

European IMRE News

Insights on developments in the European landscape*

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Lessons from the sub-prime crisis

It is clear that financial markets as a whole underestimated risk prior to the sub-prime crisis. Learning from the lessons emerging will strengthen risk management and fund governance in the long term

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Hindsight is a wonderful thing. In the case of the sub-prime crisis, three lessons stand out. Respectively, they are: evaluate liquidity, question valuations and understand the assets you are buying.

These may now seem obvious but it is interesting to note that of the 55 European asset managers surveyed by PricewaterhouseCoopers¹ in spring 2007 on behalf of the European Commission (EC), 70% of respondents rated their risk management infrastructure as either 'good' or 'very good' when it came to liquidity – seemingly in contrast with the fact that 67% performed no, or only limited, analysis in relation to the liquidity of their investments.²

Twelve months on, it is clear that the responses to the EC survey were representative of the approach taken by many market participants to certain risks. Conversely, it is also evident that certain firms' risk management systems and procedures were robust enough to limit the negative impact of the crisis on proprietary and client assets, and in some cases, even to identify successfully, strategies that have resulted in gains.

Those investment managers who have not weathered the storm so well, whether through direct or indirect exposure to sub-prime assets, or as the crisis spread outside the sub-prime sector causing mistrust in healthy assets and financial institutions, would benefit from reassessing the rigour and effectiveness of their risk management systems and procedures.

Assessing liquidity risk

Liquidity was perhaps the most overlooked or underestimated risk factor. Ratings, which – with the benefit of hindsight – may have been overly generous, may have led some investors to believe that there had been a shift in the risk – reward paradigm. What later became clear was that the attractive returns of certain instruments were nothing more than the flipside of the additional risk they carried – part of this additional risk being liquidity risk. As a result, some funds have now found themselves trapped in structured credit-type instruments that initially looked attractive, but either cannot be sold in current markets or need to be significantly discounted.

¹ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

² Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets

³ e.g. Hedge Fund Standards: Final Report, published January 2008 by the Hedge Fund Working Group (now the Hedge Fund Standards Board), and IOSCO 'Principles for the Valuation of Hedge Fund Portfolios', published March 2007.



Investment managers need to keep the liquidity of their portfolios under review, and conduct scenario modelling on a regular basis. For open-ended funds, analysis of portfolio liquidity alone is not enough. For such funds, liquidity must be viewed from both asset and liability perspectives: the liquidity you can afford on the asset side is dictated by the liquidity you offer on the liability side. The type of fund, the nature of clients, past repayment/investment history and regulatory and legal requirements all play a part in determining the required liquidity of an open-ended fund.

Identifying limitations of valuation procedures and raising the bar

The difficulties some funds currently face might have been mitigated or even avoided if fund boards/trustees, investment managers and/or fund administrators had had in place the means of valuing structured products independently and effectively. The difficulty with valuing such products lies not only in the complexity of the product but also in the lack of transparency in relation to the identity of the underlying reference assets.

Potential buyers of such products can point to recent events as a means of

leveraging their bargaining power to insist on levels of information that would make these products easier to value, and help them to get better understanding of the underlying risks.

In this world of valuation uncertainty, one needs to put in place the three pillars of a valuation framework: guidelines (a valuation policy), expertise (experienced and empowered risk management staff) and governance (for example a valuation committee with appropriate senior management oversight). Trade bodies, industry groups and supranational organisations have been active recently in developing guidance and voluntary standards relating to complex financial instruments.³

The current reporting season is, for many reporters, the first where they are obliged to follow IFRS7 and FAS157. These new accounting standards enhance the disclosure requirements in IFRS and US GAAP relating (among other things) to: the degree of subjectivity in valuation methodologies adopted by reporting entities; key assumptions underlying such methodologies; and the sensitivity of reported valuations to 'reasonably possible' movements in the variables underlying them.

In light of market events, the analysts and shareholders who scrutinise financial statements seem likely to focus closely on these new disclosures. Following best practice in relation to valuation of complex financial instruments is the best way for fund boards/trustees to demonstrate that the disclosures that they are making and the valuations they have attributed to holdings are sound.

The importance of thorough analysis

Finally, investment managers and funds untouched by the crisis have one characteristic in common – they only invest in products they thoroughly understand. For those funds still holding asset-backed securities (ABS), collateralised debt obligations (CDOs), even CDOs of ABS, it is imperative to understand what your exposures are. This means examining all the subtleties of these structured vehicles and getting access to means of independently and effectively valuing them. It has become abundantly clear that relying on rating agencies alone to evaluate the underlying credits is not sufficient.

Implementing the Hedge Fund Standards: How hedge funds can differentiate themselves and build trust

Making the most of the initiative by London-based hedge funds to counter concerns over transparency requires rigorous processes, possibly with external validation

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The Hedge Fund Standards Board (HFSB) published their Hedge Fund Standards on 22 January 2008. The intent is to improve transparency and disclosure across the sector and to deflect any over-burdensome regulation in the future. The HFSB is generally expecting all organisations across the industry will conform to these standards.

The standards are voluntary and comprise a comprehensive framework covering risk, governance, activism, valuation and disclosure. Becoming a signatory to the standards (the undertaking to conform to the standards) will require hedge funds to demonstrate how they comply with the standards or otherwise 'explain' why they feel they cannot. Adherence to this 'comply or explain' regime allows conformity, even in the event that all standards are explained away, which should not be seen as an inferior option to complying.

A 'conformity statement' is required to be submitted to the HFSB on an annual basis (the first submission being no later than 31 December 2008) and this is a public declaration of conformity. A 'disclosure statement', providing investors with overview details of the standards with which the signatory does not comply, must be made available to investors and other interested parties by the same date. The drafting of an 'explanatory statement' (which explains in detail to the HFSB where business practices do not currently conform to the standards) is also a requirement.

The difficulty with voluntary standards

There is, however, no suggestion that any of these statements will be monitored or assessed by the HFSB or any other oversight body, to ensure the quality or integrity of their content. And therein lies the problem with any unsupervised, voluntary standards if they are not simply to be viewed as self-assessment, self-certification and ultimately, self-serving.

The HFSB, on receipt of conformity statements, will allow its logo to be used on hedge fund signatories' websites, offering documents and marketing materials. But there is a risk that the HFSB's reputation and this regime will be tarnished should a signatory claiming conformity be found subsequently to have submitted an inaccurate conformity statement. The explanatory statement submitted to the

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HFSB would also have to be sufficient in detail to allow suitable dispensation under the 'comply or explain' regime.

Similarly, from an investor's perspective, the receipt of a disclosure statement that ultimately lacks detail and looks much the same from fund to fund will not increase that investor's ability to make an informed decision with respect to conformity to the standards – unless they have confidence in how the disclosure statement was prepared in the first instance.

It is not only investors and the wider marketplace that need to be confident of a level playing field. Those fund managers that invest time and money in a managed, due process when implementing the Hedge Fund Standards and disclosing conformity would rightly feel disadvantaged if a peer did not approach its implementation and disclosure with the same level of rigour and professionalism.

Achieving true differentiation

To really stand out, to differentiate themselves from the pack and to generate the most value from

implementing standards, hedge funds need a managed process in place to:

- Document current practices, processes and controls;
- Identify gaps in current practices and controls where furthest from the required standard;
- If necessary, enhance practices and controls to meet the standards; and
- Prepare the necessary evidence, to the appropriate level of detail, to enable full disclosure through the 'comply or explain' regime and associated statements.

An independent validation from a reputable and competent third party over the implementation process and subsequent disclosures would lend significant weight to the assurances that the signatories are giving to their investors (both current and prospective) and could be a real differentiator – a demonstration they have taken the process seriously and have confidence to open up their disclosures to scrutiny. It is reasonable to assume that validation of this nature would also be sought by the directors of hedge funds before any public declarations of conformity were made. Additional

value, by-products of a managed implementation approach and validation, would potentially include:

- Process improvements and realisation of operational efficiency gains;
- Enhancement of the overall risk and control environment;
- Cost reduction, as a result of the above;
- Reduced management disruption and costs involved in supporting investors' due diligence reviews; and
- Reduced direct regulatory oversight in the future, should this arise.

In summary, these voluntary standards are a measured approach to an important issue facing the sector, but how they are implemented will be key. By differentiating themselves and not following the crowd, hedge fund signatories can deliver better value to their organisation and investors, while gaining or maintaining competitive advantage over their peers. Simply going through the motions and 'ticking the compliance box' is surely not the best option and action should be taken now.

Towards a single talent pool

Convergence between the alternatives and traditional talent pools, tougher business conditions and UK Treasury moves to tax nondomiciles are all having an impact on the rewards of investment managers

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Unsurprisingly, there is a real sense of belt tightening beginning to emerge across the industry with organisations focusing on differentiating high performers and talent becoming more marked. High-quality fund managers and emerging stars are being tied in with significant bonuses and long-term awards, while underperformers are facing uninspiring pay deals with reduced, or even zero, bonuses.

Taking this to the next level, in an attempt to align costs with revenues, fee-sharing arrangements are being considered by many investment houses. These include the traditional institutions, which until now have shied away from such arrangements. There is a real push from fund managers to be seen as partners in the business of running a fund rather than employees who just manage assets as part of their job description.

Such a move in reward structures is resulting in the beginnings of a possible alignment of key aspects of remuneration for the talent pool for institutional houses and alternatives managers right through to the smallest boutiques. Whether this is an indication of a single talent pool, only time will tell.

UK Treasury moves afoot

Recent proposed changes to capital gains tax and domicile rules by the Treasury are likely to have a significant effect on the remuneration in the sector.

Broadly speaking, non-UK-domiciled individuals now face an annual fee of £30,000 and loss of personal tax allowances, after being in the UK for seven years, in order to remain taxed on a remittance basis. This is likely to result in many weighing up the pros and cons of remaining in the UK.

The move to a flat rate capital gains tax of 18% will give rise to winners and losers. Hedge fund managers receiving income through fee-sharing arrangements are unlikely to be affected significantly, while private equity managers typically face an increase in the effective tax rate from 10% (or lower) to 18% on returns through carried interest and co-investment plans. For nondomiciled managers who have historically kept realised gains offshore, the legislative changes could have a particularly severe bite. On the other hand, fund managers investing directly into their funds could see any gains they make taxed at 18% rather than up to 40% under the current rules.

Real estate managers are also worth a mention here as possible winners. Under taper relief rules, assets in real estate funds tend not to qualify as business assets and, therefore, have never really had the chance to benefit from 10% tax rates on disposals, with 24% being the best to hope for (and even this being available only after a 10-year holding period). Moving to a flat rate of 18% will make post-tax returns through carried interest plans for real estate managers far more attractive in future.

The big sums earned through successful deals for owner-managers will be affected by these changes. Crystallising equity value through an IPO or trade sale will now result for many in an 80% increase in their effective tax rate. However, net proceeds for individuals from such deals can still be very large, particularly compared to the earning power of many investment managers as the purse strings gradually tighten.

Analysing UCITS III risk

The introduction of UCITS III has not led to a marked increase in fund volatility over the five years from 2002 to 2006. These are the results of a European Commission study, carried out by PricewaterhouseCoopers

When analysing the risks of UCITS funds before and after the UCITS III Directive allowed use of a wider range of assets, especially derivatives, there is no significant difference in quantitative market risk. That said, there is an increase in qualitative risks.

For sure, all asset classes of funds (with the exception of real estate) have experienced one year of negative returns between 2002 and 2006. But this is the case for funds launched both before and after the 2002 Directive.

These are the headline results of a European Commission study performed by PricewaterhouseCoopers' European network. The study is titled: 'Investment funds in the European Union: Comparative analysis of use of investment powers, investment outcomes and related risk features in both UCITS and non-harmonised markets'. Published in February 2008, the study shows increased derivatives use has been matched by neither greater volatility, nor better performance.

Volatility unchanged

Of the 380 UCITS' funds from nine countries surveyed, even those that used derivatives intensively showed no greater price volatility than those that did not. The 150 nonharmonised, or non-UCITS, funds were less volatile, but this may have been due to less regular valuation, which has the effect of smoothing returns. While UCITS' funds are valued daily, nonharmonised funds are often valued as infrequently as once a month.

Yet qualitative risks specific to OTC derivatives did appear to have grown. The study showed these included risks relating to: valuation, liquidity and counterparty.

Legal differences

As part of the study, we did identify some differences in individual countries' legal frameworks governing UCITS, which could impact portfolio compositions, and show that supervision has yet to be harmonised completely. From a regulatory perspective, the greatest variation related to the 10% basket of unlisted investments. France appeared to have the most flexible approach to this, with Luxembourg a close second.

Regarding derivatives, we also observed differences in the following areas:

- Definition of sophisticated funds and their distinction from non-sophisticated funds;
- Commitment approach used for calculating the global exposure to derivatives for non-sophisticated funds;
- Parameters imposed by regulators for calculating value-at-risk;
- Potential leverage limitation for sophisticated funds;
- Method for calculating counterparty risks for OTC derivatives.

According to respondents, however, this lack of harmonisation does not lead to regulatory arbitrage.

Looking forward

The results of the study showed how UCITS III has affected fund risk during the legislation's first five years. It also noted a marked increase in the creation of sophisticated funds in 2007, following publication of the Eligible Assets Directive, which clarifies UCITS III rules. Quite how this will change the risk picture in future remains to be seen.

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The world in 2050

Huge demographic changes in the next 40 years will drive significant economic transformation. For everyone, real estate companies included, new ways of thinking will be required in order to master great change

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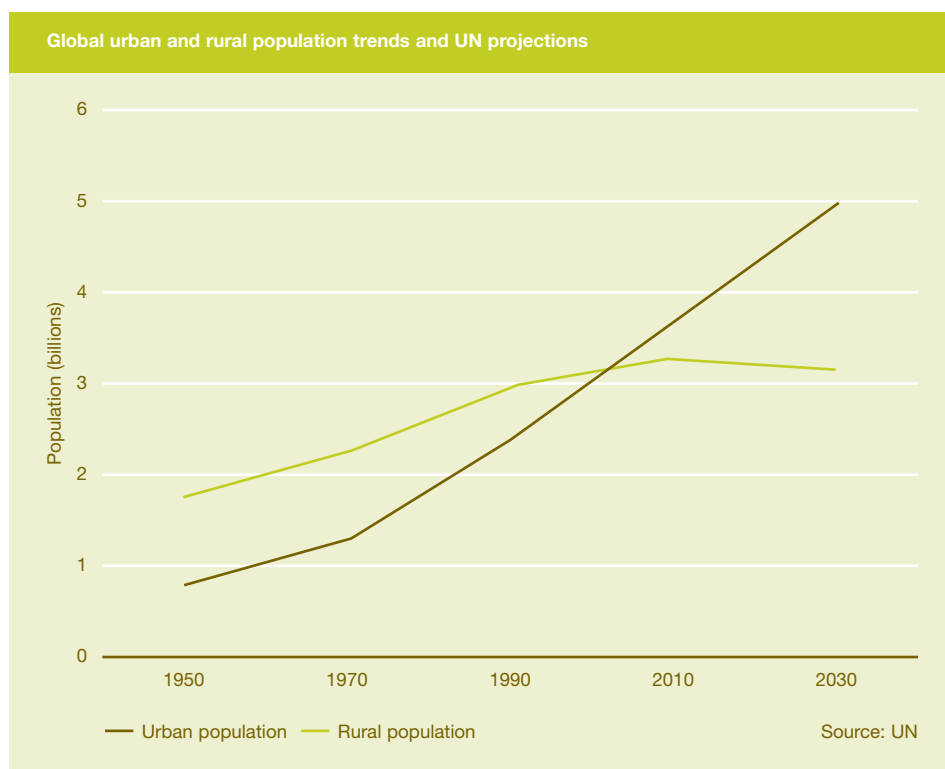
With recent uncertainty in property and broader financial markets, attention tends to focus on what is happening in the short term. At our European Real Estate client conference in Vienna in November 2007, we set out a longer term view to 2050. This was based on various pieces of research undertaken by the PricewaterhouseCoopers macroeconomic team, in particular the report 'The World in 2050 – how big will the major emerging market economies get and how can the OECD compete?' by our economist John Hawksworth, published in March 2006.

Economic change over the next 40 years will be driven by demographic change. The detailed data on population change that underpins financial modelling in this area comes from United Nations (UN) population estimates, the latest iteration of which is the 2006 Revision. According to the 2006 Revision, world population is expected to increase by 2.5 billion by 2050 from 6.7 billion today to 9.2 billion. This increase is equivalent to the overall number of people in the world in 1950 and will occur primarily in the less developed regions, where population is projected to rise from 5.4 billion in 2007 to 7.9 billion in 2050. In contrast, the population of the more developed regions is expected to remain largely unchanged at 1.2 billion and would have declined were it not for the projected net migration from developing to developed countries, which is expected to average 2.3 million a year after 2010.

Two trends: ageing and urbanisation

There are two striking features of the population growth. The first is that it is driven by longevity rather than birth rate and, therefore, results in global population ageing. The second feature is the increasing urbanisation.

In terms of ageing, by 2045 the number of old people in the world (60 years or over) is expected for the first time to exceed the number of children (under 15). The steady ageing of the world population is most advanced in Europe, where the number of old people overtook the number of children in 1995. By 2050, Europe



will have twice as many old people as children, with only the older population expected to increase. In contrast, the population under age 60 is expected to decrease, resulting in both a declining population of children and, even more critically, a declining population in the working ages to support the ageing population.

When it comes to urbanisation, we are currently at a turning point – rural and urban population are currently approximately equal. This has changed considerably from 1950, when the rural population of the world was approximately twice the urban population. By 2030, the UN projects a total global urban population of around 5 billion compared to just over 3 billion in rural areas.

Emerging markets rise relentlessly

In the 'World in 2050' report, our macroeconomists project the relative size in the period to 2050 of the 17 largest economies in the world in purchasing power parity (PPP) terms. These comprise the current G7 (US, Japan, Germany, UK, France, Italy and Canada), plus Spain, Australia and

South Korea, and the seven largest emerging market economies, which we refer to collectively as the 'E7' (China, India, Brazil, Russia, Indonesia, Mexico and Turkey). The modelling used two methods of comparing the relative size of the economies: GDP at market exchange rates (MER) and GDP at purchasing power parities (PPP).

The E7 is currently only around 20% of the size of the G7 at market exchange rates and around 75% of its size in PPP terms. By 2050, the E7 economies will be around 25% larger than the current G7 when measured in dollar terms at market exchange rates (MER) and around 75% larger in PPP terms. India has the potential to be the fastest growing large economy in the world over the period to 2050, with a GDP at the end of this period of close to 60% of that of the US at market exchange rates, or of similar size to the US in PPP terms.

China, despite a projected marked growth slowdown, is projected to be around 95% the size of the US at market exchange rates by 2050 or around 40% larger in PPP terms.

Measured by both MER and PPP, Russia will be the size of France; Turkey will be the size of Italy; Brazil will be the size of Japan; while Indonesia and Mexico will both be larger than either Germany or the United Kingdom.

For those entering the workforce now, the economic balance of power will have changed beyond all recognition by the time they retire.

When it comes to real estate, such great change has profound implications. In order to stay ahead, real estate companies will need to challenge accepted truths and find ways to take advantage of change.

Time to focus on the sustainability of real estate

With environmental taxes and regulations likely to have an impact on capital values, it is time to factor sustainability into the investment decision-making process

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Our research in 2007 suggested that businesses are looking to government to encourage them to do more to protect the environment.⁴ Now the communications issued from Brussels on 23 January 2008 regarding the EU's integrated Energy and Climate Change package, and the contemporaneous launch of PricewaterhouseCooper's 11th Annual Global CEO Survey 2008, presents an opportunity to refocus on business attitudes to environmental regulation as it relates to real estate.

From the CEO's perspective, while they still question the business case for change, 36% agree that their business is investing significant resources to address the risks and opportunities posed by climate change. The catalyst for this investment possibly comes from the fact that over a third expressed extreme concern about increased carbon emissions regulations, while a quarter were concerned about increased pressure from stakeholders to deal with climate change. Although proportionately low, these concerns are appropriate, given that public opinion has shifted decisively towards the imperative of addressing climate change and political consensus has crystallised.

For better or for worse,⁵ the EU's agreed trajectory to address the issue of insufficient environmental protection will lead to governments introducing regulation to ensure business pays for its pollution.⁶ This regulation will take the form of emission trading schemes (ETS) or, in particular for buildings outside the scope of the next generation of ETS,⁷ taxation.

Reducing building emissions

A target of 10% reduction in emissions from 2005 levels by 2020 is set for the building sector. The legally binding target means that governments are fully mobilised and the private sector should now have the long-term confidence to justify investment, addressing one of the major concerns of the respondents to our 2007 survey.⁴

Member States are free to pursue different strategies to secure their reductions, and this is leading to complexity and divergence in the development of market-based instruments across Europe.



Designing an effective tax on actual carbon emissions is proving difficult, with the closest approximation by the UK Government being a tax on the use of energy generated by fossil fuels. The EU Energy Tax Directive also assists in mandating a minimum amount of tax on energy products in the EU. As such, energy causes environmental impacts all along the chain: from extraction and production to transportation and end-use,⁴ this does broadly address the EU plan's targets as energy efficiency is one of the key ways in which greenhouse gas emission savings can be realised.

Buildings offer opportunities that need to be stimulated through a mixture of legislation and information. The imminent introduction of explicit labelling in response to the Energy Performance of Buildings Directive is a case in point. The stimulus of avoiding the impact of rising energy costs⁵ is also starting to galvanise action in corporate occupiers who do not have the ETS to worry about.

Impacting real estate values

The concerns regarding the effect that forthcoming environmental tax and regulation may have on long-term capital values of inefficient buildings

seem set to grow. Given that the easiest gains in energy efficiency may come at a higher capital cost, which is unlikely to be recovered through higher rents, investors must now seek a balance between a wide range of technical, regulatory and cultural issues that impact on existing properties, sustainability retrofitting and new development projects.

In response, sustainability assessment modelling to evaluate prospective sites, competing carbon strategies and the inevitable impact of local territory energy and climate change policy, on a post-tax basis, must now surely be integrated into the investment decision-making process.

⁴ Saving the planet – can tax and regulation help?

⁵ World Economic Forum, Global Risk Report 2008

⁶ Europa, Press Releases, State aid; guidelines on state aid for the environment – frequently asked questions

⁷ Commission of the European Communities, 20 20 by 2020, Europe's climate change opportunity

⁸ Europa, Press Releases, Memo on the renewable Energy and Climate Change Package

Eligible Assets Directive boosts potential for product innovation

The Directive, which is being adopted by Member States this March 2008, considerably enhances investment firms' ability to develop new products in response to financial market evolution, although the credit crunch may deter them for now

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When UCITS III was implemented in 2002, it was supposed to enable European asset managers to introduce a far wider range of assets into their funds, which could then benefit from the UCITS cross-border passport allowing them to be marketed without requiring specific authorisation.

In practice, UCITS III appeared to introduce more questions than it answered. While the range of eligible assets was expanded, the resulting myriad of questions of detail, coupled with the wildly differing opinions of Member States, created considerable regulatory uncertainty.

In order to provide greater clarity, the Commission issued the Eligible Assets Directive in March 2007. This sought to define the more problematic terms within the original UCITS Directive of 1985, as amended by UCITS III. Member States are scheduled to adopt its provisions by March 2008.

Prioritising pragmatism

The new Directive undoubtedly aids innovation – although the ongoing credit crunch may, for now, cause some investment firms to shy away from introducing more esoteric strategies and structures. In particular, it places greater emphasis on the overriding requirement for an appropriate spread of risk and sufficient liquidity. This indicates willingness to regulate in future more by way of principle than detailed rules (although this is not easy to recognise at present, given the detail of the arguments presented). Furthermore, the consultation that preceded the Directive's publication was intended to deliver pragmatic solutions. The Committee of European Securities Regulators' (CESR) ability to convince the Commission that certain aspects should be resolved through discussions is helpful.

Taken together, UCITS III, the Eligible Assets Directive and the increased ability for CESR to 'regulate by guidance' should be seen as positive for aiding innovation in fund design. Interestingly, most regulators accept that change within financial markets is so rapid that regulation by way of detailed rules has probably, in the funds arena at least, had its day. Providing firms can show they have addressed the broad criteria relating to the eligibility of transferable securities, and the fund achieves sufficient diversification (this does not mean that every fund actually must comprise a diversified portfolio) and is liquid, then the regulators can accept that the fund meets requirements.

It is true that certain Member States are more cautious than others. Indeed, differences of interpretation are already emerging. But, in general, firms have the ability to incorporate new investment structures and strategies within a UCITS. Above all, there is now potential for far quicker acceptance of new instruments and strategies as the markets develop. This has to be a good thing. For firms, the challenge is how best to make use of these wider investment powers.

Key changes to the UK tax regime for offshore funds

Fund promoters selling offshore funds into the UK should be aware of the significant changes to the tax regime currently proposed, and likely to be introduced into draft legislation in the spring Budget

HM Treasury published a consultation document on 9 October 2007, which proposed a number of key changes to the UK tax regime for offshore funds distributing into the UK. The proposals' key objectives are to continue to prevent tax anti-avoidance by UK investors, to achieve parity of treatment between offshore funds and UK funds (thus avoiding European Union tax discrimination issues) and to reduce compliance costs for investors and fund houses.

The current distributor status regime requires that an offshore fund satisfy both the:

- distribution test, which requires that an offshore fund physically distribute 85% of its trading income each year; and
- the investment test, which prevents a fund from investing more than 5% of its net assets in other offshore funds unless such funds also have, or could obtain, UK distributor status, in order for UK investors to obtain capital gains tax treatment on the eventual disposal of their interests in the offshore fund (if UK distributor status is not obtained an investor will be taxed on an income basis on their disposal proceeds).

Proposed changes and their impact

The key changes are:

- The move to a 'characteristics' -based definition of an offshore fund, and the removal of the exemption for investors who do not expect to be able to realise their investment within seven years (the material interest rule) are likely to result in more offshore funds such as real estate, private equity and bespoke offshore vehicles and investors being subject to the new rules.
- The abolition of the investment test and the new requirement that an offshore fund report 100% of its UK equivalent tax profits to the UK tax

authorities, and UK investors on an annual basis. UK investors will be taxed on a deemed dividend.

Therefore, as an offshore fund will be able to obtain reporting fund status without the need to physically distribute cash or having to operate complex reinvestment arrangements, it is likely that these changes will promote the distribution of a wider range of funds/share classes into the UK.

- The abolition of the 5% investment test, which will permit fund of funds (FoF) to obtain reporting fund status (subject to our comments below), but which may in practice also create a greater compliance burden for funds that invest in other offshore funds as a minor part of their investment strategy. Such funds will be required to review every fund investment in the portfolio to determine whether it has UK reporting fund status, which will be a costly and time-consuming exercise
- A proposal to tax investments by FoFs on a mark-to-market basis if the underlying funds are not reporting funds or the top fund cannot calculate the UK tax reportable income of the underlying fund. This would effectively convert tax-free capital gains into taxable income for UK investors, and therefore the distribution of FoFs into the UK is unlikely to be commercially viable unless the underlying funds also have reporting funds status (or it is possible to calculate the reportable income of the underlying funds).

What action should fund houses be taking?

Draft legislation is expected in the spring 2008 UK Budget (12 March 2008); therefore fund promoters should be reviewing fund ranges now to determine the impact of the proposed rules.

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Advocate General's opinion in Securenta potentially impacts investment managers

Private equity, real estate and infrastructure managers should carefully consider the impact of this case on their VAT positions ahead of the European Court of Justice's judgment

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The recent Advocate General's opinion in the European Court of Justice (ECJ) case of Securenta (C-437/06) may have significant consequences for all private equity businesses, infrastructure and real estate funds and cross-border investment structures. The case concerns the apportionment of input VAT to 'noneconomic activity' and is particularly significant for investors investing in businesses by share acquisition and disposal.

In Securenta, the taxpayer raised capital by issuing shares and other securities to invest in business holdings and real estate. The taxpayer invested in real estate both directly and via special-purpose vehicles (SPV). The taxpayer's income included taxable and VAT-exempt income, as well as income from passive investments.

The Advocate General opined that input VAT on expenditure connected with the raising of capital is deductible only to the extent that it is attributable to economic activity. Where such input VAT is related to noneconomic activity such as 'the acquisition, holding and sale of interests in other businesses', it cannot be recovered.

While the Advocate General's opinion is neither a judgement of the Court, nor binding on it, the possibility that the Court may follow the opinion in its judgment is cause for concern for all taxpayers investing in businesses by share acquisition and disposal, in particular private equity houses.

Impact on private equity

The opinion clearly calls into question the deductibility of VAT incurred on expenditure related to share acquisitions and disposals, particularly where the taxpayer is not actively involved in the management of the business. This would include VAT on both direct costs (deal fees and advisor costs, etc) and indirect costs (costs of capital raising and general business costs). This would have a significant impact on the current VAT recovery position of many private equity businesses and, in the United Kingdom, could be used by HM Revenue & Customs to support their longstanding challenge to VAT recovery in the sector.

The opinion would also appear to be at odds with current HMRC policy on VAT grouping, and the recovery of VAT incurred by businesses solely involved in the

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passive acquisition and holding of shares. Under current HMRC policy, a passive business may be included in a VAT group with at least one trading business. Any VAT on expenditure incurred by the passive business may be recovered in full by the VAT group if the trading businesses are fully taxable. If the ECJ follows the Advocate General’s opinion, it remains to be seen whether HMRC will alter its policy and look to block the recovery of such VAT.

Liabilities for infrastructure and real estate

The Advocate General’s opinion may also affect the VAT liability of cross-border management arrangements for infrastructure and real estate funds. Currently, where a UK investment manager manages a European fund, it is generally accepted that the fund is treated as carrying on an economic activity. Therefore, the management services are treated as supplied in the country in which the fund is established and are outside the scope of UK VAT (and either VAT-exempt or subject to a reverse charge in the country where the fund is established).

However, in many instances, the fund invests in infrastructure or real estate assets indirectly through a structure of holding and SPVs, and the fund’s activities are limited to the passive holding of shares in one or more of these vehicles. If the Advocate General’s opinion is followed, the UK investment manager’s services may be considered to relate to the fund’s passive shareholding activity and, as a consequence, would be subject to a UK VAT charge. This would result in a significant unexpected and irrecoverable VAT cost being incurred.

All private equity houses and investment managers should carefully consider the potential impact of the case on their current investment and fund structures with their advisors and a watching brief should be maintained ahead of the Court’s decision.

German regulations encourage outsourcing of operations

New regulations allow outsourcing of operations, enabling investment companies to develop more focused business models

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In the German investment business, a persistent trend is observable towards the further development and differentiation of business models and therewith towards the outsourcing of single operational functions. The coming into effect of the German Investment Act in 2004 – in particular the possibility of outsourcing the portfolio management function – with the ensuing opening of regulatory supervision significantly contributed to this trend. The legal foundations for outsourcing operational functions in the investment business were developed further in the amendment of investment industry legislation at the end of 2007.

As of 28 December 2007, the Investmentänderungsgesetz (Investment Company Amending Act) removed the credit institution definition, also amending the Investment Company Act (§16 InvG),⁹ which now governs investment activity, including outsourcing. When required, however, the MaRisk (Mindestanforderungen an das Risikomanagement, i.e. Minimum Requirements for Risk Management) regarding outsourcing (AT 9.2) can be used for interpreting the Investment Company Act.

Responsible outsourcing

The Investment Company Act allows functions that are crucial if an investment company's business transactions are to be outsourced to another company (insourcer) so as to increase management efficiency (§16 (1) 1 InvG). Fundamentally, all activities and functions may be outsourced, providing:

- the effectiveness of investment company supervision is not impaired;
- the investment company is not hindered from acting in the (best) interest of investors;
- or in managing the separate assets of the investors (§16 (1) 3 InvG).

Furthermore, the insourcing company must possess adequate qualifications to duly fulfil the functions outsourced to it (§16 (1) 2 InvG). Additionally, the investment company must perform a due diligence of the insourcer (§16 (1) 3 InvG) to verify that the insourcer has the qualifications required by law. Within these control processes the analysis of SAS 70¹⁰ reports seems to be useful. These reports are conducted by a third party, which audits the processes and controls of the insourcer. The investment company must legally enforce the

⁹ Requirement set by article 5g OGAW-RL (UCITS).

¹⁰ Statement on Auditing Standard (SAS) No. 70 is a standard developed by the American Institute of Certified Public Accountants (AICPA) specifically for client's control processes and the external audit of outsourcing solutions.



required managerial authority and rights to cancel in order to fulfil its monitoring function effectively (§16 (1a) 2 InvG).

If portfolio management is outsourced, the insourcer must be licensed for individual or collective portfolio management, and be supervised by a regulatory authority (§16 (2) InvG). Should portfolio management be outsourced to a company with a registered office in a foreign country, new amendments to the act §16 (2) InvG require that collaboration between the BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht, i.e. Federal Financial Supervisory Authority) and the local regulatory authority must be provided for.

The investment company is liable to equal extent for any default of the insourcer (§16 (3) InvG). All outsourced activities must be disclosed fully in the investor brochures (§16 (4) InvG) according to the specifications of §42 InvG. Also, the BaFin must be notified collectively of all executed outsourced activities by the insourcer directly after close of the investment company's financial year (§16 (5) InvG).

Towards more focused business models

The new regulations clearly concentrate on responsible outsourcing management as part of the overall risk and quality management of an investment company. The industry has acknowledged this and it is to be hoped that measures will be taken accordingly.

With most German investment companies lacking a focus on core competences, it will be interesting to see when professional insourcing service providers for fund administration functions emerge, as they have in Luxembourg.

Derivatives – the UK model: welcome flexibility or unworkable complexity?

The tax treatment of derivatives for funds being marketed in the UK is creating considerable uncertainty

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The use of derivatives has become an increasingly important component of the fund manager's toolkit, enabling either cost reduction or the ability to achieve particular portfolio characteristics not readily available without the use of derivatives. As might be expected, both the UK regulator and tax authorities have shown a keen interest in derivatives usage, having particular regard to investor and revenue collection risks, respectively.

The position reached in the UK is largely dependent upon the treatments adopted in the accounts and, therefore, is reliant upon the auditors understanding of the treatments, and their agreement that they are appropriate. The UK approach also has wider relevance, as the ability to distribute funds into the UK in a tax-efficient manner is dependent on the funds having UK distributor status, which can only be achieved if the fund is capable of determining what its distributable income would be under UK rules.

UK-authorized funds can utilise a wide range of derivatives; however, whether the return on these is income (and, therefore, immediately taxable in the hands of an investor) or capital (where tax is typically deferred and is expected to be at a lower rate), will have a significant impact on the effectiveness of their use. The UK accounting guidance – The Statement of Recommended Practice Financial Statements of Authorised Funds – requires that the treatment of derivatives as income or capital is dependent upon the 'motives and circumstances'.

Determining motive and circumstance

Motive is typically easy to determine. Although frequently is not recorded at the time of the transaction, simply put it is the answer to the question: 'Did you enter into the transaction to generate income, capital or both?' A manager may buy an FX contract to hedge the capital value of a portfolio or to generate a return based on interest rate differentials. Accordingly, the motive would be capital and income, respectively.



Circumstance is potentially more challenging – while the motive of the manager may be quite clear, the circumstances have to be consistent with that motive. For instance, a manager may write an ‘in the money’ call option with the motive of increasing the distribution by taking the premium received as income. However, the immediate impact of writing the option would be to generate a loss on investments, as the selling price is less than the market value. Here, the motive of generating income is not consistent with the circumstance, which is the immediate generation of capital losses rather than just forgoing the opportunity of future capital gains. Where there is a conflict between motives and circumstances, then circumstance takes precedence. Another area of discussion is where the return itself has both income (dividend or coupon) and capital elements.

The UK approach enables considerable flexibility in the use of derivatives and recognises that a fund manager may use the same instrument for different purposes. However, to market funds a degree of certainty regarding tax status is important. Many UK-based funds find that achieving this certainty without involving their auditors is difficult, and for funds not based in the UK these difficulties are multiplied.

We would therefore suggest that those funds marketing in the UK that are unsure of their positions seek advice.

New UCITS rules now permit 130/30 funds

Irish Financial Regulator has given the green light to UCITS physically shorting stocks, although other EU countries have yet to follow its example

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Due to the growing popularity of 130/30, the Irish Financial Regulator has clarified its policy with regard to the authorisation of UCITS funds. On 5 October 2007, the regulator issued a revised policy note in respect of physical short selling by UCITS funds. This Irish declaration on the UCITS rules allows funds to engage in covered physical shorting strategies, whereas to date these funds have been restricted to synthetic short selling by the use of derivatives.

So will other EU states follow suit?

To date, no other EU countries have amended their policies regarding short selling by UCITS. There is clearly a demand for this type of policy change. Many new strategies such as 130/30 can benefit from the ability to physically short stocks, as this can make shorting cheaper, simpler and more flexible.

As short selling is a big part of the 130/30 strategy, this new interpretation change is important for the success of these types of funds. 130/30 funds show the narrowing gap between traditional long-only managers and hedge funds, as some traditional long-only managers lean towards demand, and try to adapt tools such as shorting to offer more flexible strategies. From a marketing perspective, the potential for delivering these funds within a UCITS offers a distinct opportunity to devise more innovative retail funds.

'Covered' or 'Uncovered' – there is a difference

One of the key points in this change is the market's understanding of what constitutes 'cover' and this is a welcome development. There is now an acceptance of a distinction between covered and uncovered short sales.

An uncovered short sale is where the investor has no right to the security at the time of agreeing to the sale. The investor will then seek to purchase the security before delivery is required. This is prohibited under the UCITS Directive. In contrast, in a covered sale, typically the security is borrowed from another party. The security is then sold on in the belief that when the time comes to return it, it will be possible to purchase it more cheaply. The profit is the difference in the sale and purchase prices, less the cost of borrowing and any transaction costs incurred.

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In order to comply with regulation 72 of UCITS Regulations 2003, the Financial Regulator has clarified what constitutes cover and has confirmed that where a stock is borrowed prior to the sale, this would be regarded as sufficient cover. Previously, the Financial Regulator considered that techniques such as securities lending should only be engaged in for efficient portfolio management, and should not be used by a UCITS to engage in leverage. UCITS Notice 12 provided that collateral received under securities lending transactions could not be sold or pledged.

The key policy changes

The Financial Regulator will permit UCITS to engage in physical shorting strategies provided that:

- The strategy only involves covered short sales, in accordance with the UCITS Regulations;
- General leverage limits are not exceeded;
- The strategy is subject to the submission of a risk management process in accordance with the requirements of Guidance Note 3/03

(UCITS-Financial Derivative Instruments), in particular in relation to the calculation of global exposure;

- As part of the submission, the UCITS must demonstrate expertise and prior experience in relation to the use of selling strategies;
- The strategy is appropriately disclosed in the prospectus.

Looking forward, the amended UCITS rules illustrate the Irish Financial Regulator's willingness to help the investment industry achieve its business objectives.

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European IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed below:

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