

September 2005

E u r o p e a n



IMRE News

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

Opportunity knocks for UCITS funds

Following the EFTA¹ Court decision in the Fokus Bank case, UCITS funds that suffer withholding tax on overseas EU dividends should, in many cases, be able to reclaim all tax suffered (including tax withheld under tax treaties).

Reclaiming all withholding tax suffered on EU dividends could provide some UCITS funds with an additional 30 to 60 basis points of investment return annually as well as possibly a one-off boost to fund performance if prior years' taxes are reclaimed. The EFTA Court's opinion will impact on European jurisdictions such as Belgium, Denmark, France, Germany, Luxembourg, Netherlands, Spain and Italy, which currently operate dividend tax regimes similar to the Norwegian system at that time.

The Fokus Bank case concerned distributions from a Norwegian company to its non-resident shareholders. The Norwegian depository bank (Fokus Bank) did not withhold tax on the dividends, as the registered shareholders were Norwegian residents. The tax authorities held that because the beneficial owners of the shares were UK and German residents, Fokus Bank was liable for taxes it should have previously withheld.

At this time, Norway applied an imputation system for dividend taxation in domestic cases; resident shareholders were granted an imputation credit amounting to the tax on received dividends so that effectively, the dividends were tax exempt. However, non-resident shareholders were subject to a final withholding tax on Norwegian dividends and were not granted an imputation credit.

The EFTA Court decided that this practice constituted a restriction on the free movement of capital within the EEA because it could deter non-residents from investing in Norwegian companies and also prevent Norwegian companies raising capital outside Norway.

Continued on: back page

1. European Free Trade Association

Fund management companies: In or out of MiFID's scope?

The Markets in Financial Instruments Directive, known as MiFID, is rightly perceived as one of the key pieces of regulation of this decade impacting the financial services industry and will affect fund management companies in more ways than they anticipate.

The scope of transformation induced by MiFID is such that market participants have persuaded the European Commission to postpone by one year its effective date of application, originally foreseen for April 2006. In this context one key question for investment fund managers is: "Are we in or out of MiFID's scope?"

MiFID will replace the current ISD and regulates the authorisation, behaviour and conduct of business of investment firms and markets, including exchanges. The Directive, complemented by a series of technical advice given by CESR, contains detailed requirements on the organisation of investment firms and strict rules of conduct for the provision of investment services to clients. These include requirements relating to information to clients and suitability and appropriateness of services or products for clients. It also sets duties in order to identify, manage and prevent or otherwise disclose conflict of interests, as well as demanding standards for "best execution" of clients' orders.

In or out of scope?

Article 2 of MiFID excludes from the Directive collective investment undertakings and the managers of such undertakings. Nevertheless, it would be a mistake to conclude from this exemption that the Directive will have little or no implication for fund managers. Indeed, there are three main reasons why MiFID should be of concern for fund managers.

Firstly, fund management companies are dealing with a series of third parties such as brokers, portfolio managers, investment advisers and distributors that are within the scope of MiFID. New requirements affecting these parties will have important implications for fund managers in both the investment and distribution cycles.

Secondly, despite this exemption for fund managers, Article 66 of MiFID foresees that its requirements relating to capital endowment, organisational standards and rules of conduct will apply to fund management companies for individual portfolio management

and investment advice. Fund management companies providing such additional services will thus be subject to two sets of rules.

Thirdly, though MiFID does not directly apply to the provision of collective portfolio management services by management companies, the EU Commission's Green Paper on the enhancement of the EU investment funds' framework refers to MiFID as a "useful tool box" to clarify all duties of care and risk warning. This clarification could also serve as a basis to improve the distribution process of UCITS via its rules on management of conflicts of interest and on "best execution".

Thus, whether its implications for fund managers are direct or indirect, MiFID should definitively be on their compliance and business radar screen.



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Fund distribution: Is transparency enough?

03

While transparency initiatives are to be encouraged, investor education and recognised qualifications for financial advisers are also needed.

In the Green Paper for EU investment funds, eight of 18 questions related to fund distribution. In the priority actions, the key tools to enhance the functioning of the European Market and reduce conflicts of interest in fund distribution are: transparency, comparability, code of conduct and MiFID. The two main potential conflicts identified are distribution of in-house products and when the advice of an independent distributor is biased by receiving higher retrocessions from certain funds. Surprisingly, the questions of sufficient competition in distribution, standardisation of industry processes and competition from substitute products with lower regulatory requirements are seen as longer term challenges.

Switzerland has gone further than the proposals in the Green Paper. After much debate, in June the Swiss fund association released binding guidelines on the disclosure of the administration, asset management and distribution components of the management fee. The Swiss recommendation covers eligibility of distributors and a rule that admissible distribution expenses and trailer fees may only be paid from the distribution component of fund expenses. Domestic funds had to comply with these guidelines by 1 August 2005 and foreign funds by end December 2006.

In business generally, there is a discernible linkage between the service received and the price paid. However, an investor neither sees the link between the fee he pays to the distributor and the service he receives nor does he know whether the fund he bought really suits his needs.

While transparency is the cornerstone of both the EU and Swiss initiatives, it is merely the first pillar. The industry's stakeholders (i.e. producers and distributors, regulators, fund associations, advisers, journalists, etc.) need to cooperate to develop the second and third pillars of a "good distribution model", namely a) investor education and b) a standardised and harmonised European system for the status of financial advisers.

With pension deficits, education on savings products is a priority for all European countries. Investor education is essential to understand all the information available from successful transparency. Research carried out by ICI in the USA shows that the more people are educated, the more they hold investment funds and the more they ask for advice. In addition to product education, financial advice is needed to inform clients as to the types of service available and the financial adviser's added value to clients.

Europe lacks a profession equivalent to a "family financial doctor". Confusion surrounds the official status of various types of adviser and their distinction versus traditional high-street bank services. Investors would benefit greatly from a widely recognised qualification and a harmonised European legal status for financial advisers.

By having transparent products and services, recognised advisers and more educated investors, the functioning of the European market will improve.



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Flashline

UCITS III: Eligible assets not yet resolved

CESR has taken into account the number and complexity of the industry's answers to its technical advice on eligible assets and decided to consult stakeholders for a second time as from October 2005. Final advice to the Commission should consequently be published at the beginning of next year (instead of this autumn, as initially foreseen). While the importance of interests involved definitely warrants such an extended reflection period, this also means that the current uncertainty regarding eligibility of certain assets remains, leading different regulators to adopt varying positions.

Other hot topics are being discussed at the European level. The Commission has, in its Green Paper on the enhancement of the EU framework for investment funds released in July 2005, revealed its main priorities: assessing the national implementation of (i) CESR's guidelines on transitional provisions (released in February 2005) and (ii) Recommendations of the Commission on Derivatives and Simplified Prospectus (released in April 2004), simplifying the notification procedure for passporting UCITS and improving the information given to investors (by better disclosing fees and charges).

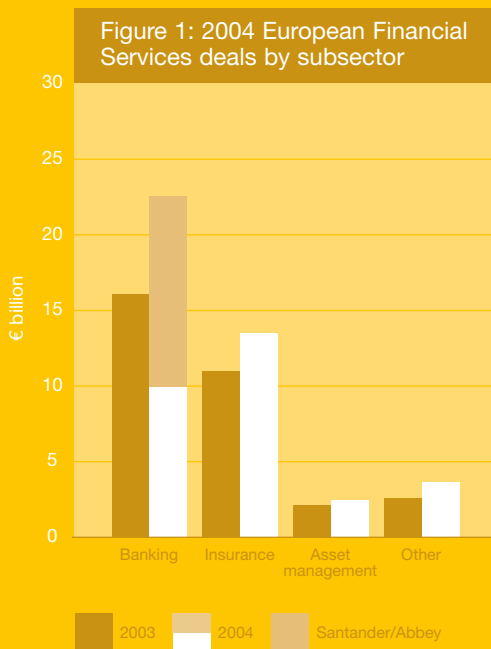
In the medium to long term, the Commission is expected to tackle: the management company and custodian passports, the interactions between UCITS and MiFID on the promotion and distribution of UCITS and investor protection.

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04

Is M&A in European asset management overdue?

For a number of years the consolidation of the European asset management sector has been widely predicted. Restructuring by institutional asset managers, interest from overseas institutions and new interest from private equity houses may shortly lead to a pick-up in deal volume in the sector.



Source: mergermarket and PricewaterhouseCoopers analysis

In the PricewaterhouseCoopers 2003 Global Investment Management Survey, over 80% of respondents stated that consolidation across the industry was expected (particularly in Europe) and was much sought after. However, this has not yet materialised and the level of recent deal activity remains low, but there are some indicators that suggest that this might change in the near term.

In the 2005 PricewaterhouseCoopers Global Private Banking/Wealth Management Survey, 43% of participating chief executive officers stated that they will change their relative shares of the European market through acquisition. Mergers and acquisitions have grown in importance as wealth managers seek to increase their product capabilities, achieve economies of scale in existing geographies and expand into new ones.

Despite this enthusiasm, European asset management was the least active financial sector (FS) in 2004. As shown in Figure 1 from the recently published PricewaterhouseCoopers Financial Services M&A 2005, European FS deal activity during 2004 increased by approximately a third in terms of announced deal value (€44.8bn) compared with 2003, and we expect this upward trend to continue. There were €3.1bn of European Asset Management deals in 2004 (accounting for only 6.9% of total European FS deals by value) although this represented growth of 15% compared to 2003 (€2.7bn). We anticipate that an increase from this level of asset management activity will be driven by two factors:

1. Corporate M&A activity

European asset managers are currently facing a number of different challenges, including continuing pressure on margins in traditional product areas (e.g. from open architecture) and concerns over conflicts of interest across the industry. The pressure on traditional European institutional players has also been driven by the increased focus by their client base on absolute returns rather than relative returns against a benchmark. This is seen by the trend to move to specialist mandates, the increased power of investment consultants (particularly in the UK and the Netherlands) and more active management from pension fund trustees.

These pressures are leading institutional asset managers to re-evaluate their strategies which may result in business restructuring. This may lead to increased M&A activity as financial institutions and asset managers seek to re-focus their activities through the disposal of non-core functions, acquire niche specialists (such as hedge funds) or bulk-up core activities through acquisition. Deals such as the sale by Deutsche Bank of parts of its UK and Philadelphia-based asset management businesses to Aberdeen Asset Management (for up to €385m), the €1.1bn acquisition of F&C by ISIS in 2004 (which created the fourth largest UK-based asset manager and a top ten manager of pension funds in Europe) and Insight Investment Management Limited's acquisition of Rothschild Asset Management for approximately €94m in 2002 (in order to gain exposure to fixed income

products) are good examples of this trend.

In addition, European asset managers will continue to be a target for overseas players seeking to increase their exposure to the European market such as MassMutual's €383m acquisition of Baring Asset Management from ING in 2004.

2. Private Equity M&A activity

In recent years Private Equity (PE) funds have been getting larger

following a greater focus on alternative investments, resulting in a significant increase in the amount of money PE funds have to invest.

To date, this has not driven a major increase in the number of investments in financial services. However, the number of PE houses showing an interest in the sector and looking actively at deals is increasing: in 2004 four of the top ten European financial services deals announced were PE-backed and in 2005 Tilney Asset

Management has been acquired by Bridgepoint Capital. We expect this trend to continue over the next 12–24 months as PE houses become increasingly adept at operating within the regulatory regime and with managing compliance issues.


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Table 1: Top 5 Investment Management deals announced in Europe 2004 and 2003

Year	Rank	Date	Target		Bidder		Value €m
			Company	Ctry	Company	Ctry	
2004	1	Jul 04	F&C	UK	ISIS Asset Management	UK	1,101
	2	Nov 04	IM activities of Baring Asset Management	UK	MassMutual Financial Group	US	383
	3	Nov 04	FS activities of Baring Asset Management	UK	Northern Trust Corporation	US	
	4	Feb 04	Laing & Cruickshank Investment Management	UK	UBS	CH	236
	5	May 04	Delaware International Advisers Ltd	UK	Atlantic Value Partners (No. 3) Ltd	UK	164
			Total top 5				1,884
			Other				1,170
			Total Europe				3,054
2003	1	Jun 03	Threadneedle Asset Management	UK	American Express	US	504
	2	Dec 03	Bankhaus Loebbecke	DE	MM Warburg & Co.	DE	364
	3	Oct 03	Bank Von Ernst & Cie	CH	Coutts Bank (Switzerland)	CH	328
	4	Jun 03	Theodoor Gilissen Bankiers	NL	Kredietbank SA Luxembourgeoise	LU	302
	5	Jun 03	Banca Primavera	IT	Assicurazioni Generali SpA	IT	252
			Total top 5				1,750
			Other				936
			Total Europe				2,686

Source: mergermarket and PricewaterhouseCoopers analysis

06

Anticipating key risks in hedge fund M&A

In the hedge fund industry, the major M&A risks generally relate to people and operational issues. As with all M&A transactions, identified risks will impact the value of the business and increase the complexity of warranties and indemnities.



Since 2000, the pace of mergers and acquisitions in the hedge fund industry has accelerated with both US managers acquiring interests in Europe and European institutions seeking access to hedge funds to enhance returns. The key drivers for the deals from the acquirer's perspective are access to product diversification, alternative asset trading talent and client/customer bases. From the target's perspective, the key drivers are access to distribution networks, an institutional scale business and of course, capital.

People issues

Hedge funds are people-based businesses; in order to develop a clear strategy for the future of the business, there must be a meeting of minds. Therefore, it is essential that the culture of the business is taken into account in setting up the management and ownership structure to avoid future conflicts. Retention of key people is also essential; therefore a significant issue to consider is whether the remuneration strategies of the acquirer and target are compatible.

Operational issues

Operational risk has been identified as a major reason for hedge fund failure and the critical areas to address in this respect are the business's infrastructure, reputation and financial and tax management.

The traditional hedge fund manager operates a "lean and mean" infrastructure, with a significant number of outsourced relationships; it is essential that the quality of service providers is evaluated and any risks identified.

The success of a hedge fund is also very much linked to its reputation. Any undermining of its reputation can have disastrous consequences. It is therefore important to know whether there has been any market abuse or conflicts of interest which could present the regulators with reputational issues. What is the quality of the business's corporate governance and its know-your-customer and anti-money laundering procedures? Has the business satisfied all its EU, UK and SEC regulatory obligations?

In terms of financial management, it is important that audited accounts are available and that the back office functions, procedures and controls in relation to the valuation and pricing of complex securities are reviewed. The impact of the merger on the business regulatory capital requirements must also be quantified.

The key tax risk for the fund is whether there is a risk of investor level taxation. Therefore, the robustness of the offshore fund structure should be reviewed. From a management/corporate perspective, any weaknesses in

remuneration/ownership structures which could be challenged by local tax authorities should be identified and, if necessary, tax warranties and indemnities obtained. Commonly, post-deal, remuneration strategies may need to be changed or new strategies devised. For both the fund and corporate structure, the quality of any prior tax planning documentation and implementation should be critically reviewed to identify any latent weaknesses that could present tax exposures.

Making M&As work

Acquirers need to have a clear strategy of what they are trying to achieve by the merger/acquisition and must ask the right questions of the target. The success of due diligence and hence acquisition is often in the detail.

Targets need to be prepared; consider a pre-sale due diligence to identify issues that may impact on value or ability to close a deal. Address those issues pre-sale so that they are removed from the discussions. For both acquirers and targets, bring experienced advisers on-board as soon as possible.

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Irish prime broker regulations updated

For several years, Irish hedge funds have been able to utilise the services of a prime broker. The Irish Regulator has now issued a revised and updated draft guidance note in relation to prime brokers and other financing arrangements for Irish domiciled alternative investment funds and hedge funds.

The following is a summary of the Irish Regulator's current position, as set out in the revised draft guidance note, for the use of prime brokers by Irish domiciled hedge funds:

- The Regulator will no longer formally review prime brokerage documentation subject to confirmation from the fund's legal advisers that the documentation incorporates the Regulator's requirements, which will reduce the time it takes for new funds to be authorised.
- In the case of a Qualifying Investor Fund (QIF), there is no limit on the extent to which assets may be passed to the prime broker.
- The value of assets of a Professional Investor Fund (PIF) passed to the prime broker must not exceed 140% of the level of the hedge fund's indebtedness to the prime broker.
- The prime broker will not be required to be appointed as sub-custodian to a hedge fund provided:
 - a. In the case of a PIF, the 140% limit of assets of the fund passed to the prime broker is respected, and in the case of a QIF, the extent to which assets are available to the prime broker is fully disclosed in the prospectus.
 - b. The arrangement between the hedge fund and prime broker incorporates a procedure to mark positions to market daily.
 - c. The prime broker must agree to return the same or equivalent securities to the hedge fund.
 - d. The arrangement between the hedge fund and prime broker incorporates a legally enforceable right of set-off for the fund.
- The prime broker must be regulated to provide prime broker services by a recognised regulatory authority, must have a minimum credit rating of A1/P1 and must have shareholders' funds in excess of €200m (or its equivalent in another currency).

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Hedge fund regulation and distribution in Europe: Changes and challenges

Pan-European harmonisation of regulation affecting distributors and manufacturers of hedge fund products is a reality. Implementation of the Markets in Financial Instruments Directive (MiFID) is due to occur across the EEA in April 2007 and this will affect manufacturers and distributors of hedge fund products in important ways as discussed below.



Distributors

MiFID will make the provision of investment advice by intermediaries such as Independent Financial Advisers (IFAs) a core service under the Investment Services Directive (ISD). As such, intermediaries will be subject to harmonised conduct of business rules and will be able to take advantage of a pan-European passport to operate on a cross-border basis without the need to be authorised and subject to national regulations in each territory.

Manufacturers

The original pan-European conduct of business requirements for all investment managers subject to the ISD were framed as high-level requirements and there was considerable variation in the manner in which individual national regulators implemented detailed conduct of business rules.

The more detailed rules enshrined in MiFID will bring about harmonisation of national rules and, in general, will result in non-UK manufacturers of hedge fund products being subject to rules which are broadly similar to those currently used by the UK Financial Services Authority (FSA) to regulate the conduct of UK-based hedge fund managers.

It should be noted that the FSA continues to consider its position on whether continued application of a "light" regulatory touch is the most appropriate manner to regulate hedge fund managers and this is part of the rationale behind its publication of two discussion papers in June this year.

Hedge fund products

In contrast to the harmonisation of rules affecting distributors and hedge fund managers, no clear consensus is emerging as to whether harmonisation of the regulation of hedge fund products is a worthwhile aim or how it might be achieved in practice. The issue remains a hot topic across Europe, with (among others) the German Chancellor, the President of the European Central Bank and the European Commissioner for Internal Market and Services all contributing to the debate, but final answers still seem to be a long way off.

This is not altogether surprising as there are probably at least as many views as there are national regulators.

We consider the issues currently faced by one of the national regulators, the FSA, in more detail below.

Case study – United Kingdom

It seems that the FSA has yet to make up its mind on whether it should seek to regulate hedge fund products and how it might go about doing so, given that most funds are domiciled beyond the limits of its geographical authority.

The key questions that the FSA needs to address are:

- Is there a case for wider retail access to hedge funds and hedge fund-like products?
- How can regulation of the products themselves be achieved when these are generally domiciled outside the limits of the FSA's geographical remit?

- Might regulation of distribution channels be more effective than regulating hedge fund products?

As a first step towards formulating its answers to these questions and on whether to seek to regulate hedge fund products directly, the FSA issued “DP05/3 Wider range retail investment products” in June in order to elicit the views of industry participants.

What is certain is that something needs to be done: following the introduction of new regulatory classifications for funds brought about by the implementation of the UCITS III Directive via a new sourcebook for collective investment schemes (COLL), it has become evident that it is possible for an authorised fund (ie. a regulated fund) to be more inherently risky than a similar unauthorised fund. The FSA’s current approach to consumer protection is based around regulations dealing with access by retail investors to funds as well as funds’ investment and borrowing powers; however, “leakage” of riskier funds into the retail market demonstrates that a rethink is required.

We believe that an appropriate approach to consumer protection is to stratify the universe of investment funds according to a mapping of investor classes to levels of risk inherent in the investment proposition. This would need to cover all risks, not just market or concentration risk. For hedge funds, operational risk can be more prominent than in regulated funds. Adoption of voluntary measures to reduce overall risk (for example, by

reducing operational risk through adoption of a code of corporate governance or making use of effective systems to monitor investment risks), would allow a fund to be marketed more widely, including (potentially) to retail investors without compromising consumer protection.

By linking distributability to wider measures of risk, the extra-territoriality issue can also be side-stepped. Marketing to UK residents is generally an activity that takes place in the UK and the FSA could seek to restrict funds’ UK investor base by reference to the overall level of risk present in an investment proposition through regulating the distribution chain. Offshore funds would then be free to choose either:

- to take measures to reduce overall risk to a level suitable for the particular types of investors who are to be targeted; or
- simply not to market in the UK.

In either case, UK consumers would be adequately protected as they would only be able to invest in funds which were subject to adequate risk management.



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The third edition of “The Regulation and Distribution of Hedge Funds in Europe – Changes and Challenges”, on which this article is largely based, can be obtained from denise.cook@uk.pwc.com or downloaded from www.pwc.com/hedgefunds.

This report:

- considers the impact of pan-European developments currently affecting the European hedge fund industry;
- gives details, on a country-by-country basis, of how individual national regulators currently supervise hedge funds and their managers; and
- considers the taxation of hedge funds across Europe and gives an overview of the various national tax regimes as they affect hedge fund managers and hedge fund investors.

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Figure 1: What percentage of your revenue is expected to result from your own efforts and what percentage will come from market appreciation?



Source: PricewaterhouseCoopers

PricewaterhouseCoopers Global Private Banking/Wealth Management Survey 2005 Who will be winners in wealth management?

The wealth management industry is embarking on a new period of confidence, with double digit growth anticipated in both profits and funds under management. Wealth managers will be fighting increasingly hard for market share and not everyone will be a winner.

The PricewaterhouseCoopers Global Private Banking/Wealth Management Survey 2005 identifies industry trends, challenges and issues facing wealth managers globally. With 130 participants from Europe, Asia Pacific, the Americas and a number of offshore centres, this is our largest ever wealth management survey.

Chief executive officers, perhaps over optimistically, all believe that their own organisations will better the overall average growth predicted in three years' time of 7.5% in the market. They anticipate their assets and revenue will grow at an annual rate of 13% over three years, winning the majority of revenue growth directly from clients (see Figure 1 above). This requires a strategy for obtaining a greater share of existing clients' wallets as well as winning clients from competitors. As this war for clients intensifies, differentiation and brand will be crucial – do you have a winning strategy and a clear client proposition?

Personal relationships with clients and the quality of staff are seen as key differentiators. Expectations and

requirements of the Client Relationship Managers (CRMs) are ever increasing but our survey noted that training is not generally adequate to support this. The survey results showed that 43% of European participants spent less than \$5,000 per person per annum on training. Quite apart from regulatory requirements and improved Know Your Client criteria, CRMs are the crucial interface with the client; development of softer skills, as well as product knowledge and technical skills, is required. The talent pool is tightening and your competitors want your prized CRMs; do you have adequate development, reward and retention strategies?

Open architecture is still a masquerade for many wealth managers and in reality only exists at the margin, especially for small and medium-sized players. Most wealth managers still manufacture products either themselves or via a parent. Organisations need to concentrate on what they do well and outsource more in specialist investment and advisory areas if they are going to be able to

focus on being true trusted advisers. Are you reaping the benefits of an optimal operational/product model?

In addition, significantly more progress must be made in collection and analysis of management information if wealth managers are to make the correct decisions to maintain growth and profitability. Segmentation and the development of better performance indicators will be vital in ensuring that the business has the right mix of clients and products, given profit margins are increasingly under pressure.

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A full copy of the executive summary and the additional analysis as it is released during 2005/6 can be obtained at www.pwc.com/wealth, along with details of our global network.

Performance-related fees: panacea, pariah or new paradigm?

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The degree to which the interests of investment managers and investors have been (and are) aligned has been the subject of much debate in recent years.

As with much in investment, debate at the macro level rarely leads to a unique solution and, in practice, individual circumstances and constraints need to be considered. However, it has been of little surprise that renewed interest in the use of performance-related fees has developed as a consequence.

Panacea

Many investment managers have faced significant challenges in recent years. Profitability has fallen and new products and alternative asset classes have created greater competition for existing assets and industry talent. In addition, investors have gradually become more sophisticated and have developed a better understanding of risk and reward. As such, the opportunities for investment managers to promise alpha (the excess return over the market) but deliver beta (the market return) and get paid an alpha fee continue to decline.

Performance-related fees can help managers address these issues:

- By rewarding genuinely superior performance, they offer the opportunity to enhance revenue.
- By promoting confidence in their ability to perform and suggesting a more equitable alignment of interests, they enhance their competitive position in the marketplace.

In addition, the insights gained from pre-implementation studies within organisations can bring valuable transparency to some key business dynamics, promote change and ultimately enhance organisational value.

Pariah

However, performance-related fees are not always the panacea that they seem. The devil really is in the detail and the direct consequences of their use can be very significant. More importantly, the potential for unintended consequences should not be overlooked. The issues can be wide ranging:

- Revenue volatility can destabilise the business and, in instances, can constrain development of the business infrastructure.
- The additional demands on the business (administration, systems, risk controls and management time) can give rise to significant expense.
- Investor profiles and regulatory requirements vary across the business book and require alternative designs.
- The behavioural issues introduced when ad valorem and performance-related fees are used can undermine the best interests of the business. (Similarly when performance-related fees become “unachievable” or “achieved”.)

In practice, their potential downside has severely limited the appetite of some investment managers for performance-related fees.

New paradigm

However, although a number of investment managers acknowledge some previous bad experiences, a new paradigm arguably exists. Basic business infrastructure has developed and can now more easily accommodate the demands of performance-related fees. In addition, organisations have taken a much more sophisticated approach to their use. Backed with better knowledge and control of management costs, an integrated approach to understanding the micro and macro impacts of their use under different scenarios has developed. Coupled with this, industry regulators have started to encourage their wider use in the interests of aligning investment manager and investor interests more fairly.

Ultimately, performance-related fees are simple in principle (increased performance will be rewarded by increased revenue). In practice, they can be extraordinarily complex and the issues they bring with them can be legion, particularly those of unintended consequence. Investment managers need to develop their knowledge of performance-related fees, the alternatives in design, the implications of those designs and, in particular, of the unintended consequences. Within the current competitive investment environment, doing nothing is not an option.



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Pensions Directive deadline approaches

Member States are meant to introduce the Pensions Directive provisions into their national legislation by 23 September 2005. However, there are still significant (tax) obstacles before true pan-European pensions can become a reality.



Flashline

Dutch pension law changes

Major changes are occurring in Dutch pension law. Of immediate importance is the "VPL" Act. This law changes the tax facilities for pension schemes and "VUT" schemes in order to move the retirement age to 65 (to encourage people to work longer because of the rising costs of the aging population).

The new law was effective as of 1 January 2005 (although those over 55 at that date stay under the old regime). Transitional provisions call for existing schemes to implement by 1 January 2006 but the heavy administrative burden this creates for companies and branches means many will not make this date. In the course of September, the Minister of Social Affairs will decide whether to postpone implementation for existing schemes to 1 January 2007.

Furthermore, there is a new Pensions Act which is a complete renovation of the Pensions and Savings Act which dates from 1953. Although this should be in place on 1 January 2006, this deadline is unlikely to be met. This new legislation includes solvency rules for pension funds (FTK). A delay beyond 1 January 2006 creates ambiguity for pension funds, as the Supervisor DNB is basing its supervision on the FTK, which still has no formal legal basis.

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The EU Directive on the activities and supervision of institutions for occupational retirement provision (Directive 2003/41/EC of 3 June 2003), which entered into force in September 2003, establishes a framework for pan-European pensions. Basically it means that an EU multinational can limit itself to one Institution for Occupational Retirement Provision (IORP), so its EU workforce belongs to a single scheme.

The Directive prescribes a minimum standard for IORPs. In particular, it impacts the IORP's governance, investment policy, solvency and the way participants have to be informed about their pension rights. It stipulates that both the company sponsor to the IORP and the IORP itself must be separate legal entities and limits the percentage of company stock the IORP can own. Additionally, it regulates the supervision of IORPs and the jurisdiction of the home Supervisors.

EU Member States retain their freedom to establish their own type of pension system and the Directive respects Member States' applicable social and labour laws. The Directive does not apply to institutions which operate on a pay-as-you-go basis and to companies using book-reserve schemes with a view to paying out retirement benefits to their employees.

An EFRP working group estimates that establishing pan-European retirement provisions can save EU multinationals about €3 billion (0.15% of their available pension assets), with a further

saving of €7 billion once Member States fully lift restrictions on investment policy of IORPs as stipulated in the Directive.

Implementation slow

The implementation of the new Directive in the 25 Member States is not a success so far. While this newsletter goes to print before the 23 September deadline, by the end of August, only five Member States had notified the European Commission that their legislation will be fully ready, and an additional Member State notified partial readiness by that deadline. Interest is high in those countries with well-developed pensions industries such as the United Kingdom, the Netherlands, Ireland and Germany.

However, in most Member States, the legislative process is in progress. European Commission officials expect that by 23 September, ten to 12 Member States will have notified the Commission and by the end of the year, 70 to 80% of the Member States will have adapted their legislation to the Directive. However, this still means that some five countries will not be ready by the end of the year, probably including France, which is still discussing the way the Directive should be implemented.



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Luxembourg tax help for microfinance

The Luxembourg authorities envisage strengthening the advantages for Luxembourg as a place to launch investment funds for microfinance institutions by exempting from the subscription tax any investment fund or sub-fund, the exclusive object of which is to invest in microfinance institutions.

Microfinance is defined as the supply of loans, savings and other basic financial services to the poor. These financial services include working capital loans, consumer credit, savings, pensions, insurance and money transfer services. Providers of financial services to the poor include donor-supported, non-profit non-government organisations (NGOs); cooperatives; community-based development institutions such as self-help groups and credit unions; commercial and state banks; insurance and credit card companies, etc.

Structuring the collection of money and the investments to make them as efficient and secure as possible is a key element. A major financial centre such as Luxembourg ought to play an effective role in favouring and investing in the worldwide microfinance industry, and, the quote (right) shows, has the clear support of authorities.

These funds or sub-funds investing exclusively in microfinance institutions are already exempted from other taxes (no income tax, no net wealth tax, no taxation for foreign investors including

no withholding tax except the potential application of the EU Savings Directive, no VAT on management fees) and have a fixed registration duty of €1,250. The exemption from subscription tax would cap this very attractive tax framework.

“Microfinance is not just another paradigm about the design of new financial instruments to eradicate poverty; it is a crucial element in the economic, social and political development process of nations. The Luxembourg government stands ready to do what is necessary to further promote this essential development tool and invites its banking community to actively participate in this endeavour.”

Luc Frieden, Luxembourg Minister for the Treasury and Budget

The draft bill was introduced on 31 May and should be discussed in the Luxembourg Parliament in October 2005.

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Good deals in German residential housing

During recent years, the German residential market has become an attractive opportunity for foreign investors. Its appeal to foreign investors includes the second lowest house ownership market (44%) in Europe and low house prices, while financing is relatively inexpensive.

When contrasted to the sharp increases in worldwide residential markets, Germany has the potential to become the biggest market for real estate investment in Europe.

For companies managing German residential property, the main income is generated from capital gains on home sales and rental income from the properties. Foreign investors generally plan to manage the properties for a period of five to ten years. Furthermore, their business models are based on the likelihood of increasing home ownership in Germany through the privatisation of apartments. On total investments in residential property, they expect a return on investment of 15% to 20%.

The high number of housing deals of residential block trades has already forced up prices in recent years. While the first deals started at €500/sqm, today's prices are €700/sqm.

A further feature of the German housing market is the tax-efficiency of former housing societies *gemeinnützige Wohnungsgesellschaften*. In 1990, these housing societies had to

give up their tax-exempt status in Germany and became subject to German corporate income and trade tax. However, they were allowed to step up the value of the real estate in the necessary opening balance sheet to the higher fair market value. The step-up amount had to be restored in a special capital reserve, called EK02. Thus, the companies today benefit from high depreciation and a high tax basis. Where units are sold at their fair market value, the capital gain is often relatively low. However, the mentioned benefits are only effective when the company retains its earnings. Under the unfavourable EK02-regulations, profit distributions are taxed at about 45.2% including solidarity surcharge, which equals 3/7 of the distributed amount.

In order to strengthen the position of Germany as an appealing residential market, the introduction of tax-efficient REITs has been widely discussed in Germany. Following the model of REITs already implemented, e.g. in France and the Netherlands, German REITs which fulfil certain conditions would receive tax-exempt status in Germany.

With the election of a new German government brought forward to autumn 2005, REITs can no longer be introduced as at 1 January 2006. However, recent discussions indicate that the introduction of REITs has been delayed but not cancelled and large residential companies are positioning themselves to take advantage when REITs are introduced.



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Germany: Focus on core competencies urgently needed

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German investment management companies (KAGs) are currently deciding which are their core competencies among the value chain of their activities and considering outsourcing those which are non-core.

In PricewaterhouseCoopers' survey "Industrialisation in the German Investment Management Market 2005", among 48 KAGs managing mutual funds and special funds (excluding real estate), some challenges emerged.

Although 81% of respondents are considered full-service KAGs, only 48% see themselves as "all-rounders" having a good command of all operations and processes within the value chain. Furthermore, 63% see their strength in portfolio management, yet only one participant is currently structured as a pure asset manager KAG. Currently, only three participants are structured to carry out pure fund administration services. Thus there would appear to be a disconnect between the supposed strengths of these firms and the business model followed by many.

So what is currently being outsourced, effectively breaking the value chain? As Figure 1 shows, for 53% of respondents, portfolio management is a mixture of providing this service for others and outsourcing. For 27% of KAGs some or all of the fund accounting function (i.e. a KAG's back office) is outsourced; 25% of participants are providing back-office services to KAGs.


Cost reduction is the major reason for outsourcing for 75% of respondents, with more than half mentioning specialisation/core competencies or individual client requirements. Lingering worries about outsourcing relate to future re-integration of former outsourced activities and loss of know-how.

Quantifying and monitoring outsourcing

The KAG retains responsibility for outsourced activities, but how effectively is this handled? In total 73% of participants claim to actively control outsourcing, but this seems to primarily be monitoring the services of external asset managers. Of those who monitor, 43% do not have specific staff to carry out the outsource monitoring function. For 23%, the monitoring is informal as outsourcing is done within their corporate group. As Figure 2 shows, 31% are currently considering using SAS 70 reports to monitor outsourcing.

If cost reduction is a major impetus to outsourcing, firms must understand in detail how costs are allocated to all individual processes in order to decide whether to perform activities in-house or to outsource. This is also crucial for calculating performance and comparative costs with competitors. Worryingly, most respondents could only make estimates of administration costs and did not have detailed figures. Of those that do claim to know their costs, 37% of respondents mentioned six basis points with a further 13% mentioning a range of six to eight basis points.

PricewaterhouseCoopers is now preparing business model-, process- and cost-optimising analyses for the German investment management market. This will give (potential) market participants an informed basis for making future strategic, reorganisation and make-or-buy decisions.

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Figure 1: How KAGs approach key functions

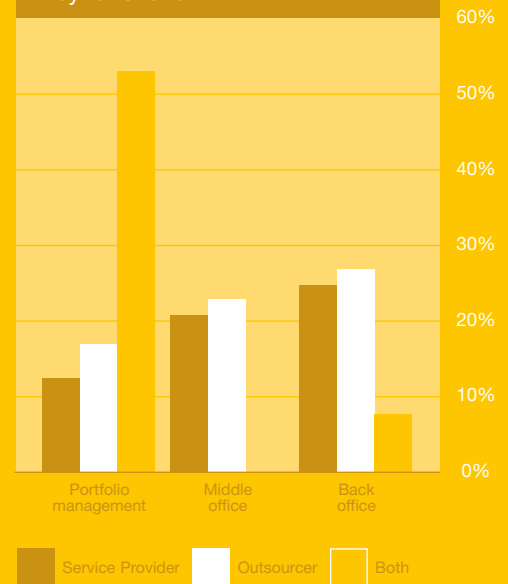


Figure 2: Instruments under consideration for outsource monitoring

Service provider internal auditor reports	65%
Service provider external auditor reports	54%
Questionnaire from outsourcer	46%
Own audit of outsourcer	35%
SAS 70 reports	31%

Source: PricewaterhouseCoopers

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IFRS for investment funds: to consolidate or not to consolidate?

Determining whether investment funds should be presenting consolidated financial statements under IFRS requires careful assessment of all relevant factors.



The presentation of financial information has never been more critical than in today's information age. Financial statements have to be not only accurate and timely but also complete. For investment funds presenting consolidated financial statements under International Financial Reporting Standards (IFRS), this issue is primarily governed by the application of a number of standards including IAS 27 'Consolidated and Separate Financial Statements' and SIC-12 'Consolidation-Special Purpose Entities'.

Explicitly stated within IAS 27 is that a parent company will present consolidated financial statements in which it consolidates its investments in subsidiaries. Applied to investment funds, a parent shall consolidate any subsidiary it controls, whether it is an investment fund or another type of entity. Control is defined as having the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. It further states that control should be presumed when the parent owns, directly or indirectly, more than half the voting power of an entity unless it can be clearly demonstrated that such ownership does not constitute control. Whilst the concepts may appear to be simple, application within the investment fund industry can be fraught with difficulties.

Taking a simple example, investment fund 1 which has a majority ownership in investment fund 2, should consolidate it. Through its majority ownership, investment fund 1 normally

has control and derives benefit from its subsidiary, investment fund 2. However, should the control of investment fund 2 rest with an investment manager or other party and not investment fund 1, the answer may be different. Examination of all the relevant factors is necessary. These would include the circumstances giving rise to and the nature of the control, the limitations and possible removal of such control, the relationship through contractual agreements or a legal set up, the benefits derived from such relationship and of course the extent of any significant ownership stake.

SIC-12 further extends the circumstances where consolidation is required under IFRS. It is an interpretation of IAS 27 and provides several examples under which a special purpose entity (SPE) would be consolidated. One such example is an entity having the rights to obtain the majority of the benefits of the SPE and therefore may be exposed to the risks inherent within the SPE. There may not necessarily be any legal ownership stake or legal control between the entity and the SPE. Again, examination of all the relevant factors has to be considered. A careful and well considered assessment is critical for investment funds as the answers may have unwelcome consequences in the realm of consolidation.



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What is the appropriate functional currency... for an investment fund?

Under IFRS, many investment funds have to face the challenge of determining the appropriate functional currency. What is the functional currency and why is this change causing such concern in the industry?

An entity's functional currency is defined as the currency of the primary economic environment in which the entity operates. IFRS now requires that the functional currency be used to record all of the transactions into which an entity enters. In the context of funds this means that the NAV should be calculated using the functional currency.

IAS 21, the accounting standard that deals with foreign currency under IFRS, is not very clear about the determination of the functional currency for an entity whose sole activity is to hold financial assets on behalf of investors and to maximise the performance of those investments. The guidance in IAS 21 which has to be used by management to determine the appropriate functional currency has been written for operational entities (industrial or commercial companies, banks, etc.).

It has introduced detailed factors (sales price and costs) to be considered when selecting the appropriate functional currency but these are not readily applicable to investment funds. The currency in which financing is received should also be considered;

however, this is considered a secondary indicator. While IFRS says that priority should be given to primary indicators, the fundamental objective of a fund is to provide a competitive return to an investor. Therefore, the primary economic environment of the investors also has an impact on the operations of the fund itself.


If one considers all indicators, the message is very often mixed since the majority of funds are influenced by a multitude of factors including:

- the economic environments in which the financial assets are invested;
- the economic environment(s) of the investors;
- the regulatory environment;
- the competitive environment;
- the fee structure, even if this is normally minor compared with the expected return on investment.

When the above indicators are mixed and the functional currency is not obvious, IFRS states that management should use its judgement to determine the functional currency that most

faithfully represents the economic effects of the underlying transactions, events and conditions. To make its decision, management may consider the currency in which the performance of the funds will be reported to the investors. Once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.

This is clearly a complex area with many operational and accounting implications. Where the functional currency is not used to calculate the NAV for a fund, it may be necessary to maintain dual currency books and records in order to be able to produce interim and annual financial statements for the fund which comply with IFRS. However, one thing is clear; now is the time to be considering the functional currency issue, not when the fund's financial year end arrives.

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All eyes on AITC VAT case

Differences between UK VAT treatment of authorised unit trusts and OEICs versus investment trusts will now be decided by the ECJ.

The JP Morgan Claverhouse test case, sponsored by the Association of Investment Trust Companies (AITC), has been referred to the ECJ by the UK VAT & Duties Tribunal. This case concerns the UK interpretation of the EU-wide VAT exemption for “management of special investment funds”. UK VAT law exempts the management of the assets of authorised unit trusts and open-ended investment companies. The management of the assets of investment trusts, on the other hand, is subject to VAT. The AITC believes that HM Revenue & Customs are wrong to restrict the exemption of the management of authorised unit trusts and open-ended investment companies as this is anti-competitive and unfair. The case therefore looks at the UK interpretation of Article 13B(d)(6) of the EC Sixth VAT Directive which provides exemption for the “management of special investment funds as defined by Member States”. The AITC is seeking a VAT exemption to be applied to management services supplied to UK investment trusts.

The case was heard at the VAT and Duties Tribunal on 9 May 2005 and it was agreed between the parties to refer questions to the ECJ. The precise wording of the questions has yet to be released; however it is understood that the issues to be referred are as follows:

- What is a special investment fund?
- Whether Article 13B(d)(6) has direct effect or whether it affords Member States discretion to pick and choose which special investment funds fall under the above provisions.
- How should the principles of fiscal neutrality apply?

This does not provide any indication as to the likely outcome of the case but it does give a better idea of the arguments to be pursued.

If the case was to be decided in favour of the AITC, significant retrospective claims would be needed for overcharged/overpaid output tax with an associated adjustment for over-recovered input tax. It is understood that fund managers were encouraged by investment trusts to lodge protective claims for the past three years soon after the launch of the case and this may well have been done

during the first half of 2004 when the appeal was first served. This will protect their position should the case be successful and the management of investment trusts become exempt from VAT. Where investment trusts have been receiving services from overseas and accounting for reverse charge VAT on these services, it should be the investment trust (and not the investment manager) that lodges the protective claim.

All investment trusts and their managers should monitor proceedings. The next step will be for the reference to be lodged with the ECJ registry, expected after the summer recess. An oral hearing will then be scheduled, followed by the issue of the Advocate-General's opinion and, finally, the ruling of the ECJ. The precise timetable is, as always, uncertain, and it may take up to two years for the ECJ ruling to be given.

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No end to German tax reporting

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In order to avoid penalty taxation of investors and to be able to pass on certain tax benefits to their investors, German and non-German fund managers marketing their funds in Germany have to comply with comprehensive reporting requirements. How are fund managers faring after their first reporting season, and what lies ahead?

The first reporting season mainly focused on the reporting of accumulated income deemed distributed under the German rules. Some of the first year reviews included a manual conversion of local GAAP figures into German tax numbers. For the second or third reporting year, a number of players intend to implement systems-based solutions which will partly automate the conversion process and alleviate the workload associated with the review.

German institutional investors, including the fund industry, have taken great interest in inspecting the quality and accuracy of German tax data provided by non-German funds in which they invest. The questions asked reflected a surprisingly intense level of scrutiny which is likely to increase further in the years ahead. The numbers are also likely to become subject to tax audits or quasi tax audits by the German tax authorities in the near future.

The next steps in the German tax reporting exercise for many players will be the review of the *aktiengewinn* (gains on equity) figures as well as a review of the interim profits, both of which generally entail daily reporting. The calculation of the *aktiengewinn* allows the fund to pass on fully or partly tax-exempt income and gains from equities to institutional investors. Computing and publishing the interim profits, which stand for certain accumulated interest income, is again necessary to prevent penalty taxation at investor level. We expect that the review of the *aktiengewinn* and the

interim profits will result in adjustments for figures published in the past. This will also be impacted by administrative guidance which was only published in its final version on 2 June and which differs in some respects from prevalent industry practice.

Despite the fact that some aspects of the reporting standards may be contrary to EU law and that they impose sometimes burdensome requirements onto fund promoters, the industry currently seems to be coping with the requirements. In some cases, the reporting has even opened up new avenues to foster investor relationships. In terms of tax efficiency, fund products are increasingly able to compete with derivatives and other structured products in the German market while the after tax return on some insurance-linked products has become less attractive. These are good times for fund managers to start the foray into the German investor market, but German tax and regulatory expertise is essential.



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Impact on UCITS funds

Our conclusion from the EFTA Court's decision in the Fokus Bank case is that the imposition of withholding taxes on cross border EU dividends to UCITS funds organised as corporate funds amounts to a breach of the free movement of capital in Article 56 of the EC Treaty. On this basis, such UCITS funds investing in shares of cross border EU companies should consider filing protective claims for the recovery of all tax withheld on dividend receipts (i.e. both treaty rate tax and non-treaty rate tax withheld) and simultaneously lodge details of the claims with the European Commission.

UCITS funds that are subject to domestic tax (for example UK OEICs), may also need to file their domestic tax returns on the basis that those EU dividends should not be subject to domestic tax. This would ensure that any withholding tax recovered from overseas tax authorities would not be lost through a higher domestic tax charge. This filing basis is already widespread and is supported by the outcome of another tax case, Manninen, decided in the European Court of Justice last year.

Dividend yields on EU dividends are currently around the 2% level². UCITS funds suffer a range of 15-30% withholding tax rates on EU dividends. Assuming a full exemption or refund from withholding taxes for domestic UCITS, withholding taxes reduce a foreign UCITS performance by between 30 and 60 basis points, when compared with a domestic UCITS with the same EU investments. The recovery of these taxes would boost the annual investor returns on fund assets. Given that reclaims should be possible for prior years, there could also be the capacity for additional one-off benefits to fund performance. Fund operators should now review the amount of withholding taxes suffered over the last three to five years on cross border EU dividends to ascertain the magnitude of a potential claim.



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