whether the product will be presented as closed ended or (much more challenging) open ended.

Investor appetite in Germany traditionally is greatest among private life companies, certain pension plans and high net worth individuals. Life companies and pension plans typically are subject to some regulatory restrictions. These will need to be taken into account when structuring the fund vehicle, a feeder fund or a repackaged solution.

It will also be paramount to reduce structural tax leakage. As German life companies and pension plans are normally subject to low taxation, their focus will be on avoiding non-German taxes at investment, holding and fund

levels, while they will tend to be less concerned about receiving income subject to tax in Germany. The solutions to be considered may be similar to the structures used for private equity and real estate funds in the past. However, the impact of fund tax, controlled foreign company (CFC) tax and ordinary tax rules, all of which may apply depending on the asset identified, can pose additional challenges. Fund vehicles attracting the detrimental German trade tax will need to be avoided, too.

High net worth individuals may, conversely, be interested in tax treaty-sheltered profits or gains eligible for the beneficial German capital gains regime. The currently-governing grand coalition has, however, announced its intention to do away with this beneficial regime as of next year, so an alternative approach may be required.

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Emerging Trends in Real Estate® in Europe for 2006

European real estate investors are optimistic about the industry's potential to generate healthy returns over the coming year, according to the annual real estate investment report, Emerging Trends in Real Estate® Europe 2006. Published by PricewaterhouseCoopers and the Urban Land Institute (ULI), the report is based on surveys and interviews with more than 250 of the real estate industry's leading authorities. Those surveyed still believe that real estate has the best outlook relative to other asset classes despite the phenomenal performance of the past year.

In the markets to watch, Paris reigns supreme, for the second year running, as the top overall investment market for risk-adjusted returns out of 27 markets surveyed, with London a close second and Helsinki jumping to third place from sixth place for overall investment prospects in 2006.

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The report is now available on the PricewaterhouseCoopers website. If you would like a hard copy of the report please email Meryn Stewart, Global IMRE Marketing, at meryn.stewart@uk.pwc.com.

04

Implications of SEC registration on hedge fund managers

By 1 February 2006, certain foreign and US domestic hedge fund advisers were required to register with the US Securities and Exchange Commission (SEC). What happens now? For many it is a journey through uncharted territory – for others it may be a path well worn.

If a hedge fund has had, in the preceding 12 months, more than 14 investors that are US residents, the offshore adviser to that hedge fund generally must register with the SEC under SEC Rule 203(b)(3)-2

Registration Under the Advisers Act of Certain Hedge Fund Advisers. With SEC registration comes the inevitable examination where SEC examiners (either alone or jointly with a local regulator) will want access to your policies and procedures, books and records and management personnel to assess compliance with applicable US rules and regulations. A major focus of the examination will centre around conflict management and how an organisation, identifies, monitors and mitigates conflicts of interests inherent in their business.

The SEC will have certain expectations when they announce their intent to visit your operations (although examinations may also be undertaken on an unannounced basis). The rules state that, "During an examination, the registered offshore adviser must provide to our staff any and all records required to be kept under our rules as well as any records the adviser keeps under foreign law". You will likely receive, in advance of the review, a detailed document request list setting out specifically what the SEC would like to review.

Typically, at the commencement of the SEC's fieldwork, they will speak with member(s) of senior management to obtain an overall view of the organisation, business, control environment, and compliance culture. They may also want to interview

persons responsible for certain functions such as portfolio management, trade execution, back office/administration, information technology, anti-money laundering, and marketing.

Specifically, the SEC examination staff will be interested in determining whether:

- a. Portfolio management decisions are consistent with client mandates and/or private placement memoranda;
- b. Decisions made and costs incurred in maintaining registrant's brokerage arrangements and placing orders (trades) for clients are consistent with maximising the value of clients' accounts and disclosures made to clients;
- c. Allocations among clients accounts of IPOs and blocked and cross trades in issues traded on secondary markets are fair and consistent with disclosures;
- d. Prices used to value positions in clients' accounts reflect accurately current market conditions and the process used to calculate NAV per unit of commingled accounts results in consistently accurate allocations of the commingled accounts' net assets among participants;
- e. Information provided to investors regarding transactions in and balances of their accounts reflects accurately the actual transactions in and balances of those accounts;
- f. Personal trading activities of advisory representatives and proprietary accounts of registrant are consistent with codes of

ethics, regulatory requirements, and disclosures;

- g. Performance information used in advertisements and other marketing materials is calculated accurately and fairly and is used in ways that are not misleading; and
- h. Data about registrant's operations and activity in investor accounts are accurately created, captured, and safeguarded from unauthorised access, use, and manipulation. Such data are used to provide accurate and timely information to management, advisory clients, investors, and regulators.

At the conclusion of the examination you will likely receive an exit interview and/or communication from the SEC examiners setting out areas of concerns and possible deficiencies. You should respond to any correspondence in a concise and accurate manner and within any time constraints set by the SEC.

The SEC have expressed an interest in working more collaboratively with registrants to jointly identify, assess and remedy industry issues in a timely manner and before they escalate into major issues. Such an approach would be widely embraced by many registrants, especially those undergoing such examinations for the first time.

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Changes to UK fund tax rules bring simplifications – and complications

In December 2005, the UK tax authority, HM Revenue & Customs (HMRC) published draft regulations on the tax treatment of UK authorised funds. The proposed changes are intended to apply from April 2006; here are some of the implications...

The bulk of the regulations aim to simplify and consolidate rules governing the tax treatment of Authorised Unit Trusts (AUTs) and Open ended Investment Companies (OEICs) by consolidating the different streams of tax legislation into one set of rules. The regulations also address a number of unintended differences in the current tax treatment of AUTs and OEICs. While the industry will welcome these proposals, there are some technical instances where HMRC do not intend to roll forward existing provisions into the new regulations, a decision that might disadvantage a minority of authorised funds.

Qualified investor schemes

Qualified Investor Schemes (QIS), which are lightly regulated UK authorised funds aimed at sophisticated and institutional investors, were launched in April 2004.

The draft regulations introduce “substantial” holding rules which apply to investors which alone or together with associates or connected persons

hold 10% or more by net asset value of a QIS. These investors will be taxed annually on the increase in the market value of their holding until their entire holding has been sold, even if it later falls below the 10% threshold.

In order to meet their tax reporting obligations, QIS investors will require fund managers to provide information to enable them to check the status of their investment by reference to the 10% threshold. This will include access to daily unit prices, the number of units in the QIS and details of their holding at the two annual reporting dates. While the compliance obligation is on the investor, the administration burden and associated costs of this regime are likely to fall to QIS providers and will probably limit the number of fund managers which launch QIS funds. Equally, since once investors are subject to tax under the QIS regime, they cannot get out of the regime other than to sell their holdings, the tax regime is likely to impact the success of QIS funds in the UK. Furthermore, as authorised funds – where they are

investors – are also subject to this tax, this will impact the structuring of QIS funds-of-funds.

The rules provide exceptions for investors in newly launched funds, where substantial investors will have up to six months to comply, and, investors who inadvertently breach the holdings rules will have until the next reporting date to reduce their holding to less than 10%. In addition, where funds are wound up, there will be a grace period of six months. While the exception for inadvertent breaches is reasonable, an investor would need immediate awareness of breaching the 10% limit, which will put pressure on both investors and fund managers alike. Furthermore, the grace periods for newly launched funds or funds in the process of winding up seem insufficient, given that funds frequently take more than six months to successfully launch or wind up.

Extension of gross payments of distributions for bond funds

The draft regulations allow tax-exempt UK resident individuals to receive gross distributions from bond funds. HMRC's rationale for this change is that it will reduce costs for both investors and HMRC by eliminating the extra administrative work required when investors reclaim the tax deducted. However, these costs will simply be passed on to fund managers who will be expected to bear the burden of maintaining additional records and developing their systems

to meet the procedural requirements for paying to an additional class of investors without the deduction of tax. Moreover, in contrast to the position HMRC adopted when the gross payment of interest rules were extended to companies in 2001, the new rules would appear to be mandatory from the date the regulations become effective and without a transition period for fund managers to update their systems and procedures.

In conclusion, while the draft regulations are positive in terms of simplification of tax rules, investors and fund managers are understandably concerned about the other elements of the new rules. In particular, the proposed taxation of substantial investors in QIS means that both investors and fund managers are likely to consider similar products in other European territories, thereby undermining the competitiveness of the UK asset management industry. As such, it is hoped that following industry feedback the rules will be modified prior to their implementation in April 2006.



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MiFID: watch your clients!

07

In promoting MiFID, one of the Commission's strategic goals is to establish a high level of investor confidence in financial markets. Some of the key measures supporting this objective include new requirements of best execution, higher standards of rules of conduct and strengthened rules relating to conflicts of interest.

Currently, a number of firms transact customer orders internally as a matter of course. Under MiFID, if they continue to do this systematically, they will be required to have the same pre- and post-trade transparency as a regulated market or multilateral trading facility (MTF). On the other hand some markets which operate a concentration rule will no longer be able to do so. Thus there will be direct competition between regulated markets, MTFs and internalisers. MiFID also requires firms to define and implement an execution policy ensuring the firm obtains the best possible result for their clients taking into account a series of factors. Best execution will apply to all instrument types for firms providing execution services, as well as to those rendering portfolio management services. Firms will need to obtain the prior consent of their clients on their execution policy.

MiFID standards will require firms to provide their clients with a much larger amount of information than under ISD. This information relates not only to the company, its services and the financial instruments proposed, but also to more internal and possibly sensitive information. Information must be provided on its execution policy, including instances where the firm is a member of a trading venue; on its conflict of interest policy, with a prior specific disclosure of instances where it cannot reasonably be guaranteed that the interest of the client will not be prejudiced; on costs and charges including inducement received, etc.

When providing investment advice or discretionary portfolio management services, firms will need to obtain

sufficient information regarding the client's objectives, situation, knowledge and experience to ensure that the proposed transaction or strategy is suitable for him or her. Even when providing receipt and transmission or execution services, firms will need to ensure that the financial instrument considered is appropriate given the client's knowledge and experience.

As these higher standards will undoubtedly represent an increased cost of doing business, the Commission has adopted rules aimed at ensuring that its standards are proportionate given the type of clients and the complexity of the financial instruments considered. The Directive therefore defines three categories of clients: eligible counterparties, professional clients and retail clients. These three types have successively higher levels of protection.

However, those categories benefiting from a lower level of protection can request that higher standards be applied to them, generally or per transaction. For example, in defining risk management procedures for its treasury department, a corporate client qualifying as a professional client, could ask to be treated as a retail client when dealing with specific derivatives. In certain instances, retail clients could also ask to be treated as professional client. In terms of financial instruments, the Directive foresees that when providing execution services or receipt and transmission of orders, firms do not need to meet all appropriateness obligations, if the service relates to "simple" instruments and is provided at the initiative of the client.

Though proportionate measures might appear as lowering operating costs, the high level of flexibility introduced by these measures will potentially affect firms' databases, IT systems and procedures. In term of IT systems and procedures, flexibility is a synonym of increased costs and development time.

In view of MiFID's higher standards of investor protection, firms should investigate the implications of the Directive for the way they currently conduct business with their clients. Questions that should be rapidly investigated include:

- Are marketing materials and communication compliant with new information standards?
- Does the current revenue model reflect the transparency requirement regarding costs and charges?
- Have staff in client-facing processes been trained on new rules of conduct?
- Are systems and procedures able to cope with the level of flexibility of the standards per clients, transactions and instruments?
- What implication does this Directive have on agreements?
- How should clients opting for higher protection standards be handled?
- What is the implication of the Directive on client profitability and on the firm's client strategy?

And perhaps the final question should be, is your firm truly ready for MiFID?

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The rise of CMBS in Europe

A success story in the US, commercial mortgage backed securities (CMBS) have been gaining in significance since the late 1990s. With 2005 proving a record year for issuance in both Europe and the US, how will this important source of financing evolve?

Securitisation is a form of financing where illiquid, financial assets with predictable cash flows are sold by an originator to a special purpose vehicle (SPV) which has borrowed money to finance the purchase. The SPV raises funds through the issuance of either asset-backed commercial paper (ABCP) or bonds (ABS).

History

The growth of CMBS gained momentum during the 1990s, primarily within the US market. With the exception of 1999 and 2000, the US has experienced increased levels of CMBS issuance for many years. Annual growth during the past few years has continued to surprise some market participants. The 2005 US issuance was over \$169 billion, a significant increase over 2004.

So what does this mean for the European CMBS market, if anything? Historically there has been very little correlation between the US and European markets with respect to CMBS issuance. In 2001 the European market witnessed a significant change in the levels of CMBS issuance and annual issuance has continued around

the €20 billion mark. However, 2005 proved to be a record year for European CMBS issuance as well. As Chart 1 shows, the non-US total issuance was \$69.4 billion; approximately 80% of this was European issuance.¹

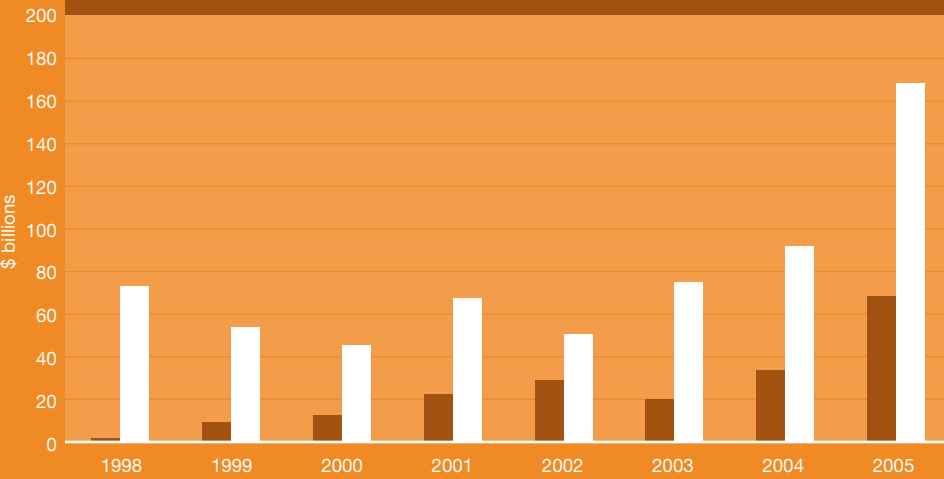
Within the European real estate community, CMBS was not seen as a primary source of financing for several reasons. "Relationship banking" is a strong and important factor within European financing and was a major hurdle to overcome from a lender perspective. Recently, many European and, in particular, UK banks have used this relationship banking network as a feeder for their conduit programs. Conduit lenders are set up to provide lending alternatives to borrowers with the intention of securitising those loans or groups of loans shortly after funding. Even more important for the growth in European CMBS was the increased demand from investors. As the US market matured, investors began looking elsewhere for product. It didn't take long for the arrangers to work on increasing the supply of CMBS in Europe. Initially this was

achieved mainly through single-borrower, large loan transactions, but it has progressed to a more mixed market of conduit, single-borrower (single and multi-property), and credit tenant lease transactions.

The continued growth in investor demand helped influence a tightening of spreads. At mid-year 2004 the AAA spreads were pricing near 40 basis points, with some transactions during the first half of 2005 closing between 14 and 17 basis points for AAA classes. Near the end of 2005 transactions were closing at around 20 basis points. The European CMBS market has been largely dominated by AAA rating issuance, historically making up about 60% of the total issuance.

While the tightening spreads reduce the compensation for bond investors in comparison to similarly risked assets, they also reduce the overall cost of funds for the loan originators and, most importantly, borrowers. The reduced cost of funds has helped borrowers to see CMBS as a more attractive source of financing than other more traditional funding

Chart 1: CMBS volume trends US vs Non-US



■ Non-US (\$) ■ US (\$)

Source: Commercial Mortgage Alert

alternatives. The result has been significant growth in European CMBS issuance from 2000 through 2005, with 2005 the highest yet.

What's next?

Can the European CMBS market continue to grow and sustain a level of issuance to keep investors, lenders, and borrowers interested in this source of financing? Given the emergence of a number of existing and announced European CMBS conduit programmes, it appears the investment banks certainly believe the European CMBS market will continue to grow. Currently there are close to twenty announced conduit programmes working the European market. Given the US experience, it seems likely that twenty, or possibly more, conduit programmes could eventually compete in the European market.

While there has not been a dominant transaction type, the single-borrower single-property transactions have accounted for 28% of transactions to date.² While this type of transaction is expected to remain strong, it is anticipated that the true conduit transactions, which include multi-borrowers, will increase in size and frequency.

The UK has dominated European transactions with respect to collateral location. As can be seen in Chart 2 historically to date, 74% of European issuance occurred in the UK, followed by France at 8%, with most other countries fairly evenly represented with

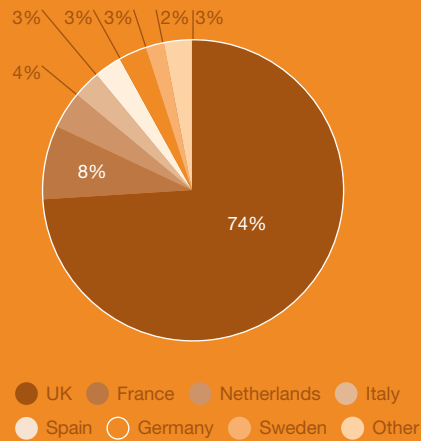
respect to collateral percentage. While these trends are likely to continue, there is scope for countries such as Germany and France to increase their market share as CMBS becomes more widely accepted in those jurisdictions. This is already evident in looking at data from the first nine months of 2005, where increased activity in other European locations has led to a decrease in the UK share of European issuance to 60%, although the UK level of activity has not decreased. As Chart 3 also shows, there is the first evidence of pan-European CMBS.

After the strong first half of 2005, many had predicted €35-40 billion in total European issuance for the year and even this was exceeded. Given the rising demand for CMBS issuance on the part of both investors and borrowers and the growing number of conduit platforms in Europe, the market seems likely to experience more years of increased issuance. With the growth in the overall market, we anticipate more diverse products, such as those which have evolved in the US marketplace. As the European CMBS market increases and expands into more complex structures, investors will be expecting more help from analytic systems and issuance platforms to enable them to carry out due diligence.

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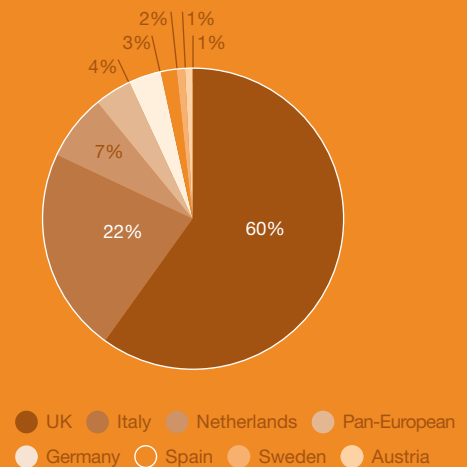
1, 2. Source: Barclays Capital

Chart 2: European CMBS issuance by geography to date



Source: Barclays Capital

Chart 3: European CMBS issuance by geography for 9 months 2005



Source: Commercial Mortgage Alert

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Credit risk in the fund management industry

The deadline for the implementation of the Capital Requirements Directive (CRD) is fast approaching.



Flashline

UK reports on internal controls of service organisations

New guidance will soon be released in the UK for reports on internal controls of service organisations. The changes are significant and therefore careful planning is necessary to ensure a smooth transition.

The new guidance provides details of the minimum control objectives that the report needs to cover. It also envisages that management's report on the effectiveness of the control procedures is supported by an evaluation comprising internal audit and other management directed testing or self assessment.

It also requires the reporting accountants to provide an opinion on the design and operating effectiveness of the control environment.

A first key step for the service provider to transition to the new guidance is the preparation of a gap analysis between your current reporting under the FRAG21 framework and the required reporting under AAF01/06. This should highlight those areas previously not tested and should provide internal focus for management's evaluation.

We are currently running client workshops and will present AAF01/06 in our 2nd March Investment Management Discussion Group.

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For most asset managers and UCITS management companies, the implications are neither large nor difficult to comprehend and usually focus on operational risk. But for others involved in the funds business, the CRD brings some unexpected issues. And these can move beyond the strictly prudential into broader conduct of business considerations.

Since all credit institutions and investment firms are covered by the CRD, service providers such as custodian banks, registrars, transfer agents and distributors may be affected. There are also some – mainly asset management groups – with a credit institution in the group. And the scope may widen further under MiFID.

Custodian banks, in particular, may need to focus on the credit risk weightings if they either make loans to funds, often as short-term overdrafts, or if they invest in funds.

When a credit institution invests in a UCITS, if the UCITS is considered as a whole, then it is treated as an investment in shares with a high risk weight in the CRD calculation. It is usually beneficial for the prudential capital calculation to be made on a "look-through" approach, taking the portfolio line-by-line. Some investors may instead ask for a calculation of the average risk-weighted exposures of the fund as an acceptable proxy.

Custodian banks are well placed to provide this data although other service providers could fulfil the function. But there are a number of conflicts which could arise.

- Custodians or data providers should seek the permission of the fund before releasing proprietary portfolio data.
- Timing of the data release is an issue. Non-public data which could be beneficial to a person trading in the funds should not normally be released. Thus any portfolio data that is released should normally apply only to half-years, and then only after that information has been publicly disclosed. If other data is requested, such as average risk-weighted data, the fund and custodian should seek to ensure the data cannot be handled in an abusive manner. It is worth remembering that release by custodians of portfolio data was at the heart of some of the US market-timing and late-trading scandals. It enabled traders to correlate funds with particular market movements.
- Special care is needed when the investor is the custodian bank itself or part of the same group as the custodian or fund manager. Appropriate conflicts policies should be in place.

The industry is faced with an issue where regulatory requirements pull it in different directions. All involved need to be very clear on the underlying principles as they consider each case on its merits.



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Investment managers prepare for Third Anti-Money Laundering Directive

The Third Anti-Money Laundering Directive was approved by the European Parliament in May 2005 with the provisions of the Directive to be transposed into national law by the end of 2007. How will this impact investment managers, and what should they be doing?

Background

The aim of the Third Directive is to consolidate the First and Second Directives, which defined money laundering in terms of organised crime, tax evasion, fraud against the EU, corruption and other serious offences, and imposed anti-money laundering obligations to key financial service providers (i.e. banks, insurance companies, independent legal professionals and investment managers). It also incorporates the June 2003 revision of the Forty Recommendations of the Financial Action Task Force (FATF) into EU law and applies to lawyers, notaries, accountants, real estate agents, casinos, trust and company service providers.

Main changes of the Directive

The Third Directive reproduces much of the Second Directive but it is significantly more detailed and increases the scope of the regulated sector. It creates a new definition of money laundering, explicitly covering terrorist financing and introduces new definitions such as for Politically Exposed Persons, Beneficial Owner, and Business Relationship and extends the regulation to those trading in goods and services who accept cash payments of €15,000 or more. A Politically Exposed Person (PEP) is someone who may involve a reputational risk or be entrusted with prominent public functions (such as Head of State, Government, senior politicians, important political party officials) and includes close family members and associates of these people. A Beneficial Owner is defined as the natural person who owns or controls 10% or more of the shares of a legal person in a company, which is not listed on an official stock exchange. A Business Relationship would be “an arrangement” which facilitates a transaction to be carried out on a frequent basis and where payment cannot be ascertained.

One of the main issues of concern is the requirement imposed on institutions to have a more detailed customer due diligence (CDD) process, in particular for

higher risk customers. This is dealt with under Article 5 of the Directive and it contains examples of when enhanced and simplified due diligence should be undertaken. Financial institutions must ensure that they are capable of risk rating their customer base in order to determine which customers require CDD.

Firms will also be required to have more detailed requirements on “know your customer procedures”, relating to enhanced due diligence for higher risk customers which in turn will incur additional training time.

Implications for investment managers

One of the primary impacts on the investment management industry will be the requirements in relation to identifying the beneficial owner. Institutions must be able to verify the identity of the beneficial owner and take reasonable steps to understand the ownership and control structure of the customer. They must obtain information on the intended nature and purpose of the business relationship, conduct ongoing due diligence on this business relationship and scrutinise any transactions undertaken throughout the course of that relationship in order to ensure that these transactions are consistent with the institution’s knowledge of the customer, the business and risk profile, including, where necessary, the source of funds. Institutions are then required to report to the public authorities if

there are any suspicions of money laundering or terrorist financing.

Internal implications

In order to comply with these requirements, institutions will have to take on a number of actions, such as ensuring proper training of personnel and establishing internal policies and procedures for CDD, reporting, record keeping, internal control, risk assessment, risk management, compliance management and communication.



Although the Directive sets out suggested procedures in establishing compliance with anti-money laundering legislation, each firm can design procedures which most appropriately suit the size and structure of the firm, which allows each firm to customise their internal training procedures to better suit their organisation. This flexibility is a key change introduced by the Directive and will enable Investment managers and other financial service providers to build Anti-Money Laundering procedures which reflect the actual risk to their institutions.

Conclusion

Implementation of the Directive will help to establish a coordinated EU-wide approach to tackling the global problem of money laundering, tax evasion and terrorist financing. It is considered that the Directive will integrate the sector and assimilate a more consistent standard of money

laundering preventative measures across the EU as well as reducing the opportunities for criminals to exploit weaker money laundering systems in other countries.

Consequently, it is recommended that institutions take the time to analyse the Directive and the potential implications for their business, in particular reviewing procedures and training requirements.

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Alternative investments in CEE – Europe’s (not so) new Eastern Frontier

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The alternatives markets in Central and Eastern Europe (CEE) are true growth markets, with investor interest and deal volumes increasing year on year. Significant developments are occurring in both real estate and private equity, and encouragingly also to the tax and legal infrastructure in the CEE region.

Real estate

The real estate markets of central Europe – particularly in the Czech Republic, Hungary and Poland – have been on investors’ radar screens for some time.

By some estimates, there are between €12-15 billion of raised investment funds, either in specific CEE funds or CEE allocations of pan-European funds, looking to invest in real estate in CEE. This compares with an annual transaction volume of between €5-6 billion in 2005. This supply-demand imbalance has had a number of impacts.

First, as with the more mature markets of Europe, the real estate markets in CEE are generally sellers’ markets. Competition among investors for properties is high, resulting in significant reductions in returns for investors, particularly in the core markets of Central Europe. This has meant that yields have rapidly converged to levels approaching those of Western Europe. As a consequence, investors are looking further east to the emerging markets of the Baltics, Russia, the CIS, Bulgaria, Romania, and other South Eastern Europe markets where higher returns can be achieved.

Second, given the difficulty of sourcing properties, investors are looking at a wider range of property types and classes. To meet this demand, there is a great deal of development in all types of property – office, retail, industrial and logistics, residential and tourism.

Third, rather than only buying standing properties, investors are also looking to get involved in projects at an earlier

stage by participating in their development or by committing to forward purchases of new properties, both to secure investment opportunities and to maximise returns.

Private equity

Private equity is now also keenly chasing opportunities within the CEE region.

It is estimated that over the last 15 years, more than €7 billion of funding has been raised by private equity funds that are dedicated to the CEE countries. In 2004, fundraising increased by 59% compared to 2003. Various global private equity funds have recently set up CEE dedicated private equity funds while others are continuing to explore the investment opportunities throughout the region. The majority of the funds raised are being invested in Poland, Hungary, Romania and the Czech Republic.

To match this demand for transactions, an increasing number of commercial banks are focusing on acquisition finance and there is enhanced activity of mezzanine funds in the CEE markets.

CEE legal challenges for alternative investment



The local tax and legal platforms are developing to address the issues typical for leveraged private equity and real estate transactions.

Over the past few years, the tax and corporate laws in all CEE countries have undergone significant developments to harmonise their local regimes with EU regulations. Though

most of these changes have not been specifically aimed at regulating leveraged transactions, they have improved the investment infrastructure for investors. Due to the relatively young history of real estate and private equity throughout the region and the consequent absence of precedents, investors need to be very careful when designing acquisition structures to be put in place.

Local tax authorities have little experience with sophisticated instruments and acquisition structures. Also, the wording of tax laws often leaves large scope for multiple interpretations. The tax treatment of leveraged acquisition structures is not yet being properly addressed in all territories. Careful attention needs to be given to the deductibility of the interest on acquisition loans and transaction expenses; the amortisation of goodwill within multi-tier structures and recently introduced loss carry forward restrictions for change of ownership/business.

With the increased competition in the region to secure deals and the enhanced availability of secure debt financing, more sophisticated acquisition structures will be implemented. The expected improvements in the tax environment in the region will bring more confidence to investors wishing to move into the CEE region.

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Pension fund governance: delivering transparent accountability

As pension funds play an ever-increasing role in society and the economy, the importance of proper corporate governance and control is growing. Pension fund governance is not just internal control but also external control which is all about delivering accountability. And that is where the annual report comes in. Here we look at the Dutch experience...

Pension funds are rapidly gaining in social and economic significance. They manage the money saved for retirement for millions of workers, pensioners, and inactive members. Through investments in (government) bonds, shares and real estate, they play an important part in financing social and economic activities. Between them, pension funds manage funds in excess of the combined value of companies listed on the Euronext stock exchange. It is partly for this reason that the financial services industry is so heavily embedded in rules, principles, directives and recommendations imposed by various regulatory bodies. It is also why proper pension fund governance has become an increasingly hot topic.

Recent developments

In the Netherlands, a number of governance initiatives have been launched for the financial services industry. In September 2004, Allen & Overy and Boer & Croon published a Dutch-language report commissioned by the Dutch Ministry of Social Affairs and Employment on "Pension fund governance, unity in diversity", to which PricewaterhouseCoopers made a contribution on delivering accountability. In response to the report, Mr De Geus, the Social Affairs Minister, in late 2004 stated that he was committed to developing a uniform code for the entire pension fund industry. He asked the Dutch Labour Foundation (*Stichting van de Arbeid*, representing Dutch labour unions and employers organisations) to draw up a plan of action specifically

aimed at modernising and defining pension fund governance. This led to the publication on 11 October 2005 of a draft set of recommendations in Dutch entitled "Principles of proper pension fund governance", which the Labour Foundation has submitted for review to the organisations represented in the Foundation. The principles are set to take effect in 2006, from which time they are to be rigorously implemented. Come 1 January 2008, pension administrators must have shaped their pension fund governance along these principles. Governance principles are also being developed for directly insured schemes, in addition to pension funds.

Additionally, the Dutch securities industry watchdog (AFM), in consultation with the investment funds sector, set up a Committee for Modernising Investment Schemes. In December 2004, this Committee issued a report setting out new ideas for investment fund governance.

Annual report

Drawing up a corporate governance code is a complex affair. A key element is for the board of directors to account for the entity's financial situation and results in the annual report. In doing so, the board must answer for the policies it has pursued in the financial year. However, the annual reports of many financial institutions leave something to be desired.

The annual report could be more effective in delivering accountability. Information is needed on the decision-making procedures and conduct of operations by pension

Interests	Stakeholders →				
	Insurees	Employer(s)/sponsors	Regulator(s)	Administrator/outsourcing partners/insurers/suppliers	Public/society/financial industry
Targeted policy and relevant safeguards	✓✓✓	✓✓✓	✓✓	✓✓✓	✓
Policy and administrative transparency	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓
Secure future pensions	✓✓✓	✓✓	✓✓	–	✓
High-income, targeted and inflation-proof inv.	✓✓✓	✓✓✓	✓✓	–	✓✓
Predictable and lowest possible premiums	✓✓	✓✓✓	✓	–	✓✓
Solid financial position	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
Conduct of business meets justified expectations	✓✓✓	✓✓✓	✓✓	✓✓	✓

Key: number of ticks indicates strength of interest Source: PricewaterhouseCoopers

funds: who has control; how are things arranged; who is involved in the process; and what role do they play?


Pension funds must, first and foremost, account for their financial situation and results in their regular financial statements. Owing to the growing number of stakeholders and great social importance of pension funds, however, the accountability requirements are becoming increasingly stringent. Today, qualitative elements must also be considered. These include pensioners' participation, board expertise and independence, communications policy, the (funding) relationship with the underlying business, the social and economic environment and the potential impact of these factors on (future) pension security.

Matrix of interests

Pension fund leaders need to have the interests of their stakeholders in mind

when delivering accountability. This is best achieved by incorporating qualitative elements that improve transparency into the Dutch Generally Accepted Accounting Principles (*Richtlijnen voor de Jaarverslaggeving*). Here we set out board accountability recommendations in a matrix of interests, which systematically maps the stakeholders and their interests.

To what extent are these recommendations already being met? Our full findings, after reviewing a number of pension fund annual reports, can be obtained in the publication below. The overwhelming conclusion is that most pension funds' annual reports can be put to much greater use in delivering accountability.

- 
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For a copy of the Dutch-language booklet "Delivering Transparent Accountability", please e-mail eefke.van.adrichem@nl.pwc.com or call (31) 20 568 42 82. Included in this booklet, but also available as a stand-alone item, is a Dutch-language checklist for pension funds and their auditors to determine whether the fund delivers maximum accountability to its stakeholders in its annual report (as tested against our recommendations).

UK distribution opens up to European funds

A number of European fund houses were active during 2005 in exploiting recent changes in the UK offshore fund tax rules to enable the selective distribution of their Luxembourg or Dublin-based funds to UK investors. This process looks set to gather further momentum in 2006.

Tax barriers to the sale of foreign funds into the UK market (a subject all to itself in the light of developing EU law against discriminatory tax practices!) are gradually being reduced. The tax rules on UK investment in foreign funds used to make it impossible to sell into the UK umbrella funds that accumulated income for the benefit of continental European investors. The recent changes now permit umbrella funds to market distributing sub-funds or share classes on a selective basis to UK investors, while maintaining accumulation sub-funds or share classes for other investors without breaching the UK tax rules. So it is now possible to use a single umbrella fund as an effective distribution platform across Europe, including the UK.

Much of the resulting activity by fund houses in this area has focused on debt and derivative based fund products – a traditional area of

investment expertise for continental European banking houses and US suppliers of fixed income products.

However, the UK offshore fund rule changes have also created a good deal of complexity when it comes to calculating the required level of income distributions (as measured under UK tax principles) by such funds. The way in which a fund accounts for and presents its returns under its local accounting policies, and how similar this is to the equivalent accounting treatment for a UK authorised fund, are key elements to a successful outcome for UK distributor status. There are particular tax and accounting challenges for funds that present their accounts under International Financial Reporting Standards (IFRS), for example Irish listed funds, but these can be overcome.

The UK market has also witnessed an increase in the range of fund-of-funds

products being marketed to investors following the introduction of the UCITS III Directive. However, the UK tax rules have failed to keep up with the changing market environment, as there are still restrictions in place that affect the ability of foreign funds to invest in other foreign funds.

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Tax consequences of IFRS for real estate in Europe

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The new accounting standards from the International Accounting Standards Board (IASB) raise the question as to the manner in which taxation of real estate will be affected. Accounting for (deferred) taxes is, of course, an area which is significantly impacted by the new standards and the deferred tax implications relating to investment properties are a significant issue.

The accounting aspects of the tax impact of IFRS are, however, only one issue – another issue is whether IFRS will also have a direct impact on corporate tax, i.e. a direct cash flow effect.

European survey on tax impact of IFRS

PricewaterhouseCoopers has conducted a survey of a number of European countries to examine the extent to which IFRS will have an impact on taxation.

This impact depends largely on whether IFRS based financial statements are used for tax purposes. In some countries, such as the UK and Ireland, the statutory accounts are the starting point for the computation of taxable profits, while in others, such as Germany, separate financial statements are used for tax purposes. As a result, the tax consequences can vary greatly in each country – from the UK position where IFRS is likely to have an impact on taxation, to the German position where IFRS will have almost no impact.

It is important to note that the ongoing policy in many countries of converging local GAAP with IFRS will mean that the underlying tax impacts will begin to affect the majority of companies in those countries over the coming years. In these countries IFRS may have a gradual impact on the manner in which fiscal regulations will develop (e.g. the Netherlands and Belgium). Even if tax treatment is based on local GAAP, the new standards could be of importance. One example is Belgium where IAS 16¹ could serve to defend the use of the

component approach for tax depreciation. Another example is the straight-lining of lease incentives (IAS 17²) in the Netherlands where it is conceivable that IFRS could be implemented also for tax purposes, if IFRS introduces certain amendments which are not covered by tax accounting principles.

Areas such as revenue recognition, bad debts, deferred consideration and interest free loans (among others), may give rise to current tax adjustments in Ireland once IFRS rules are adopted.

Given the importance of investment property, IAS 40³ (which introduces the fair value model or cost model) needs to be considered in particular detail. However, this standard cannot be regarded in isolation and its impact needs to be assessed in conjunction with IAS 2⁴, IAS 11⁵ and IAS 16⁶. If the fair value model is used, movements in fair value are recognised immediately in the profit and loss account. If the revaluations are taxable/tax deductible, such fluctuations may have a significant impact on corporate tax.


For tax purposes, most countries assess taxable gains on the disposal of such property based on the initial cost of the property, and take steps to avoid a tax charge arising on the revaluation gain, for example Belgium (temporary exemption) and the UK and Ireland (specific government statement of practice).

The challenge facing tax authorities is to ensure that revaluation surpluses cannot be distributed free of tax. In Sweden the possibility of using the fair

value model for investment property reported by legal entities (i.e. in their financial statements) has been postponed until 2009 (at the earliest). The reason for this is that the regulators felt that it was necessary to find a model to prevent the distribution of revaluation gains if such gains had not been subject to taxation. In Belgium revaluation gains are subject to the intangibility condition and are, therefore, exempt. These gains cannot, however, be distributed without triggering taxation due to this same intangibility condition.

The revaluation of real estate assets in these countries may have no immediate current tax impact, but they will give rise to deferred tax liabilities. The complexity of the new rules for calculating deferred tax, and the fact that the results are usually not as one might intuitively expect, means that this issue needs to be carefully considered.

Additional information as to how IFRS will or may affect taxation of real estate in your country is available from your local contact or:

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1. IAS 16: *Property, Plant and Equipment*
2. IAS 17: *Leases*
3. IAS 40: *Investment Property*
4. IAS 2: *Inventories*
5. IAS 11: *Construction Contracts*
6. IAS 16: *Property, Plant and Equipment*

BaFin permits launch of guaranteed funds

The first German guaranteed funds are expected to be launched shortly, following changes in how guarantees can be offered in Germany. With increasing investor focus on safety, guaranteed funds have become a growing product area.

In Germany, genuine guaranteed funds, i.e. investment funds guaranteed by a third party, have always been permitted. However, the launch of genuine guaranteed funds was prevented by the need for a guaranteeing credit institution to provide security for its guarantee in the form of equity capital. Investment companies were solely allowed to set targets and launch capital maintenance funds with a targeted upper loss limit. They were not allowed, however, to issue written guarantees of their own. For this reason, German investment companies would choose neighbouring countries (primarily Luxembourg) to offer their investors guaranteed funds under the law applicable there.

Far-reaching guaranteed schemes

The German supervisory authority (BaFin) has responded to this trend and permitted the launch of guaranteed funds in Germany where the investment company itself promises certain redemption prices. Since December 2005, companies have been allowed to submit requests for the launch of such guaranteed funds to BaFin. This means that BaFin might soon approve certain guaranteed fund schemes. The German supervisory authority has defined possible guaranteed structures broadly. Permissible schemes are single guarantees (guarantee commitments as of the end of the investment fund) and multiple guarantees (guarantee commitments with fixed, regularly recurring dates and commitments with fixed threshold values). This means that investment funds without limitation on their duration are also permitted.

Issuing new guaranteed funds or adding guarantee commitments to existing specialised funds will now be allowed. The requirements for the amount of equity capital to be provided by the companies as security are less strict than those for pension products already established in the market (*Riester* pension funds). This means that it is henceforth permissible to provide security on the basis of the amount of short cover expected at the date at which the guarantee is provided. This is in accordance with the German Banking Act as well as with the EU capital adequacy rules.

Outlook

The mathematical details of the equity related requirements and the extension to additional guaranteed structures will be discussed further by BaFin in a detailed separate circular. The investment companies' requests for approval, however, are not immediately affected by the comments yet to be provided, and the outstanding comments are no hindrance to the approval process. The market prospects for guaranteed products thus are considered to be good.

The investment fund industry therefore expects the first German guaranteed funds to be launched on the market soon. This new type of investment will also have an impact on the product ranges of European subsidiaries of German investment companies. It is likely that different forms of guaranteed funds will henceforth be launched primarily in Germany.

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Jersey adopts protected cell companies legislation

While the concept of protected cell companies is not new to offshore jurisdictions, the innovative flexible structures of Jersey's two new corporate vehicles are likely to become widely used in financial transactions.

Jersey has recently approved substantial amendments to the Companies (Jersey) Law 1991 (the Law) which will now allow the creation of Jersey cell companies from 1 February 2006. Two types of cell company are permitted under the Law, the protected cell company (PCC) and the incorporated cell company (ICC).

The PCC is a single legal entity that attributes its assets and liabilities either to the protected cell company itself or to the individual cells it creates. The assets and liabilities of the protected cell company and those attributed to its cells are "ring-fenced" from each other. The Jersey PCC legislation has been designed to address criticisms of equivalent entities established in other jurisdictions, giving certainty to investors and parties transacting with PCCs. The developments that are unique to Jersey include:

- stronger ring-fencing of assets and liabilities
- reduction of insolvency risk for cell company
- clear distinction between the cell company and the cells it creates

(and thus, clarification of the duties of the directors of cell companies)

- choice of incorporated or unincorporated cells
- ability to have cells which create shares without reference to the shares of the cell company
- rights of cells to invest directly in each other
- no statutory limitation upon uses of cell companies
- greater certainty and flexibility in numerous areas through subjecting cells to the Companies Law as if they were companies.

The ICC is a new vehicle and a further development of the PCC concept.

Each cell of an ICC is itself an individual incorporated company which can hold assets and incur liabilities in its own name without contamination of or by the assets and liabilities of another cell. The rights of the shareholders in such cells are fettered in that cell, although individual companies cannot act independently of the incorporated cell company that created them. It is expected that the combination of the umbrella of the

incorporated cell company and the separate legal personality of each individual cell will prove extremely attractive to investors seeking segregation of assets and liabilities within one vehicle while allowing those jurisdictions unfamiliar with the PCC concept to recognise and respect such segregation.

The amendments to the Law will considerably enhance the flexibility of Jersey's corporate structures and remove uncertainties or anomalies which might exist in the legislative basis for equivalent structures of some other jurisdictions. The introduction of the PCCs and ICCs are likely to be particularly attractive to those operating expert funds where the benefits can be fully utilised.

These new developments are indicative of the flexible and progressive approach being adopted by the Jersey authorities in order to support the further development of the island's finance industry.

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If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Investment Management and Real Estate publications, please contact Merryn Stewart at merryn.stewart@uk.pwc.com

IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. It is not intended to provide specific advice on any matter, nor is it intended to be comprehensive. If specific advice is required, please speak to one of the contacts below.

Continued from page: 1

Techniques and instruments – clarification that use of collateral, repos and securities lending and borrowing are allowed. The advice also defines “efficient portfolio management” to include “the generation of additional capital or income”.

Money market funds – Twenty of the sixty-six pages of text are devoted to this subject. The key issue is that, within limits, the value of units can be calculated using the amortisation method allowing the creation of par-value funds and bringing Europe into line with the US.

Caveats – There is, of course, much more detail and the debate must have been quite tough. CESR comments “the consensus reached on the eligibility of financial indices is very fragile”.

Finally, this is CESR’s advice. The Commission will draft the final clarifications, these will be much shorter than CESR’s advice. It is to be hoped that they follow the advice closely.

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