

December 2005

E u r o p e a n



IMRE News

Inside this issue:

02: UCITS Green paper

03: Mapping MiFID tasks

04: Nordic region real estate

06: Guernsey limited partnerships

07: Outsourcing to South Africa

08: Swiss fee transparency

08: Italy: industry operational re-think

10: Belgium: Savings Directive

10: UK property derivatives

11: VAT: Abbey National case

12: Malta attracts hedge funds

13: German proposed changes

14: UK funds tax regime

15: German client reporting

Funds tax discrimination in Europe – the finishing line in sight?

For several years there has been increasing focus on the tax barriers facing funds marketed cross-border in Europe. It has been accepted within the industry that such barriers severely limited the ability of investors in several member states to take advantage of the cross-border marketing of funds, even under the UCITS provisions.

However, recent progress has been made in removing tax constraints, now making it easier to market funds based in one EU member state into other member states. Within the last 18 months there have been significant developments in the UK, France, Germany, Austria, Ireland and Denmark to eliminate discriminations preventing foreign UCITS being sold to investors in these countries. These developments include:

- Austria – differential income tax rates removed in most cases
- Germany – removal of tax barriers against foreign funds provided there is compliance with the German reporting obligations
- UK – refinements to the offshore funds regime to enable foreign funds with both distributing and accumulating share classes to obtain UK distributor status.

There is increasing acceptance by member state governments that such tax discriminations need to be removed from domestic legislation. This follows the increasing industry recognition that these rules are, in almost every case, illegal under the provisions of the EU Treaty. However, despite this progress, UCITS funds sold cross-border in the EU still only amount to around 16% of the UCITS market.

This has increased focus on other areas where taxation issues represent an obstacle to a single market for investment funds. A recent report by PricewaterhouseCoopers and EFAMA identifies the remaining concerns.

Issued by PricewaterhouseCoopers LLP
Southwark Towers, 32 London Bridge Street,
London SE1 9SY

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



Continued on: [back page](#)

Green paper moves UCITS forward

“The era of the long-only fund is quickly disappearing in the rear-view mirror.”

EU Commissioner

Thus Charlie McCreevy demonstrated the Commission’s understanding of the pace of innovation in financial services as UCITS, deposit structures, unregulated funds and insurance products now all offer the same economic outcome for investors under very different product and conduct of business regulation regimes.

Commissioner McCreevy was speaking at the open hearing on the Commission’s Green paper on UCITS where a number of themes recurred and the Commission set out its vision for the future.

There was a noticeable intellectual tension between industry and regulators. The former want simplification and harmonisation of regulatory practices and definitions to make the industry more efficient. Standardised notification procedures, pooling, fund mergers and non-divergent implementation of UCITS provisions figure high up on their shopping list. And the Commission, with CESR, will work towards these goals.

The regulators, including the Commission together with consumer

representatives, had additional concerns. Clear disclosure of risks, fees and retrocessions was one. The growth of open architecture is shining a spotlight on retrocession practice and the industry is still working its way towards acceptable solutions.

Similarly the relatively new division between producer and distributor has raised the question of a fund manager’s responsibility to an end-investor where a distributor provides advice. The Swiss model where the manager retains clear responsibility for how a fund is distributed is not greeted with open arms by all.

Some regulators, too, worry about the different roles that depositaries play in different jurisdictions. Nasty cross-border surprises could result if responsibilities undertaken in one jurisdiction are assumed to be shouldered in another too, when the reality is different.

“I will not kick-start the regulatory machine for marginal benefits.”

Charlie McCreevy

The Commissioner’s work programme includes:

- agreement on eligible assets under UCITS III
- standardised notification procedure
- analysis of true cross-border management company passport
- analysis of inter-relationship between MiFID and UCITS
- establishment of expert groups on alternative investments and on rationalisation of the investment fund value chain
- new research on the fund industry.

All these steps will lead to a White Paper in a year’s time which, McCreevy concluded, will point “the way towards cost-effective and sensible actions.” “I will not kick-start the regulatory machine for marginal benefits.”

Philip Warland: [London](#)
(44) 20 7212 6345

Mapping the major tasks for MiFID

03

Major European firms have already established MiFID projects and are setting aside budgets running into tens of millions of euros for them. In the UK the FSA has written to all firms alerting them to the need for clear project management and budgets now for 2006/7. The time for action is here even though the final text is not agreed.

Much has been made of the impact MiFID may have on the structure of equity markets but for most of the investment management industry, the Directive will also affect a wide range of other functions.

It is worth recalling the message from our September 2005 IMRE News. UCITS managers who only manage UCITS are not directly affected, but anyone carrying out investment activities, whether under an extended UCITS III or ISD/MiFID authorisation, will have to pay attention to the new requirements. Key areas for attention are likely to be the following.

Client classifications

All clients/counterparties will need to be classified according to MiFID's definitions. The classification, which may or may not follow current client agreements, has to be made known to the client and fully documented. Clients can ask for different treatment for different classes of assets. The process has to be carried out for all clients/counterparties including market counterparties.

Suitability

Advice offered on investments, whether as advice or as a discretionary management agreement, must be suitable. To meet the test of suitability, a substantial amount of information must be known about the client, and documented. When offering advice per transaction, the suitability test must be applied for each transaction. This burden may encourage the wider use of discretionary management agreements and collective funds. The implied requirement to review all clients may be used by distributors to segment their client base more carefully. Credit institutions advisory staff may be caught by these regulations for the first time.

Many investment managers are not

distributors so may be tempted to ignore these points. But they will need to check, in future, that their distributors are correctly authorised and are handling their clients appropriately.

Customer agreements

These agreements will have to document the agreed risk appetite of customers, but will also have to set out the firm's policy on order handling, aggregation and choice of venues to deliver best execution. Also disclosed will be any conflicts of interest and the arrangements for managing them. Equally, inducements will have to be disclosed; this has already led some managers to form nil retrocession share classes.

Transactions

It follows that dealing desks will need to ensure the terms of customer agreements are met in the course of transaction flow. Some believe this can only be achieved electronically. It has been said that, post-MiFID, a dealing desk will consist of a machine, a man and a dog. The dog is there to stop the man touching the machine.

Whether or not that is true, transaction reporting and recording, in particular to record that customer agreements have been satisfied, will be a substantial challenge for some.

Organisation

Many of the features of a bank's systems and controls are found in MiFID. Thus, not only must there be an independent compliance function but firms will have to take a global view of risk and conflict management, and not only document, but actively manage, these issues.

Although the final text may not be available until late spring next year, and implementation is likely to be delayed until October 2007, the amount of

planning implied requires firms to have initiated a stand-alone project now. It is already clear what the major tasks will be even without the final detail. Project plans with estimated timings and costs can, and should, be prepared. Most importantly, senior management must be engaged early on. So must the host of areas involved: trading, research, IT, operations, marketing, compliance, risk, audit, custody and legal affairs.

Key tasks will be:

- Carry out a gap and impact analysis against current rules and procedures.
- Initiate work on client classification and agreements.
- Establish rules for suitability.
- Consider front-office requirements for best execution, market venue and pre and post trade reporting.
- Evaluate procedures and systems for data management and record retention.
- Evaluate current arrangements for risk and conflict management, control of client assets, and for internal audit against new requirements.
- Initiate training programme for all parts of business affected, front to back office and distribution as appropriate.
- Consider whether strategic benefits are available from the changes.
- Consider pan-European structures to evaluate whether the new rules allow a simpler control structure or one best met by centralisation on one country's practice.

There is no time to be lost.

	Olivier de Vinck: Luxembourg (352) 49 48 48 4122
	Philip Warland: London (44) 20 7212 6345

The Nordic region – high returns and risk diversification in the same package

To an international observer, the Nordic countries often appear to be homogeneous – and there is much truth in this impression. These countries represent stable societies with a well-functioning legal infrastructure, government finances in good condition and a high level of IT maturity. To the discerning investor, however the reality is more differentiated.

A good example of this is the currency environments of these countries. Sweden is a member of the EU but has yet to introduce the euro, Finland is a member of the EU and has introduced the euro, Denmark belongs to the EU and has not accepted the euro but has tied its currency to the euro on the basis of the ERM framework agreement, while Norway neither belongs to the EU nor the Euro zone. As these countries also differ when it comes to the development of their respective property markets, the Nordic region can be well worth closer study from a portfolio perspective. Stable growth in the region, combined with interesting differences within the sub-markets, offers possibilities for investors who are attracted to high returns and diversification of risk in one and the same environment.

Sweden – the largest and most liquid

The Swedish market is the largest and most liquid. During 2004 the total

transaction volume of property investment in Sweden amounted to more than €10 billion. According to the government body ISA, foreign investment in the Swedish property market 2004 amounted to €2.8 billion. During 2005, the transaction volume is expected to reach the same level as in 2004 while the foreign investors' share is expected to increase relative to 2004. This implies that the Swedish property market will become one of Europe's leading markets in attracting cross-border investment. The Swedish system is very transparent from an international perspective.

With interest rates which, according to all forecasts, will continue at record low levels and with the possibility of attractive investments in the regionally-differentiated phases of the cycle, one can certainly expect that the dominant Stockholm property market will continue to be attractive. One concern worth noting, however, is that

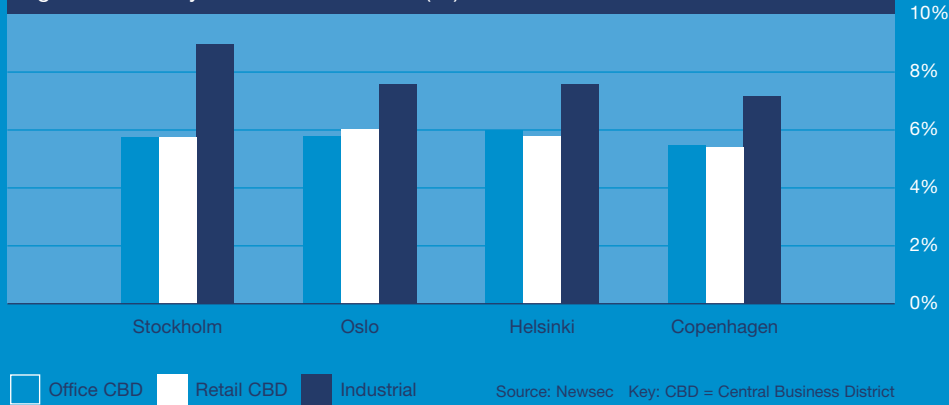
the vacancy level in the office market in Stockholm continues to be high as that market has not really recovered after the IT crash at the end of the 1990's.

An interesting alternative could be Swedish retail properties. Stable rent levels and stable prices for retail properties have attracted a number of international investors and resulted in a significant number of acquisitions during 2005. Also, in the medium-term, the growth in private consumption and the increase in the population, primarily in Stockholm, imply that the prospects for retail property are positive.

Finland – on the way to opening up

After "discovering" the Swedish market, there are now many international investors who are keenly following the developments on the other side of the Baltic Sea. The Finnish economy ranks amongst the

Figure 1: Prime yield for Nordic cities (%)



world's best economies when it comes to competitiveness and has shown a significantly higher level of growth than other countries within the Euro zone during recent years. For many years it was difficult to find investment properties in the Finnish market but during recent years a large number of transactions have been executed.

Many international investors now follow this development with a large degree of interest in order to see if this "break in the ice" has really taken place. Foreign investment has been focused primarily on the capital city, Helsinki. The city shows strong growth compared to other European cities and office rents are now beginning to level off. Another notable trend is that the increased level of international investment activity has led to a greater degree of professionalism within the industry. This, together with increased liquidity, implies that the Finnish property market is well on the way to becoming as dynamic as the Swedish market.

Denmark – attractive but difficult to access

Similar to the Finnish property market, Denmark is characterised by a weak property offering and difficulties for foreign investors trying to break into the market. In spite of this, the interest has been significant here for a number of years. The Danish economy is in very good condition and domestic demand is expected to drive growth during 2004. An increase in the number of jobs positively impacts the

office market and there is a strong indication that office rents will level off during the last half of 2005. It is worth noting in this context that Danish investors have been very active in the Swedish market during 2005.

Just as in Sweden, there has been significant interest in commercial properties, particularly shopping centres, and in conjunction with the on-going restructuring of the industrial base of the economy, the requirement for modern logistics properties has also increased. Against the background of growth forecasts for the Baltic Sea region as a whole, the development of the market for logistics properties in all of the Nordic region merits attention.

Norway – increased foreign activity during 2005

In the Nordic context, Norway represents an exotic, raw materials economy, which has at its disposal a government oil fund worth as much as €150 billion. The country's currency is strong and growth has recovered after a number of weak years. The domestic institutional players have accounted for a large portion of transactions during 2005, but international investors have also been very active. This has meant that the market is more liquid than would have been the case in many years.

The vacancy level in the Oslo office market is, just as in Stockholm, relatively high, but the assessment has been made that this level is beginning

to decline. Oslo finds itself somewhat in advance of Stockholm in the regionally-differentiated phases of the cycle.

The way forward

With strong economic foundations and stability, the Nordic market offers a number of different investment possibilities given the variations found within the national markets making up this regional market. In Sweden, with the most mature market, there has been an interesting line of development. Properties companies which went public a number of years ago have been purchased and are now privately owned. Investors have subsequently been offered investment through private equity. The most recent trend is that property companies which have arisen through restructuring measures are now, once again, listed. Will this pattern spread to other parts of the Nordic region?

Henrik Steinbrecher: Stockholm
(46) 8 555 330 97

Change to audit requirement for Guernsey limited partnerships

On 6 September 2005 the Commerce and Employment Department of the States of Guernsey passed a Statutory Instrument which will have the effect of allowing for even more flexibility in the use of Guernsey Limited Partnerships as investment vehicles.

The passing of the Statutory Instrument prescribes those classes and descriptions of limited partnership to which the audit requirements of The Limited Partnerships (Guernsey) Law, 1995 do not apply.

Specifically any Guernsey limited partnership which is closed-ended does not now need to comply with the audit requirements under The Limited Partnerships (Guernsey) Law, 1995 provided that the limited partnership agreement requires information on the state and prospects of the assets of the limited partnership business to be provided to the partners in relation to each financial year of the partnership.

Potentially this is a significant development for those venture capital and private equity firms that have been using Guernsey limited partnerships as there is now no longer a requirement for the financial statements to be prepared so as to show a “true and fair” view in line with accounting

standards. This move away from a rigid “true and fair” reporting model for Guernsey limited partnerships will increase the scope for more flexible financial reporting to investors. General partners will be able to prepare financial statements for investors in line with, for example, requirements drafted as part of limited partnership agreements rather than a set of generally accepted accounting standards. There will also be the scope for general partners to agree the financial reporting framework directly with investors in a user-friendly fashion.

This change in the legislation ensures that the Guernsey limited partnership mirrors the same flexibility allowed for Jersey, English and Delaware limited partnerships as well as others more commonly used by venture capital and private equity groups.

The Statutory Instrument continues to require the auditors to report in “true and fair” terms on the financial

statements for those Guernsey limited partnerships carrying on regulated business in Guernsey including those that are licensed as open-ended funds. In these cases and where the limited partnership has elected to have an audit under The Limited Partnerships (Guernsey) Law, 1995 then the financial statements and the auditors’ report must be filed with the Guernsey Financial Services Commission within six months of the period end. This is an extension from the original four month period. In all other cases there will be no filing requirement with the Guernsey Financial Services Commission.



John Roche: [Guernsey](#)

(44) 1481 727 777

South Africa – a future in investment management outsourcing?

07

Outsourcing in the investment management industry is here to stay. At its heart is the concept of specialisation – managers are afforded the opportunity to select the best services and products from providers who excel in that area. Outsourcing is now a global phenomenon. In this article, we look at South Africa's credentials in this space.

Language, time zone and culture

The primary language of South Africa's sophisticated financial services industry is English – the lingua franca of the investment management industry. From a European perspective, South Africa and Europe share the same time zone, facilitating real-time servicing access for UK/European clients. In fact, as in Ireland's case, South Africa can service Europe in the morning, North America in the afternoon and Asia in the evening. The concept of 24-hour servicing is now a reality.

South Africans are familiar with UK, European and North American culture. The cultural implications of outsourcing cannot be overlooked, as failure of the vendor to understand clients' existing culture can lead to conflict and inefficiency.

Labour costs

South Africa offers an educated workforce and competitive labour costs. It is estimated British and American firms can cut costs of some services by 30-40%¹ by providing them from South Africa. The country is known for its professional and consumer friendly service levels, evidenced by the fact that it is one of the top ranking locations for providing quality service and prompt output (a commodity which is proving increasingly difficult to obtain in the investment management industry).

Infrastructure

South Africa is blessed with world class physical and technological infrastructure. Although fixed line telecoms continue to be run by the previously State-owned monopoly, Telkom, costs are falling and the Government has signalled its determination to introduce competition in the fixed line market.

Economic reforms

The South African Government is currently transforming the economy through free market mechanisms by establishing a strategy for Broad-Based Black Economic Empowerment and a Broad-Based Black Economic Empowerment Act 2004, followed by Codes of Good Practice. This structure aims to empower ownership and management control of businesses by black people. The result of this structure has already created increased competitive intensity, more Government tax revenue and greater spending power in the economy. It will also provide short term relative competitiveness and introduce new entrants in the sector, lending new skills and ideas. However, companies establishing in South Africa must be aware of the various recruitment and procurement policies to be put in place.


The future

South Africa's status as one of the leading BPO (Business Process

Outsourcing) hubs worldwide is rising.

This reputation is extending to the investment management industry, where a strong domestic financial services industry provides a pool of existing talent and experience.

Investment management needs efficient and predictable processes, improved costs, transparent work-flows and access to world class experience and best practice, all of which South Africa is addressing in order to be a significant player. The extent of South Africa's success is likely to depend on its ability to attract large volumes of business without comprising its cost and quality advantages. This will require significant investment in training and retaining young South Africans in the industry.

 Pierre de Villiers: Johannesburg
(27) 11 797 5368
Andy O'Callaghan: Dublin
(353) 1 662 6247

¹ <http://www.callcenters.co.za>

Bank of Italy Decision sparks industry operational re-think

The changes introduced by the Bank of Italy's Decision dated 14 April 2005 are an opportunity for asset managers to outsource business processes but, most importantly, a chance to realise cost efficiencies and capital allocation optimisation.



Flashline

Improving transparency for administration fees of investment funds

In July 2005, the Swiss Funds Association (SFA) published its new guideline, which will make Switzerland the European leader for transparency of administration fees. The guideline's main aim is to give investors a more objective picture of how administration fees are used. The guideline is to be followed by all Swiss investment funds as well as by all foreign funds approved for public distribution in Switzerland.

In future, the application of administration fees will be separated into three different components: management, asset management and distribution. The prospectus must disclose the (intended) maximum rate for the individual components. Furthermore, the guideline defines the notions of portfolio maintenance fees and reimbursements and determines the relevant group of recipients. In order for an audit firm to confirm a fund's compliance with the guideline, these aspects (disclosure, apportionment, group of recipients) need to be assured on the organisational and accounting levels. The prospectus of each fund must be adjusted no later than the end of 2006. The audits are based on random sampling on various levels: by fund, as well as by fund manager.

Martin Büchel: Zurich
(41) 1 630 2454

After five years of rapid development and double-digit growth between 1995-2000, followed by a period of downsizing, the Italian investment management industry is now facing new challenges relating to client relationships, product restyling, new corporate governance rules and cost efficiency achievement.

The competitive environment has been impacted by the new Bank of Italy Decision of 14 April 2005, enforcing the Legislative Decree Nr. 274 of 1 August 2003, so-called "UCITS III", which will promote European market integration through increased product offerings, wider investment diversification and re-engineering of back office processes.

Following this Decision, Italian asset managers have undertaken strategic analysis aimed at assessing economic impacts of outsourcing a portion of their activities or entire processes.

Outsourcing: what opportunities?

In the past Italian fund companies have been allowed to delegate only a limited range of activities. The new regime enables outsourcing of a much wider range of activities, since NAV calculation can be entrusted to custodians.

The Italian market is thus addressing the issue of what type of activities could be entrusted to custodians – or outsourced, where responsibility still rests with the investment management company. The general opinion agrees that "non-core" activities are most suitable for outsourcing, notably fund accounting administration and, to a broader extent, operations, including information technology.

The main administrative activities which could be transferred to custodians, are illustrated in Table 1 below.

Table 1: Administrative activities which could be transferred to custodians

	Entrust or Outsource	Outsource
Law	Bank of Italy's Decision of 14 April 2005	Italian Financial Law – Article 33 of Legislative Decree Nr.58, 24 February 1998
Activities	<ul style="list-style-type: none"> ✓ NAV calculation; ✓ securities masterdata management; ✓ pricing management; ✓ corporate actions management; ✓ ex post compliance management. 	<ul style="list-style-type: none"> ✓ reconciliations; ✓ transfer agent management; ✓ regulatory reporting; ✓ other back office activities.

Source: PricewaterhouseCoopers

Table 2: Advantages and disadvantages of entrusting NAV calculation to custodians

	Advantages		Disadvantages
	Strategic	Economic	
Asset Manager	<ul style="list-style-type: none"> ✓ shorten the fund management value chain; ✓ transfer responsibility of NAV calculation to custodian; ✓ improve service quality as a result of a deeper focus on core activities. 	<ul style="list-style-type: none"> ✓ variable vs fixed cost structure; ✓ reduce IT investment. 	<ul style="list-style-type: none"> ✓ high expenses to withdraw from outsourcing decision; ✓ improved controls and new procedures needed for dealing with third party.
Custodian	<ul style="list-style-type: none"> ✓ become a centre of excellence for administrative activities; ✓ target non-captive clients. 	<ul style="list-style-type: none"> ✓ obtain economies of scale and scope; ✓ cut costs; ✓ increase revenues. 	<ul style="list-style-type: none"> ✓ lower revenues due to aggressive pricing from new entrants; ✓ need for different procedures/segregation of duties to address clients' requests: entrust vs outsource.

Source: PricewaterhouseCoopers

Currently, these choices are hindered by various issues. On the one hand, outsourcing would guarantee better quality and efficiency and accordingly better cost control and flexibility, moving from a fixed to a variable cost structure. On the other hand, concerns about the protection of client confidential data and asset allocation strategies might obstruct the decision to outsource. Furthermore, an outsource choice will necessitate a review of the control framework in order to be compliant with standards already in use in the European market and especially in the US market (i.e. Statement of Auditing Standards 70 – SAS 70).

Future developments

Global custodians are increasingly playing a key role in the local market thanks to their comprehensive experience and their ability to offer competitive and effective fund accounting services, based on large volumes of assets under management.

The new regulation, granting the possibility of delegating the responsibility for the NAV calculation, eventually changes the relationship between asset managers and custodians. As a result players need detailed analysis of their processes aimed at identifying those business areas impacted by the change: it is crucial that asset managers correctly estimate the cost savings deriving from the spin-off of back office activities. In turn, custodians who intend to provide services to a wide variety of clients are expected to have their internal control system examined by external auditors in accordance with SAS 70.

Entrusting NAV calculation: a plus or a minus?

The main Italian asset managers are already performing feasibility studies on the impact of entrusting the NAV calculation to custodians. Table 2 above illustrates main advantages and disadvantages of this choice.

Conclusions

The new regulation gives the Italian investment management industry the opportunity to realise cost efficiencies and optimise capital allocation. In the medium-term, there is likely to be substantial industry re-organisation as a result of asset managers' cross border M&A transactions. Key features of this will be global players absorbing smaller competitors, which might be less efficient and unable to face the investment efforts required by the regulation, as cost reduction drives concentration. Concurrently, spin-offs will occur as business migrates from local banks to global custodians.

Mauro Panebianco: Milan
(390) 2 66720 568
Fabiano Quadrelli: Milan
(390) 2 66720 538

10

UK property derivatives take off

The past year has seen the emergence of a property derivatives market in the UK and some helpful tax clarification.



Flashline

Belgium issues Savings Directives definitions

Further to the Act of 17 May 2004 implementing the European Savings Directive into Belgian law (including the introduction of a State of Residence Withholding Tax), the Belgian tax authorities recently issued a practice note to give further details on the definitions of “beneficial owner”, “paying agent” and “payment of interest”. The Belgian practice note expands on the particularities of payments derived from investment undertakings and on the withholding procedure.

On the notion of beneficial owner, the practice note, for example, comments on the particular cases of life tenancies, fiduciary arrangements and trusts.

To be classified as a paying agent, the practice note specifies that an economic operator (which is not itself the debtor of the interest) has to have received an active payment order either from the debtor or from the beneficial owner of the interest. There is a list of practical examples to identify the person qualifying as paying agent.

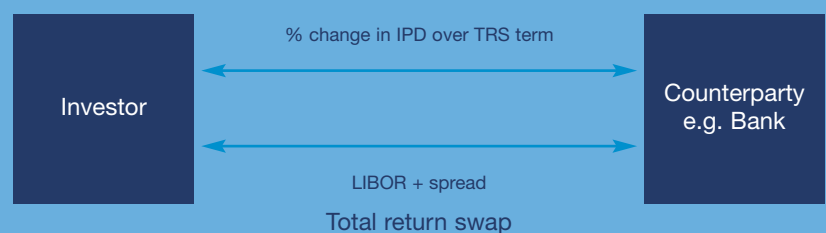
On payments derived from investment undertakings (UCITS), Belgium applies the 15% and 40% asset tests to determine whether or not they fall within the scope of the application. In this regard, the practice note also indicates that Belgium applies the so-called “home country rule”.

Olivier Hermand: Brussels (32) 2 710 44 16
Amélie Lagache: Brussels (32) 2 710 43 62

The derivatives markets have seen enormous growth over the past twenty years with derivatives being written over an increasingly diverse array of underlying subject matter ranging from the “vanilla” – such as interest rates and foreign currency – through to the “exotic” such as weather conditions. It is perhaps somewhat surprising, in view of the dynamic and innovative nature of the derivative markets, that it has taken so long for derivatives to emerge in the real estate sector given that real estate is one of the core investment assets.

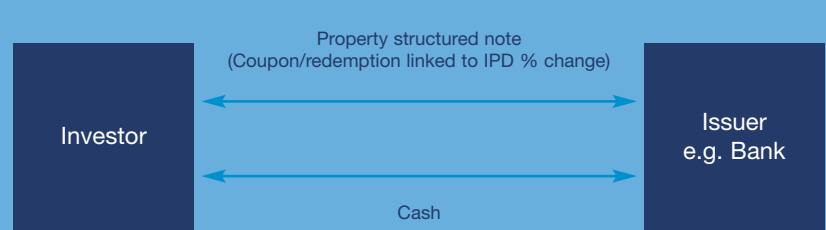
For players in the UK real estate sector, this wait is now over. To date, the UK market has been dominated by two basic types of instrument, property total return swaps (see Figure 1 below) and property structured notes (or “property index certificates”) (see Figure 2 below).

Figure 1: Property total return swap



Source: PricewaterhouseCoopers Key: IPD = Investment Property Databank

Figure 2: Property structured note



Source: PricewaterhouseCoopers Key: IPD = Investment Property Databank

The market is still at an early stage of development and trading volumes have been relatively low compared with established derivative markets such as those relating to interest rate and currency derivatives (being in the hundreds of millions of dollars as opposed to trillions), there are strong signs of interest in the market among a wide range of potential users and there is a steady stream of new entrants.

In the past the development of a property derivatives market in the UK was hampered by the uncertainty associated with the taxation treatment of such instruments in the hands of investors. Specifically, there was some concern that

profits arising from such instruments could be taxable but losses may not be deductible for tax purposes.

This uncertainty was largely resolved by the introduction by Finance Act 2004 of a specific regime dealing with the taxation of property derivative instruments. This new regime came into effect on 17 September 2004 and applies to property derivative transactions entered into on or after 1 August 2004.

Broadly, the changes introduced by FA 2004 bring property derivatives within the scope of the UK tax rules (the “Derivative Contracts” rules) governing the taxation treatment of derivative contracts in the hands of companies. Previously such contracts were excluded from this regime.

In addition, special rules were introduced in order to provide capital gains treatment for the property value linked element of property derivative transactions in the hands of non-traders in an attempt to replicate the capital treatment of physical real estate assets.

The expectation is that the market will continue to grow as potential users become more familiar with the basic property derivative instruments and begin to see more clearly the extensive advantages and opportunities which they offer.

Matthew Barling: London
(44) 20 7212 5544
John Forbes: London
(44) 20 7804 3161

Awaiting VAT exemption enlightenment

On 8 September 2005, the Advocate General of the ECJ delivered her opinion in the *Abbey National* case regarding the scope of the VAT exemption granted to “the management of special investment funds”.

Firstly, the Advocate General indicated that the notion of “management” is a Community concept and cannot be defined by the member states who however remain free to define the beneficiary funds.

Secondly, outsourced custody and administrative services could be exempt if they form a distinct whole and are essential for and specific to the management of the fund. This would be the case of a bundle of services that would form an essential part of all functions arising from the management of the fund. Outsourced services not meeting these requirements should thus be liable to VAT. The Advocate General considers that “pure technical safekeeping” services could not benefit from the exemption. If these “technical” services are the most characteristic component of the custodian role, VAT will have to apply to the custodian services in their entirety. It is then up to the national courts to determine whether this is the case.

In practice, the principles outlined seem difficult to interpret and to apply, since they remain quite general and vague. It is thus essential to wait and see how the European Court of Justice (ECJ) will rule, hoping that ECJ’s decision will shed some welcome light on this important topic.

Laurent de La Mettrie: Luxembourg
(352) 49 48 48 3204
Michel Lambion: Luxembourg
(352) 49 48 48 2519

Malta attracts hedge funds and their managers

Since the introduction of various financial services legislation in 1994, including the Investment Services Act (ISA), and in particular since Malta's accession into the EU in May 2004, Malta is emerging as an alternative domicile for both hedge funds and hedge fund managers.



The Maltese ISA provides a comprehensive regulatory regime for investment services and collective investment schemes (CIS) — which also includes professional investor funds (PIFs). All hedge funds that have been set up in Malta are PIFs.

The Malta Financial Services Authority (MFSA) is responsible for the licensing, regulation and supervision of CISs, including PIFs. The main regulations concerning the establishment and regulation of hedge funds in Malta are:

- Hedge funds may not be marketed to retail investors in Malta although Malta's entry into the EU means that UCITS funds (which may have certain hedge fund-like characteristics) are eligible for a "passport" enabling them to be marketed in other EU member states.
- Hedge funds are typically established as PIFs, however, it is also possible for a fund established overseas to transfer its domicile to Malta and apply to be registered as a PIF.
- There are two categories of PIFs which are available to different types of individual investor (as well as corporates and trusts):
 - Qualifying investors must have more than \$1 million of net assets and meet other criteria. The minimum initial investment is \$100,000 (or equivalent in another currency).
 - Experienced investors are persons having the expertise, experience and knowledge in the acquisition/disposal of funds of a similar risk profile to the proposed PIF. The minimum investment threshold is \$20,000.

- There are no restrictions on the investment powers of a PIF. However, this is subject to restrictions on leverage through the use of derivatives or borrowing in the case of PIFs sold to Experienced investors.
- The MFSA has committed to process applications for the authorisation of PIFs within seven working days, provided all relevant documentation has been provided and that all functionaries are based and regulated in a "Recognised country" (i.e. members of the EU or EEA and some third countries).

As to the tax treatment of such funds, any distributions to non-resident investors and capital gains made by such investors on exit are exempt from Maltese tax. However, a 15% final tax is imposed on distributions to Maltese resident non-corporate investors and capital gains made on exit by Maltese residents.

Financial services is the fastest-growing sector of the Maltese economy and the creation of the MFSA as a single regulator was part of Malta's long term strategy to become a mainstream finance centre. Companies have benefited from streamlined procedures, lower fees and compliance costs and consistently-applied standards. These, together with Malta's EU membership, make Malta an attractive alternative location for the registration of new funds or re-domiciliation of existing funds.



Joseph Camilleri: Valletta

(356) 25 647 603

German proposed policy changes unveiled

The recently formed German coalition government have agreed on a programme for the next four years. The basic tax policy is to accept a substantial budget deficit in 2006 in the hope of boosting the economy prior to a return to budget discipline in 2007.

While some proposals have been released, the overall picture is as yet far from complete. Some of the key announcements are highlighted below.

Tax proposals

- There will be a reform of corporation, trade and income taxes from 2008 intended to simplify and protect the system from abuse.
- Despite earlier indications, there will be no changes with regard to the taxation of capital gains resulting from the sale of participations in 2005 and it is unlikely that there will be changes in this area in 2006.
- The standard rate of VAT is to climb from 16% to 19% from 2007.
- Trade tax in its present form might be abolished altogether, but only if the consequences of an alternative method of financing local government appear sufficiently assured.
- The top rate of income tax is to be increased from 42% to 45% for annual incomes over € 250,000 (€ 500,000 for married couples).
- Investment income and capital gains of individuals will be taxed at a rate of 20% (withheld at source).
- Declining balance depreciation is to be improved for 2006 and 2007 only

and declining depreciation of rented real estate is to be abolished from 1 January 2006.

- The coalition agreement includes a passage to give the federal states (*Länder*) the opportunity to determine the Real Estate Transfer Tax-rate (currently uniform 3.5%).

Improvement of financing options for small and medium-sized businesses

- There will be improvement through expansion of the market.
- Potentially there will be a formation of a "German Small and Medium-sized Business Fund".

Creation of new investment options

- The introduction of Real Estate Investment Trusts is planned, provided that suitable investor taxation treatment is ensured.
- There will be an expansion of the securitisation market.
- The investment options for Public-Private Partnerships (PPPs) are to be increased by change of law.
- An extension of the existing Law on Equity Investment Companies

(*Unternehmensbeteiligungsgesetz (UBG)*) is planned in order to create a 'Private Equity Law'.

The Federal Government also intends to improve the environment for venture capital investments including proposals for easier formation of equity capital, a better credit supply and an adequate supply of venture capital by mid-2006.

Other changes

The new Federal Government plans to align the existing corporate governance rules to the new requirements in light of international developments. This will include changes to accounting rules and the mutual recognition of German, European and American financial reporting standards.

The coalition is intending to reduce superfluous regulations, by establishing an inter-ministerial work group, which will present a "feasibility paper" for reducing bureaucracy in the financial sector, following industry consultation. The initial objective for reducing bureaucracy should be amendment of the Law on Investments (*Investmentgesetz*).



Uwe Stoschek: Berlin

(49) 30 26 36 5286

Continuity for UK funds tax regime – but uncertainty remains

Earlier this year, the UK tax authorities announced wide-ranging changes to the UK funds taxation regime within the Budget. The impact of these has now been scaled back although fund promoters continue to suffer from tax uncertainty in the UK.

The original proposals included the following:

- Amendments to the tax treatment of distributions from authorised funds such that investors would be taxed as if the income had preserved its original character as received within the fund. For example, interest receipts would be taxed on the investor as such rather than as part of a dividend.
- An amended taxation regime for investors holding more than 10% of a “Qualified Investor Scheme”. Taxation would have been on a mark-to-market basis rather than treated as realised on disposal.
- The potential for this taxation basis to be extended to all holdings in UK authorised funds.

Since these proposals were released, there has been significant lobbying of the UK Government to explain the dramatic operational implications of these proposals, and also the impact that such amendments could have on choice of fund location for investors. Following these efforts, it was

announced in September that the distribution changes would be postponed. Such changes will not be made, at least until after the introduction of a UK REIT regime. This is good news for the industry, as the scale of the proposed changes would have meant significant business interruption. However, it remains to be seen if the Government will allow time for discussion of any new distribution basis, and also whether significant lead time will be allowed before any new regime is introduced. Such considerations would be helpful to the industry and also ensure that the ultimate investors are not inadvertently affected by any change.

In addition, the UK tax authorities have recently released further clarification of the taxation treatment of derivative investments within authorised funds. Following the increased investment powers brought in by UCITS III (and COLL in the UK), there had been concern that the UK tax authorities approach to taxation could change, and that the exemption from tax for derivative profits taken to capital under

the SORP could be removed. The UK tax authorities have confirmed that their approach to taxation of funds remains broadly unaltered.

One concerning aspect of the events this year is that the UK legislation now enables the tax regime for funds to be amended by way of secondary legislation: no parliamentary process would be required. While the current UK Government has given reassurances to the industry regarding the timings of any changes, these powers remain in law and future administrations could introduce change speedily and with no formal consultation or parliamentary scrutiny. These powers do little to re-establish tax stability within the UK funds landscape and as such could prove damaging to the industry over time.



Charlotte Worthington: [London](#)

(44) 20 7804 3051

Reporting to German institutional clients needs improvement

15

When it comes to customer satisfaction in reporting to German institutional investors, a third of institutions are often not satisfied with the reporting they are receiving from KAGs. This is one of the striking findings of the PricewaterhouseCoopers Survey “Reporting for institutional investors in the German Asset Management Market 2005”, which sought views of institutional investors.

At a time when information requirements of institutional investors are increasing (e.g. through IFRS), the asset management industry has not always been paying sufficient attention to high quality reporting. Nor has it been seeking client feedback on what is wanted. Discussions of transparency and completeness of reporting information will play a growing role in debates between institutional investors and German investment management companies (KAGs). The reporting standards delivered by most global custodians are making institutional investors much more aware, and critical, of KAG reporting. Thus addressing the reporting issue can provide significant competitive advantage for a KAG in gaining business and encourage higher customer satisfaction and potentially more assets from clients.

The results of the survey show that between 32% and 38% (depending on the reporting service) of German institutional investors consider the reporting they receive from KAGs to be “not sufficient”. The major reasons for expressed dissatisfaction are “quality” and “user-friendliness”.

As Figure 1 shows, the most frequent improvements wanted are to content (44%) and layout (38%). An improvement in distribution is wanted by 17%. A growing trend, which was mentioned by many institutional investors and is particularly sought, is an implementation of an online/web solution (e.g. e-reporting).

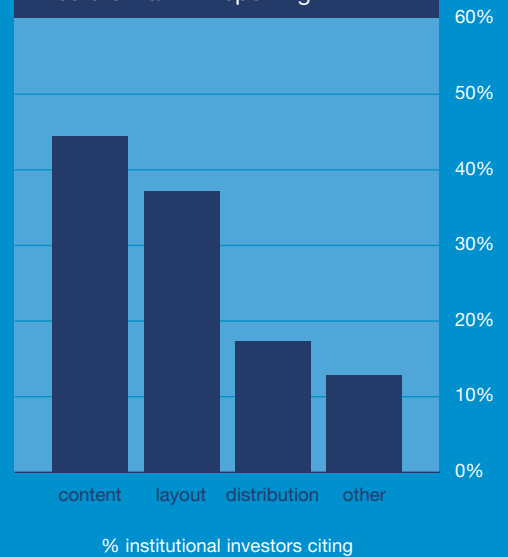
Obtaining feedback on customer satisfaction

While measurement of customer satisfaction has been common in most industries for years, it is in the early stages in asset management in Germany. Worryingly, 40% of the KAGs do not actively seek customer satisfaction feedback on the quality of the reporting they are delivering. Of the 34% of KAGs which ask for and evaluate feedback, 19% obtain feedback regularly and 15% get it occasionally.

Reporting can be an important competitive factor for KAGs and certainly can help improve overall client satisfaction and loyalty. But to deliver quality and user-friendliness, KAGs must first understand what their customers want and then meet these customer demands. This may necessitate re-organising processes and possibly even changes in strategy.

Following on from this survey, PricewaterhouseCoopers is preparing extensive analyses of customer satisfaction measurement for KAGs. We are supporting KAGs in setting up high quality reporting which can provide (potential) market participants with an informed basis for making the changes necessary to ensure they are competing effectively.

Figure 1: Improvements institutional investors want in reporting



Source: PricewaterhouseCoopers

Wulf Ley: Frankfurt (49) 69 9585 2710
Michael Kispert: Frankfurt (49) 69 9585 2711

Editor: Andrea Lowe

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

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

- Withholding taxes on EU dividends are around 30-60 basis points of equity fund values and represent a hidden charge on UCITS investing in cross-border equities. This is invariably suffered by investors as part of the 'total expense ratio' of the fund but is not usually suffered if investors invest in a domestic UCITS. Following the recent Fokus Bank case, it can be seen that if a country has a domestic system to remove double taxation and withholding tax on corporate dividends, then the advantage of this must be extended to other EU investors including foreign UCITS.
- Costs of local compliance can run into hundreds of thousands of euros. While currently most fund managers choose to comply with these requirements to market their funds cross-border, overly burdensome administrative requirements which are occurring to varying degrees in Austria, Belgium, Denmark, Germany and the UK may be judged incompatible with the EU Treaty.
- Barriers to cross-border fund mergers can prevent fund promoters streamlining their ranges to increase fund size and so deliver economies of scale to their investors.

It is clear that the legal framework exists to challenge most discriminations against funds that are sold on a cross-border basis. The Commission and the European Court of Justice (ECJ) are prepared to take action to enforce member states' obligations under the EU Treaty where necessary. However, it is up to sponsors and managers to bring these discriminations to their attention. Without this, little progress can be expected.

David Newton: London	(44) 20 7804 2069
Charlotte Worthington: London	(44) 20 7804 3051

'Tax Discrimination against Foreign Funds: Light at the End of the Tunnel', a joint report published by PricewaterhouseCoopers and the European Fund and Asset Management Association (EFAMA). This report is the third in a series, and analyses the tax constraints and looks at progress in removing those constraints as well as identifies the remaining tax barriers to the effective operation of the EU single UCITS fund marketplace. It also makes suggestions for change by the European fund industry and the European Commission. To obtain your copy, please contact merryn.stewart@uk.pwc.com

We have investment specialists in more than 50 investment centres around the world

Contact Name	Location	Position	Phone Number	Email Address
Simon Jeffreys	London	Global Investment Management Industry Group Leader	(44) 20 7212 4786	simon.j.jeffreys@uk.pwc.com
David Newton	London	Global Investment Management Tax Leader	(44) 20 7804 2069	david.newton@uk.pwc.com
Frank van Zelst	Amsterdam	Global Real Estate Tax Leader	(31) 20 568 6872	frank.van.zelst@nl.pwc.com
Marc Saluzzi	Luxembourg	European Investment Management Industry Leader	(352) 49 48 48 2511	marc.saluzzi@lu.pwc.com
Henrik Steinbrecher	Stockholm	European Real Estate Industry Leader	(46) 8 555 330 97	henrik.steinbrecher@se.pwc.com
Barry Benjamin	Baltimore	North American Investment Management Industry Leader	(1) 410 783 7623	barry.p.benjamin@us.pwc.com
Robert Grome	Hong Kong	Pacific Rim Investment Management Industry Leader	(852) 2289 1133	robert.grome@hk.pwc.com

Location	Contact Name	Phone Number
Austria	Christian Kraetschmer	(43) 1 501 881901
Belgium	Emmanuele Attout	(32) 2 710 40 21
Channel Islands	Brendan McMahon	(44) 1534 838 234
Cyprus	Costas Mavrocordatos	(357) 2 555 202
Czech Republic	Petr Kriz	(420) 2 5115 2045
Denmark	Mikael Sørensen	(45) 3945 9102
Estonia	Urmas Kaarlep	(372) 614 1801
Finland	Juha Wahlroos	(358) 9 2280 1437
France	Jean-Pierre Bouchart	(33) 1 5657 1702
Germany	Arno Kempf	(49) 69 9585 2367
Gibraltar	Colin Vaughan	(350) 73520
Greece	Nicos Komodromos	(30) 210 6874 671
Hungary	David Wake	(36) 1 461 9514
Iceland	Hjalti Schiöth	(354) 550 5337
Ireland	Marie O'Connor	(353) 1 662 6308
Isle of Man	Mike Simpson	(44) 1 624 689 689
Israel	Joseph Fellus	(972) 3 795 4683

Location	Contact Name	Phone Number
Italy	Elisabetta Caldirola	(390) 2 7785 380
Latvia	Juris Lapshe	(371) 709 4400
Lithuania	Chris Butler	(370) 5 239 2303
Luxembourg	Thierry Blondeau	(352) 49 48 48 2549
Malta	Joseph Camilleri	(356) 25 647 603
The Netherlands	Sonja Barendregt-Roojers	(31) 10 407 6639
Norway	Geir Julsvoll	(47) 23 16 0540
Poland	Antoni F Reczek	(48) 22 5234 339
Portugal	António Assis	(351) 213 197 013
Romania	Vasile Iuga	(40) 21 202 8800
Russia	Rick Munn	(7) 095 967 6374
Slovak Republic	Eva Hupkova	(421) 2 5441 4101
South Africa	Pierre de Villiers	(27) 11 797 5368
Spain	Antonio Greño	(34) 91 568 4636
Sweden	Susanne Sundvall	(46) 8 555 33 273
Switzerland	Thomas Huber	(41) 1 630 2436
United Kingdom	Pars Purewal	(44) 20 7212 4738