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E u r o p e a n



IMRE News

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

New business models for new asset allocations?

The start of the new millennium has heralded significant change in investment management. Equity market falls and consequent solvency issues have focused investors' attention on their liabilities (as have the new risk-based capital reporting requirements for insurers).

There has been a considerable reorganisation of assets which has included significant reallocations to asset classes that generate lower fee revenues.

Ironically, at the same time as the fee revenue pool has decreased, business pressures continue to mount:

- The burden of compliance and disclosure has expanded incessantly.
- Competition for investment management talent has increased considerably due to the realignment of asset allocations towards expanding or "new" asset classes.
- Expansion of the alternative investment universe – and hedge funds in particular – has challenged the structure of traditional long-only investment manager reward and incentivisation packages. Traditional long-only investment management firms that have developed hedge fund units have faced additional pressures.
- The business planning and administrative burden has expanded with renewed interest in performance-related fees and new forms of investment mandates, where short-run volatility in the revenue stream can give rise to considerable business issues.

At the same time, the industry has evolved and there is a greater awareness of the distribution and impact of risk. It is very likely that the drive towards the separation of alpha (the excess return over the market return) and beta (the market return) will continue. Increasingly, investors are less willing to pay high fees for broad market



02

Real estate: Too much money, too little product

Globally, there is a weight of capital that is being felt in virtually every niche of the real estate markets. This, together with a lack of investment stock, contributed to yield compression and strong capital growth in all sectors during 2004.

Markets to watch

Investment Prospects

US	Europe
Washington DC	Paris
Southern California	Milan
South Florida	London
New York	Lyon
Las Vegas	Brussels

This and other findings are included in the US and European "Emerging Trends in Real Estate" publications which are produced annually by PricewaterhouseCoopers and the Urban Land Institute. These publications analyse both survey responses and interviews with a wide range of leading real estate industry players for both the US and European markets (some of whom are quoted herein). The diversity and depth of input helps formulate a unique forward-looking insight.

European and US direct real estate investment is expected to outperform most other assets in 2005, although modest, not exciting, returns are expected for core portfolios in 2005.


Whereas in the US "the smart money is selling" into a tide of capital, those that continue to invest are betting on modest economic growth to contribute to improving supply/demand fundamentals sufficiently to outstrip any negative impact from higher interest rates. Pent up demand from institutional investors will help to sustain capital flows and bolster values as leveraged buyers back off in a rising interest rate environment.

In Europe, further slight yield compression is forecast, particularly in the faster growing economies of central Europe. "There's been a structural change in cap rates because there's been a structural shift in the investor base." Any interest rate rises will be marginal, reflecting the still weak core eurozone economies. Private buyers and syndicates are likely to continue to play a significant

role. The key area of difference in Europe for 2005 is the expected withdrawal of German open-ended fund capital – not completely, but it will no longer retain a dominant position.

In the US the "big money continues to go bicoastal". The favoured few – Washington DC, southern California, New York City and south Florida – not only benefit from good investment and development prospects, but also the best supply/demand balance. These top US markets feature global gateways with barriers to growth, solid economic underpinnings and a draw for immigrant labour forces. "Everyone wants to be in the same places." The best markets may offer only bond-like returns, but these investor magnets offer owners exit strategies and liquidity.

In Europe, the survey points to Paris, Milan and London for the best returns on a risk-adjusted basis in 2005, but it is the emerging, high risk markets of Istanbul and Moscow that feature at the top of the development prospects rankings. What is interesting is that it is not the "safe" cities that score highly in the survey's "Buy" list, but the central European capitals of Prague, Warsaw and Budapest.

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To access these publications go to www.pwc.com/realestate

UK: Clarification of new offshore fund rules

Progress has been made in the newly published (and long-awaited) Guide to distributing offshore funds, but areas of uncertainty remain.

The Guide by the UK HM Revenue & Customs (HMRC) clarifies a number of issues relating to distributor status applications, including changes introduced by Finance Act 2004:

- Separate sub-funds or share classes of funds or sub-funds are now treated as offshore funds in their own right.
- The calculation of UK Equivalent Profits (UKEP) now follows UK corporation tax rules more closely.
- The only remaining investment limit relates to investments held in offshore funds.

The Guide provides an overview of the offshore funds regime and application process, and addresses specific issues relating to both the distribution and investment tests for distributing offshore funds. It provides guidance on technical issues such as:

- application of the 5% investment test in relation to investments held in other offshore funds.
- for Protected Cell Companies, each case will be looked at on its own merits to determine whether each

cell, or the company as a whole, constitutes an offshore fund.

- where an election is made on behalf of an umbrella fund that existed prior to 22 July 2004, then all new sub-funds or share classes will be bound by it going forward.


Additionally, the Guide emphasises the importance of discussing possible breaches and late applications with the Offshore Funds Centre (OFC) at an early stage.

The new rules treat offshore funds in the same way as UK Authorised Unit Trusts (AUTs) and UK Open Ended Investment Companies (OEICs) for loan relationships and derivatives. In order for the UKEP to follow the accounts, it is therefore necessary for offshore funds to prepare accounts which are in line with the UK Statement of Recommended Practice (SORP) for AUTs and OEICs.

No guidance is given on what the position will be for funds which make the election but which are not able to satisfy the OFC that the accounting treatment is in accordance with the UK

SORP. It is therefore not clear whether failure of an offshore fund to “broadly” comply with the UK SORP would result in normal corporation tax rules being applied, such that profits taken to capital would be taxed, or whether the offshore fund would be taxed under the old income tax principles. For funds that do not make the election, the income tax rules that previously applied (subject to HMRC’s consultation on the Accrued Income Scheme rules) will be the default.

The issued guidance is a helpful step forward but we do have concerns that it does not address all the areas of uncertainty. Those promoting distributor status funds should ensure that their current practices will not create difficulties in the future.

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Opportunities abound with Irish fund law amendments

The Investment Funds, Companies and Miscellaneous Provisions Bill (published on 31 March 2005), amends Irish law in important ways for umbrella investment companies and Common Contractual Funds.

Segregated liability of sub-funds

The Bill provides for complete segregation of liability for sub-funds, specifically providing that no umbrella investment company should be obliged to apply the assets of any sub-fund towards liabilities of any other sub-fund within the umbrella structure. To avail of these facilities, the umbrella investment company must include the words “an umbrella fund with segregated liability between sub-funds” in all of its letterheads and in any agreement entered into in writing with a third party. The umbrella investment company is also obliged to disclose that it is a segregated liability umbrella investment company to any third party with which it enters into an oral contract.

The Bill provides that there will be implied into every contract, agreement etc., that any parties contracting with the umbrella investment company shall not seek to have recourse to any assets of any sub-fund in discharge of any liability which was not incurred on behalf of that sub-fund. Existing umbrella investment companies which

obtain the consent of its shareholders by special resolution may convert to avail of the benefits of segregated liability. The segregated liability provisions of the Bill are more detailed than those in other EU jurisdictions.

Cross-investment of sub-funds

The Bill proposes to allow a sub-fund of an umbrella investment company to acquire, hold and dispose of shares in other sub-funds of the same umbrella investment company.

This new provision will facilitate promoters seeking to avail of economies of scale within their own investment complexes as they can now avoid establishing separate investment companies for each asset class where they intend to cross-invest between asset classes.

Extending CCFs

The Common Contractual Fund (CCF) was introduced in Ireland in 2003 as a tax-transparent fund for pension asset pooling purposes. The Bill proposes expanding CCFs in two important ways. All institutional investors, not just

pension funds, can invest in CCFs without compromising the fund’s Irish tax transparency.

Additionally, CCFs can be used for both UCITS and non-UCITS funds (and the corresponding taxation changes are already in place). Thus CCFs can be marketed more widely and also can have more flexible investment policies, which will be of interest to promoters seeking to establish pooling structures for private equity funds, hedge funds, property funds, etc.

These new developments are indicative of the business-enabling attitude of the Irish Government and the Irish Financial Services Regulatory Authority, both of which continue to foster policies that support the further development of the investment management industry while at the same time seeking to provide an appropriate level of prudential supervision and investor protection.

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Switzerland: keeping up with changing hedge funds

05

Switzerland is a key customer base for non-traditional funds, and market and regulatory developments should ensure this continues.

The public distribution of domestic and foreign non-traditional funds benefit from a sympathetic regulator and liberal and flexible regulation. There are three commonly used structures in Switzerland for non-traditional funds. Most such funds are funds-of-hedge-funds set up as open-ended mutual funds (category "other funds with special risk") regulated by the Swiss Investment Fund Act and approved by the Swiss Federal Banking Commission (SFBC). There are also eight domestic fund-of-hedge-funds which are closed-ended investment companies listed on the SWX. The third category includes structured products typically not subject to regulatory supervision. In the last two years, the number of open-ended non-traditional funds in this special risk category has grown from 27 to 68 domestic funds and 23 to 91 foreign funds. Not included in these numbers are hedge fund registrations which due to the absence of leverage, short-selling and the use of derivatives for other than hedging purposes are not classified "with special risk".

The ability to allocate some assets to non-traditional funds in discretionary client accounts has proved beneficial. However it is fair to say that typical Swiss investors (private and institutional) are still in early days of using alternative investments and allocations are modest. The focus is on risk diversification and portfolio optimisation. Concurrently, the licensing practice of the SFBC gives risk diversification (both of strategies and managers) special attention. With the growing institutional education of investors and regulators, we are seeing

increasingly sophisticated recent product launches (e.g., directly managed multi-strategy multi-manager products and more specialised single funds). Current regulation and the SFBC are flexible enough to cope with asset management techniques and instruments typically used for many hedge fund strategies, e.g. the extensive use of derivatives, short-selling and leverage. Nevertheless, first-time registration of a new product may still require some effort and "time to market".

The proposed new federal law for Collective Investment Schemes, expected to replace current market regulation by 2007, is designed to keep pace with major fund locations in Europe and further promote Switzerland as a liberal fund market. Among proposed changes which would impact hedge funds and hedge fund managers are: qualified investor concept similar to EU-regulation; simplified prospectus; new legal forms for funds (e.g., Swiss SICAV, Swiss limited partnerships); dual approval concept (products and asset managers/promoters); prime broker (replacing domestic custodian bank) concept; elimination of required written contract for the sale of non-traditional funds; revised capital adequacy requirements to conform with international requirements. And last but not least: the fund classification "other funds with special risk" will be replaced by "other funds for alternative investments", another sign of changing attitudes.



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06

Netherlands: Major strides in investment fund governance

The governance of investment funds should be greatly improved following a modernisation review and new legislation. This will significantly change the manner in which Dutch investment funds are structured and operated.

Recommendations accepted (expected in Wft)

Management company

If the fund is managed by an external management company which is responsible for the investment policy, risk management and compliance with rules and regulation, then that company has to be appointed as the formal director of the fund.

Proxies

The 'Stichting Beleggersgiro' (legal entity which holds proxies) has to grant a voting proxy without restrictions to the investors.

Management company dismissal

Investors have the right and should have the core competence to dismiss the management company of closed-end investment companies if necessary.

Recommendations under consideration (further analysis underway)

Supervisory board

The supervisory board of every management company needs to be sufficiently independent from the management company and from related parties.

Independence of board members

A fund needs to have sufficient independent Supervisory Board members (assessed on independence and disclosed in the Supervisory Board report).

Directors' disclosures

The remuneration policy and remuneration structure of the management company for portfolio managers of the fund's assets need to be disclosed in the directors' report of any managed investment fund.

In early 2004, a sector-wide investigation ('Monitoring collective investment schemes') by the AFM (the supervisory authority of the Netherlands) noted shortcomings in the transparency and prudent working methods for investment funds, and raised questions on investment fund governance and other topics. The AFM initiated a committee for the modernisation of investment funds (CMB) chaired by Professor Jaap Winter. The committee concentrated on four main themes: 1) the Dutch trading system 2) transparency of investment fund costs 3) internal controls and the role of the internal and external auditor and 4) investment fund governance.

While some listed self-managed investment funds have to comply with the Corporate Governance (Tabaksblat) Code, others are regarded as financial products and this code does not apply. Generically, investment funds have very specific governance issues, e.g. there is almost a complete separation between management (the management company) and ownership (the investors), giving rise to a special agency problem. This is usually solved by a trustee function in the form of a Supervisory Board, allowing additional supervision of investment of the fund in the interest of investors. This trustee function is usually not available in the current structure of investment funds.

This has led to new legislation which implements the UCITS III Directive and modernises the 1990 Act supervising investment funds to *De Wet toezicht beleggingsinstellingen 2005*, hereafter

'Wtb 2005'. The Wtb 2005 and related legislation becomes effective 1 September 2005 and CMB recommendations implemented through this include: authorising external auditor appointment at unitholders' meeting; requiring a website for the investment management fund company; disclosing in directors report that internal controls (AO/IC) systems are compliant, adequately specified and effectively functioning; and disclosing voting rights policy (how votes were exercised in those companies in which the fund invests) for that financial year.

The six CMB recommendations listed in table left might be included in new legislation at a later stage, for example in the Act on financial supervision, *De Wet financieel toezich* (the 'Wft') which is expected to become effective in 2006. The first three recommendations have been widely accepted and will be implemented in the Wft. Recommendations regarding independence of the Supervisory Board and its members are currently undergoing cost-benefit analysis. An investigation into whether portfolio managers' remuneration and structures disclosure adds value is also underway. Results of these analyses are expected to be released in the second half of 2005, so improving investment fund governance will be an ongoing priority in the Netherlands.



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Revised GIPS enhance performance presentation

The revised GIPS standards will replace existing local country versions of GIPS effective 1 January 2006, further increasing transparency and enhancing the investment performance presentation framework.

The Global Investment Performance Standards (GIPS®) are ethical principles of the investment management industry for fair and transparent calculation and presentation of investment performance. So far more than 20 countries have adopted GIPS as their local investment performance standard. Since the introduction of GIPS in 1999 the standard-setters – CFA Institute (formerly AIMR) and the Investment Performance Council (IPC) – have pursued an evolutionary approach, with continual enhancements through interpretations and guidance statements. In 2004-2005, the IPC has completed a major revision of GIPS to establish the highest quality and most rigorous performance presentation framework, which will become effective 1 January 2006.

Firms compliant with a country version of GIPS will be granted reciprocity for periods prior to 1 January 2006, and can count their prior compliant history toward the required 5-year (minimum) performance track record. In this way, firms from all countries will comply with one global standard and the full convergence will be achieved. If a country adopts the revised GIPS, from 1 January 2006 the compliant firms in this country can no longer positively


assert that they are in compliance with a country version of GIPS but must state that they are in compliance with GIPS. This convergence will require education of investment management clients, in which the country sponsors of GIPS should play an important role.

Important modified or new provisions in the revised GIPS include:

- Compliant firms must make every reasonable effort to provide a GIPS compliant presentation to all prospective clients (i.e. they cannot present compliant performance selectively).
- Firms must document, in writing, their policies and procedures used in establishing and maintaining GIPS compliance.
- In GIPS terms, “the firm” can only be defined as an investment firm, subsidiary, or division held out to (potential) clients as a distinct business entity, i.e. it is organisationally and functionally segregated from other units and departments and retains discretion over the assets it manages and autonomy over the investment decision-making process.
- Applying accrual accounting for dividends (as of ex-dividend date) is recommended (not required).

- Recognising the asset or liability within at least three days of the date the transaction is entered into will still satisfy the trade date accounting requirement for the purposes of GIPS compliance.
- Beginning 1 January 2010, portfolios must be valued as of the calendar month-end or the last business day of the month while portfolio performance must be calculated on the date of all large external cash-flows.

The IPC is committed to re-evaluating GIPS every five years and has an ongoing intention of assuring relevance to the changing investment management industry. Both investment managers and their clients will benefit from the improved performance presentation framework, additional transparency and global standardisation.

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The full version of the revised GIPS as well as the relevant Q&As are available on the website of CFA Institute
http://www.cfainstitute.org/standards/pps/gips_redraft_2005.html

Guaranteed fund products, but not rules, converge

The mutual fund markets in Europe have developed from different starting points over the past decade, but there is now increasing convergence. In many countries, e.g. Germany and France, the traditional fund was a bond fund but there has been a gradual migration towards equity.



In a few – the UK stands out – equities have always dominated. For others, Italy and Spain in particular, the bull market of the 1990's attracted investors into equities in significant volumes.

Thus for many investors the bear market at the end of the century was the first they had encountered. It was an event for which the past performance data and marketing literature had not prepared them. Initially, many simply stopped investing, but more recently there has been a growing role for guaranteed funds. PricewaterhouseCoopers recently surveyed market developments in Europe.

In the past, guaranteed funds have been used as the first step away from a deposit account. They are now also being used as a way to allow investors to continue to access equity returns, but with lower risk. Belgium has a long history of the former; capital protected funds have regularly captured a quarter of the funds market, and outstripped sales of equity funds in 2002 and 2003. France, too has a long history of innovation with protected products.

In Spain, guaranteed funds are relative newcomers but have taken an astonishing market share with funds that were marketed as “deposit plus”. Protected funds have come into the Italian market too, following regulatory changes that allowed funds to offer capital protection in competition with insurance products.

Investment structures

The underlying investment structures have also changed over time. In the mid-90's funds structured via zero-

coupon bonds plus options offered reasonable returns. Changes in volatility lessened the attractions of these structures.

Today funds are likely to be based on CPPI (Content Proportion Portfolio Insurance) or to operate through an investment bank's structured note. This is leading to growing competition between asset managers and investment banks.

Because of the underlying investment strategies, few of the protected funds are UCITS. Thus there are no Europe-wide harmonised rules on the construction, naming or marketing of the funds. Generally, for a fund to be called “guaranteed” it must mean that the investor will receive their money back, including any initial charge, although whether the guarantee is continuous or at a particular point in time varies. Few funds guarantee income. However, the rules are different in each and every jurisdiction.

Similarly there are differences as to whether the guarantee must be contractual and backed by an institution subject to solvency requirements, or is merely moral.

Most jurisdictions make a distinction between “guaranteed” and “protected” funds, although this is not always written into local regulations.

A few protected funds had been structured to comply with the UCITS III Directive, but their future has been called into question by CESR's consultation paper on eligible assets. This takes a legalistic approach to the interpretation of the Directive rather

than looking at the economic consequences and is likely to have the paradoxical effect of allowing the cross-border sale of junk bond funds but outlawing cross-border sales of low risk, protected funds.

The guaranteed market is, nevertheless, not a wholly local market. Structured products can be marketed cross-border by banks. And many protected funds have underlying them a selection of non-local funds to gain the asset mix and liquidity required. This can bring its dangers to managers, as a portfolio readjustment can lead to a large outflow from an underlying fund leading to potential dilution if the fund manager of that fund is not alert to the consequences.

For investment managers the growth of guaranteed funds raises some key questions:

- Is there local demand for these products?
- Do I have the skills and controls to meet the demand?
- What are the local rules on structure?
- Are the local marketing rules sufficient to protect my brand?
- What is the reputational risk involved? Is it correctly managed and accounted for?
- If my fund is used as part of a protection portfolio, will other investors be protected from large swings into and out of the fund?

Countdown to EU Savings Directive

The EU Council for Economic and Financial Affairs (ECOFIN) met in Luxembourg on 12 April 2005 to consider, inter-alia, the progress on the signing and ratification of agreements on the taxation of savings income.

ECOFIN concluded that sufficient progress has been made agreeing measures with European third countries and EU dependent and associated territories. Therefore, the EU Savings Directive will apply to all interest payments made on or after 1 July 2005.

Broadly, the Directive applies when a “paying agent” based in an EU Member State, an EU dependency¹ or in certain third countries² makes “interest payments” to “individual beneficial owners” resident in another EU Member State. The paying agent is required to report details of the payee and the interest payment to its local tax authority. Paying agents in Austria, Belgium and Luxembourg, those in the third countries and in certain dependent territories (i.e. Jersey and Guernsey) will withhold tax on the interest payment rather than report.

It is essential that all investment funds and their service providers determine if the Directive impacts on their fund range and to what extent. Two key questions that must be resolved before 1 July 2005 are:

- Who is the paying agent and where it is located; and
- Are distributions or redemptions from the fund within the scope of the Directive?

Who is the paying agent?

The paying agent is the last economic operator in a chain of payments who ‘pays or secures’ interest for the immediate benefit of the beneficial owner; there can only be one paying agent in relation to any given payment.

In the context of investment funds, the paying agent could be the fund itself or the administrator, transfer agent, investment manager or the investor’s nominee. Given this ambiguity, it is important that fund houses and their service providers



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¹ Guernsey, Jersey, the Isle of Man, Anguilla, the Cayman Islands, Montserrat, the Turks and Caicos Islands, the British Virgin Islands, the Netherlands Antilles and Aruba.

² Andorra, Liechtenstein, Monaco, San Marino and Switzerland.

Update on hedge fund regulation and distribution

Hot off the press! The third edition of PricewaterhouseCoopers' guide "The regulation and distribution of hedge funds in Europe: Changes and challenges" has just been published. Key findings will be discussed in the September issue of IMRE News. To obtain your copy, please contact:

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review their respective roles in relation to investor payments to determine whether or not they would be regarded as the paying agent.

Is the fund in scope?

In determining whether the fund is within the scope of the Directive, it is important to note that ECOFIN also confirmed that:

- the 15% debt investment threshold, which is relevant in the case of fund distributions, like the 40% threshold which applies in the case of redemption payments, is to be calculated on a direct and indirect investment basis. Unlike the 40% test, however, the 15% test only applies to UCITS funds; and
- interest accrued pre 1 July 2005 will be excluded.

In addition, certain countries such as the UK and Ireland have indicated that they intend to apply a "UCITS equivalent" test to determine whether funds established in EU dependencies, such as the Cayman Islands, are within the scope of the Directive when a paying agent in their territory is involved. This approach goes beyond the wording in the Directive but it is consistent with the EU's treaties with dependencies which include payments from locally established funds only to the extent the funds are "UCITS

equivalent". The "UCITS equivalent" test will not apply to funds situated outside the EU dependent territories (e.g. Switzerland, Liechtenstein, US, Bermuda, Hong Kong, Singapore, etc). Funds established in these territories would in principle be within the scope of the Directive if they invest in debt-claims regardless of whether they are "UCITS equivalent".

The comments above highlight only a few of the complexities that must be considered in determining if funds are within scope. As individual countries issue guidance notes and conclude their own interpretation of concepts within the Directive (e.g. UCITS equivalence, etc.), the complexity will only increase. As investors begin to demand clarity of whether a fund is within or outside the scope of the Directive, we anticipate that a growing number of funds will need to provide such confirmation in their fund's annual financial statements.

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Wide ranging changes for UK fund taxation announced

11

The HM Revenue and Customs (HMRC) have announced measures to reform the taxation of collective investment schemes and the tax treatment of investors in certain schemes. Implementation of these rules was delayed by the 5 May UK General Election.

The main changes aim to prevent the use of certain collective investment schemes for tax planning and to align better a fund's distributions with the nature of its underlying income. The key announcements are:

- the introduction of anti-avoidance rules where an investor holds a substantial interest in a Qualified Investor Scheme (QIS);
- the possible extension of the anti-avoidance rules to investors holding a substantial interest in any type of authorised fund; and
- the introduction of streaming rules to align a fund's distributions with the underlying nature of its income, which will allow funds to make both interest and dividend payments in a single distribution period.

Substantial investors taxed on mark-to-market basis

In its December 2004 Pre-Budget Report the UK Government announced its intention to implement a measure to restrict the application of the favourable taxation regime for authorised investment funds to those funds where no investor holds more than 10% of the fund. The potential impact of these proposed changes has caused significant concern within the investment management industry.

In response to significant industry lobbying, HMRC has shifted the focus of the anti-avoidance rules from the fund itself to the investors, and secondly, has seemingly adopted a more targeted approach by confining the anti-avoidance rules to investors in QIS funds. Investors in such funds that

hold more than 10% of the fund, together with their connected parties and associates, will be subject to tax on increases in the value of their fund units/shares on an annual mark-to-market basis. Such an increase in the value of the fund's units/shares will be taxed as income rather than as a capital gain. This tax treatment is disadvantageous as it taxes gains not yet realised by the investor and denies the investor access to taper relief and annual exemption (UK individuals) or indexation allowances (UK corporates). The position for non-resident investors in such funds remains unclear.

The draft legislation released also permits the exemption of certain types of investors such as pension funds, charities, and companies carrying on life insurance. However, the position of other institutional investors remains unclear, for example, fund-of-funds and investment trust companies.

The draft legislation released also enables HMRC to extend any anti-avoidance provision to cover substantial investors into any UK-based funds. However HMRC has decided to consult more carefully before extending the anti-avoidance rules to investors holding substantial interests in other types of authorised investment funds.

New distribution rules

Changes to the distribution rules for authorised investment funds have been announced which will allow funds to make interest and dividend distributions in the same period. These payments would be in proportion to

the interest and other income received by the fund itself. Funds would, however, be able to elect to distribute all income as dividends.

The current tax system enables UK funds to make interest distributions if the assets of the fund are more than 60% held in cash, bonds and similar investments throughout the distribution period. Interest distributions are deductible in arriving at the fund's tax liability and no tax is generally paid within such funds. Such payments can be paid gross to certain investors including pension funds, ISA holders, companies and non-residents. HMRC appears to be concerned that funds would seek to pay interest distributions where there is a mix of cash/bonds and other investments such as real property within the 60/40 limit.

Although the detailed regulations have yet to be announced, these changes (anticipated for 2006) will clearly have a significant impact on systems for fund promoters if they wish to continue to provide their investors with the most tax efficient investment returns.

In overview, while the UK authorities have indicated their willingness to listen to industry concerns over the proposed changes and a further period of consultation is expected, the ongoing uncertainty over the taxation treatment for UK funds may well discourage promoters from choosing a UK fund platform.

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Turkey: Transformation of investment income taxation

Non-resident foreign investors are among the most affected by the new tax law which brings fundamental changes to the taxation of portfolio investment income between 1 January 2006 and 31 December 2015.



Flashline

Netherlands: attracting foreign investors

A tax bill is expected to be put forward to the Dutch Parliament in summer 2005 which will abolish Dutch capital tax as from 1 January 2006 and amend the conditions for the Dutch tax regime for Dutch fiscal investment institutions (including Dutch REITS), according to a Ministry of Finance press release of 24 March 2005.

The press release mentions several ways Dutch fiscal investment institutions may be made more attractive to investors. These include dropping the distinction between listed and non-listed Dutch fiscal investment institutions and abolishing several specific limitations for foreign shareholders of Dutch fiscal investment institutions.

Additionally, the press release discusses how the profit distribution requirement with its great administrative burden is a deterrent to foreign investors. Although the press release does not confirm its demise, this is a signal that the profit distribution requirement in its current form is being reconsidered.

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Details of the new law, which was enacted by the Turkish Parliament and published on 31 December 2004, are as follows:

- The new law brings a temporary provision to the current Income Tax Law (ITL), which will be applicable between 1 January 2006 and 31 December 2015 and changes in the Corporate Tax Law (CTL). For the income that is not covered within these new rules, permanent ITL and CTL provisions will be valid.
- The basic approach of the new law is to change the taxation of capital gains derived from securities except Turkish Eurobonds and other capital market instruments that are defined by the new law. For those instruments that are not covered by the temporary provision, the permanent ITL and CTL provisions will be valid. The position of OTC transactions is not clear and this needs further clarification by the Ministry of Finance (MoF).
- Instead of the current self-declaration mechanism, the new law brings an income withholding mechanism to be applied by local banks and brokerage houses, at a flat rate of 15% on capital gains and interest income. However, a number of types of investors would no longer be required to file any tax declaration for the said income and 15% withholding tax would be the final taxation in Turkey. This would be the case for individual investors, foreign corporate investors that do not have any fixed place of business or permanent representative in Turkey and foreign corporate investors that have a permanent representative in Turkey but whose Turkish sourced income will solely be composed of income taxed through the new temporary provision of the ITL.
- The responsibility to compute, declare and pay the taxes on a quarterly basis will belong to the local banks and brokerage houses that act as intermediary. For OTC transactions which would involve transfer of securities from one account to another account held at the local custodian, the responsibility of the local custodian is not clearly set out, and needs to be clarified by the MoF.
- In computing capital gains, the FIFO method will be applied. Quarterly losses arising from the disposal of the same kind of instruments will be deducted in computation of the withholding tax base but will not be carried forward to the following years.

For investors that use different local brokerage houses and local banks, the actual costs are to be notified to the local brokerage house or local bank through which the sale is made. In practice this may lead to the use of a single intermediary.

- Income generated from the newly established Turkish Derivatives Exchange (Turkdex) has been exempted from taxation in 2005. Moreover, for 2006, instead of 15% withholding tax, 0% withholding tax will be applied and there would be no further taxation. Commencing from 2007, income derived from derivatives in Turkdex will also be subject to 15% withholding. However, there are significant grey areas regarding the application of 15% from 2007 and onwards which need further clarification by the MoF.

The group most significantly affected by the new tax rules will be foreign investors who used to benefit from the non-resident investment fund status, an exempt status which has been applied by many corporate foreign investors since the mid-1990's. At this transition period, whether the non-resident investment fund status will continue to be valid and the

implications for investors who currently benefit from this status are not crystal clear. However, even if it is assumed that this status continues to be valid (which seems rather unlikely to us) it will not be as beneficial as previously due to the application of 15% withholding at source regardless of the fund being type A or B (type A have more than 25% Turkish equities on a monthly average basis, B less).

Therefore, foreign investors need to re-evaluate their current structures. Foreign investors would still be able to benefit from the relevant double tax treaties signed with Turkey. However, we would strongly suggest reviewing the mechanics of the actual transactions which give rise to treaty benefits in order not to face any challenges by Turkish tax authorities.

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Challenge for real estate investments in France via Luxembourg

Subsequent to the enforcement of the new income tax treaty between France and Luxembourg which is now under negotiation, the once widely used real estate investment structure in France – using a Luxembourg company as the investor – may be facing a genuine challenge.



Background

The taxation of rental income is exclusively attributed to the state where the assets are situated, according to Article 3 of the current treaty between France and Luxembourg (signed 1 April 1958, amended 8 September 1970). However, a different viewpoint was taken by the French tax authorities as per a published Doctrine dated 11 August 2000, in combination with a French Supreme Court Case dated 18 March 1994. From the French side, when the income is realised by an entity which derives commercial and enterprise income which – under French tax rules is the case when the income is realised by a corporation – the income is taxable in France only if the Luxembourg entity has a fixed place of business in France. The French tax authority also confirmed that, in the absence of a fixed place of business, capital gains derived by Luxembourg tax residents are also exempt from both French corporate income tax and withholding tax at source of 33.33% under article 244bis A of the French tax code. In other words, income and capital gains derived by a Luxembourg company from real estate located in France is not subject to tax in France, unless the income in question is attributed to a permanent establishment there. Therefore this Doctrine expressly states that the mere ownership of a

real estate asset does not constitute a permanent establishment. As such, rental income and capital gains derived by a Luxembourg company owning a real estate asset in France are not taxable in France.

On the other hand, the Luxembourg tax authorities considered that since the French tax authorities renounce their right to tax the income, it should be taxed in Luxembourg instead. This position was brought to the Tribunal Administratif of Luxembourg in December 2001 by a plaintiff company for a claim against tax assessments from 1995 to 1997, in which the rental income of a French immovable property was subject to Luxembourg income and net wealth tax irrespective of the fact that articles 3 and 20 of the treaty provide for an exemption in Luxembourg. This is the famous "La Costa" case.

However, this position was rejected by the Tribunal Administratif of Luxembourg. The Tribunal considered that the treaty allocates the right to tax capital gains and income from real estate to the state where the property is situated (Article 3). The fact that France does not make use of its taxation right does not allow Luxembourg to tax the income, and the current interpretation of the treaty by Luxembourg should not be affected by the decision made by the French authorities. The Tribunal emphasised

that the international tax treaty provides for limitation and allocation of taxation rights between contracting states. The principles laid out in the tax treaty override domestic laws and regulations and therefore should be respected by one state (i.e. Luxembourg) even if the other state entitled to the right to tax (i.e. France) does not levy tax on the income taxable in its jurisdiction according to the treaty.

Continuing use of Luxembourg entities?

Since the two countries have divergent interpretations of the treaty, Luxembourg investment vehicles are often used to hold real properties in France as the income and capital gains would be tax exempt in both countries. The only constraint is that Luxembourg should avoid creating a permanent establishment in France, for example, it should not develop the real estate or conduct asset management activities via dependent parties there.

Possible amendment of the treaty had been discussed, with the negotiation of a new tax treaty between France and Luxembourg under way for a few years and then halted for a while. It should have restarted in early 2005, but the situation is still stagnant and the negotiation is yet to be kicked off. It is believed that the new treaty,

supposedly based on the 2003 OECD model income tax treaty, will subject rental income and capital gains derived by Luxembourg entities directly investing in real estate in France to tax even if no permanent establishment has been constituted. However, the issue of the right to tax the gain from the alienation of shares in French real estate companies by Luxembourg is still unclear. Meanwhile, such gain would be exempt in France as per Article 18 of the treaty and also in Luxembourg if the conditions under the domestic participation exemption regime were fulfilled.

The road ahead

Companies having a Luxembourg-France real estate investment structure should keep an eye on the development of the new treaty and start looking for an exit route if required. One possible strategy would be to contribute all the assets and liabilities (i.e. the real estate properties) of the Luxembourg entity to a French joint-stock company before the new treaty is enacted. However, situations differ and professional advice should be sought to tailor-make the strategy to the needs of different companies.



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Highlighting discriminatory tax treatment for pension funds

Tax has been identified over the years as a major obstacle to the efficient operation of pension schemes within the EU. The European Commissioner for Taxation and Customs Union has recently received two reports on discriminatory tax treatment in respect of pension funds.

These were prepared by the European Federation for Retirement Provision (EFRP) and the EU Direct Tax Group of PricewaterhouseCoopers. Both groups are currently preparing formal complaints together with the EC on the discriminatory treatment of pension institutions in respect of cross-border transfers of pension capital and payment of dividends and interest to foreign pension funds.

Cross-border transfers of pension capital

EFRP found that a number of Member States have legislation which may be in breach of the EC treaty.

The report commented that when transfers of pension capital occur between two domestic funds they are tax-free but in many cases when pension capital is transferred into a cross-border fund, tax is levied. Some Member States even operate a straightforward ban on cross-border transfers of pension capital while allowing tax-free domestic transfers.

Such provisions could constitute an obstacle to the free movement of workers and of capital and a breach of the principle of the free provision of services by pension funds.

The EFRP report highlights that some Member States already have appropriate legislation and do not tax cross-border transfers of pension capital. Some others are planning, as part of the implementation of the Pension Fund Directive, to make such transfers tax-free. However, some Member States tax cross-border transfers of pension capital severely and some even tax inward cross-border transfers.

An attempt to tackle this area could encourage Pan-European pension schemes to develop.

Cross-border pension investing

PricewaterhouseCoopers concluded that differing treatment between domestic and foreign pension funds may be in breach of EU law; in particular, it could be contrary to the free movement of capital and payments.

In many Member States, interest and dividend payments to local pension funds are either not subject to withholding tax or the local pension fund can benefit from a refund of the tax withheld. Many of these Member States do not allow the exemption or refund for pension funds established elsewhere in the EU. As a result, dividends and interest paid to foreign funds are taxed more heavily than those paid to domestic funds.

Where UK pension schemes have suffered significant amounts of irrecoverable European tax, the trustees of the scheme should consider lodging (and may have a fiduciary duty to lodge) anti-discrimination claims to recover these taxes.

It is likely that this area will develop further over the near future and could lead to significant improvements for pension fund investors.

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Probing hedge fund pricing and valuation practices

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AIMA's unique global survey, "Asset Pricing and Valuation Practices in the Hedge Fund Industry", enhances understanding of the issues associated with valuation, as well as formulates recommendations for current practices. PricewaterhouseCoopers is proud to be the lead sponsor – some highlights follow:

The survey comprised both quantitative (questionnaire) and qualitative interviews with institutional investors, managers and service providers (including prime brokers, administrators and auditors). In total the research included 92 organisations globally which manage \$58bn (unlevered), invest/allocate \$72 bn (unlevered) and service \$420 bn (the latter being more than half of global industry assets).

The survey has confirmed the commonly-held view that the hedge fund industry is not only growing in size but in sophistication and maturity. In addition to the survey there is a number of recommendations on governance, transparency, procedures and valuation models.

Survey highlights

Pricing sources were seen by 41% of respondents as the main challenge to pricing instruments including availability, accessibility, quality or timeliness. For OTC instruments, US institutions prefer to source information from independent brokers and marketmakers, while European firms tend to use information provided by counterparties to the specific OTC transactions. Keeping this in context, however, 92% of respondents' hedge fund portfolios positions are priced by

Strategies which may give rise to pricing/valuations issues

Strategy	% of respondents believing	actual % of hedge fund market (\$) **
Distressed debt	35%	3.18% (\$30.9 bn)
Fixed income/arbitrage	18%	4.22% (\$41.0 bn)
Convertible arbitrage	17%	3.36% (\$32.7 bn)

** Source: www.hfr.com (28.1.05)

recognised industry sources. The most frequently cited illiquid instruments were complex derivatives (28% of respondents), mortgage-backed securities (12%) and distressed debt (12%). The table above gives the strategies most frequently cited as "potentially" giving rise to pricing and valuation issues; however, note that all three strategies represent just over 10.76 % of the hedge fund market.

Based on the findings of the survey, a number of recommendations were made, such as:

- A summary of practical and workable pricing and valuation practices and procedures should be documented, approved by the board of directors, trustee or general partner of the fund and reviewed on a regular basis.
- The NAV of the fund should be produced by parties who are not involved in the investment process of the investment management entity.

- The pricing and valuation policy should explicitly clarify the role of each party in the valuation process.
- The decision to use a pricing model rather than a market price in determining an asset value should be properly justified.
- Where necessary, NAV calculations should be subject to appropriate checks and balances.

It has always been paramount that investors fully understand the strategy that the manager is trading and are cognisant of the pricing methodology applied to funds' portfolios. The results of this research will be a useful general resource to hedge fund investors and an important step in enhancing industry practice.



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The full Executive Summary of this survey, which expands on the article above, may be obtained on the AIMA website www.aima.org

Is Europe losing enthusiasm for the REIT?

The development of Real Estate Investment Trust (REIT) type vehicles in Europe has been in the news on a regular basis in recent years. However, in the last two months, the news has been less positive.



Flashline

A brighter future for UK investors in the US?

The UK and US tax authorities have reached an agreement to extend treaty benefits to a wider range of pension fund investors. In an agreement backdated to 1 May 2003, the nil withholding tax rate applicable to direct pension scheme investors is extended to pension schemes invested in the US via UK-based exempt unauthorised unit trusts and UK life assurance pension businesses. Previously, pooled vehicles suffered withholding tax of 15% or more on US dividend receipts.

Although the new agreement will increase the number of UK pooling arrangements able to obtain full treaty benefits, the tax authorities have imposed conditions. In particular, the trust deeds of exempt unauthorised unit trusts will need to limit membership to UK pension schemes, while only certain unitised life assurance businesses will be eligible. In addition, all vehicles still need to meet the Limitation of Benefits provisions of the double tax treaty. These requirements mean that in practice the industry may still have to amend pooling structures for US investments to facilitate treaty access.

In 2003, France introduced a new REIT-type vehicle, the Societe d'Investissement Immobiliers Coteés (SIIC). This created a listed property investment company exempt from tax on its rental income and capital gains, provided that it distributed annually a minimum of 85% of its rental income and 50% of its capital gains. The conversion charge on unrealised gains of approximately half the tax due if charged at normal rates, which can be spread over four years, was sufficiently attractive to encourage qualifying companies to convert. The resulting tax-exempt vehicles were attractive to buyers, resulting in significant takeover activity since introduction in 2003. Changes introduced in December 2004 with effect from 1 January 2005 added further to the attractiveness of the SIIC. In particular, the changes allow corporate taxpayers to contribute real estate assets in exchange for the issue of shares in a SIIC, the gain arising being taxed at approximately half the normal rates. Enthusiasm from local and overseas investors has been considerable.

The original reforms in France provoked a flurry of responses elsewhere. In particular, the UK and Germany both announced that they too were considering the introduction of REIT-type legislation. This in turn had a knock-on effect on the investment management industry, with a number of fund managers investigating the possibility of fund-of-fund and fund-of-REITs products.

Unfortunately, both the UK and Germany are approaching the process of REIT implementation in a more measured manner than France and in the process have identified a number of technical difficulties that are currently in the process of consultation. As a result, introduction of the REIT-type vehicles has been deferred in Germany and the UK until (at least) 2006. The key issue appears to be the potential loss of tax revenues in respect of income earned by non-resident investors. According to press speculation, France has somewhat belatedly identified the same problem. The issue arises from the fact that corporate entities are entitled to the benefit of double tax treaties. Under most existing treaties, distributions from REITs would be regarded as dividends eligible for reduced rates of withholding tax. The treaties do not typically have the mechanisms that the US has generally negotiated into its treaties to preserve taxing rights when the underlying source is immovable property. Coupled with the tax exemptions in the REIT, the typical European treaty provisions would result in very low overall rates of tax on foreign investors.

In practice, after the effects of efficient tax structuring, foreign investors often pay relatively low effective rates of tax on property investment anyway, so it is not clear how much of a loss of revenue there would be in practice. Further complexity is added by European Union anti-discrimination

provisions which further limit the options for reducing the apparent loss of revenue. It also raises some interesting questions regarding the compatibility with EU anti-discrimination legislation of existing REIT-type regimes in the form of the Belgian SICAFI and Dutch FBI. The authorities in Germany and the UK are actively seeking solutions to the issue of lost tax revenue from non-resident investors. PricewaterhouseCoopers is actively involved in the consultation process in both countries, and the governments in both countries will hopefully allow the long-term benefits to overcome the short-term practical difficulties.

On the positive side, in both the UK and Germany, the views expressed by industry during the consultation process have been taken on board, and there seems to be a general move away from regulation to govern REITs to a market-driven approach. Despite the delay in their introduction, the result should therefore be more flexible and thus ultimately more useful investment vehicles.

As mentioned above, one of the side effects of the media attention given to REIT-type vehicles was a flurry of activity concerning fund-of-fund and fund-of-REITs products. There was some suggestion that the fund-of-local-REITs might replace the current pan-European property fund model as the favoured investment route,

particularly for funds lower down the risk/return spectrum. The delay in REIT legislation in Germany and the UK appears to have dampened enthusiasm for launching funds to invest in them and attention in recent weeks has been squarely back in the direction of more traditional pan-European fund offerings.

The creation of REIT-type vehicles in other markets, notably the US and Australia, arguably provided the impetus that makes those markets dynamic today. The experience in France suggests that the development of REITs in Europe would also prove bracing for local markets. However, enthusiasm in the markets is not matched to the same degree by governments that see a concerning loss of revenue. Early predictions of a bonanza in Germany and the UK are now being tempered with realism, and the introduction of REITs is likely to be slower and more complicated than many had hoped. However, based upon the experience in the US and Australia, this is a long-term gain and in the grand scheme of things, a delay until 2006 while governments resolve technical difficulties should not be an undue concern to industry.



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exposure (which they can achieve through low cost vehicles) and more willing to focus fees on those investments which offer the opportunity of alpha for the same level of risk. Within this environment, significant future institutional flows are likely to be directed towards alternative investments with continuing capital reallocation from traditional long-only asset classes.

Investment managers need to adapt to this changing market environment. But by how much and in which direction will vary – standing still is not an option in today's competitive market place. However, efficient and effective change can only be delivered through both acknowledgement of the limitations of the existing investment service offerings and understanding of the structure of the broader institutional market and how it is likely to develop.

The threat from managers of alternative investments will continue to increase as their business models and infrastructure evolve to appeal more to mainstream investors. As such, the opportunities for the future lie in understanding fully the structure of the institutional market and likely future trends in:

- the expansion and contraction of asset classes
- the development of institutional market segments and opportunities (beyond the traditional core)
- the development of new service offerings.

The successful investment managers of the future will be those which actively embrace change and realign their business models in anticipation of the evolving market.



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