

European IMRE News

Informing on the changing face of Europe*

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Wealth managers plan for prosperity

The 2007 PricewaterhouseCoopers Private Banking/Wealth Management Survey reveals a time of great prosperity for those prepared to make hard strategic choices

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This is a period of unprecedented opportunities for wealth managers, according to the latest PricewaterhouseCoopers Private Banking/Wealth Management Survey, released in June. Buoyed by rising global wealth, private banks and wealth managers everywhere are anticipating extremely high rates of profitable growth that have not been seen during the 14-year history of this survey, and probably at any other time.

Yet the survey also shows that Chief Executives have some hard choices to make in order to achieve their growth ambitions. This is a time when strategic choices have to be made and finite resources have to be focused on serving existing clients as well as supporting highly ambitious growth plans.

A particular strategic issue is how to respond to the fast emergence of wealth management in developing countries, which presents huge opportunities. The issue of scarce resources is also of fundamental importance. Client relationship managers (CRMs) are in exceptionally short supply, so the issue arises – how can organisations make best use of their most talented people? Furthermore, can wealth managers afford not to invest in new IT systems to facilitate and support growth plans?

Supporting growth and dealing with the issues arising from it emerge as the key challenges in our largest survey yet. More than 265 organisations from the full breadth of the global private banking and wealth management industry responded to a greater number of questions than ever before. Below are the highlights of what is the most comprehensive set of findings since we started compiling this survey in 1993.

Chief Executives (CEOs) are staggeringly optimistic about growth

The move to a more client-centric approach continues and is driving further professionalism of client service. The ability of CEOs to develop the brand, transform IT, and to attract and to retain quality CRMs is seen as the key success factor.

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



The realisation that client service is not just about products but about understanding clients' needs is changing the business model

'Share of wallet' is the new key performance indicator as wealth managers seek to become trusted advisors and gain new clients.

Chief Operating Officers plan to increase information technology (IT) spending in order to transform systems and processes

With legacy systems impeding wealth managers' ability to achieve growth, effort is being directed towards IT efficiency, especially to support the increased effectiveness of CRMs. Improving risk management and management information, as well as enabling better client service and reporting, are also high on the agenda.

Finance Directors are confidently looking forward to a period of extremely profitable growth, with increasing revenues and high margins

They are focusing on supporting growth through increasing efficiency. But they face increasing costs and need to remain alert to the growing

significance of regulation and corporate reporting.

Wealth managers must get serious about HR

The current CRM model is under severe strain and needs re-engineering. Talent management must be on the main board's agenda. Retaining and recruiting new CRMs is critical to success. Improving their skills and capabilities is essential for meeting clients' needs.

Unless wealth managers address the shortage of CRMs, and improve their skills and core competencies, they will not achieve their growth expectations

CRMs are in short supply and often insufficiently skilled. They recognise that they have more to do if they are to truly reach 'trusted advisor' status. Understanding the client more fully, as well as having an appreciation of wider family issues, is critical.

Risk officers are significantly upgrading their risk management frameworks and systems

The regulatory impact of expanding into new jurisdictions and introducing new products is a real challenge. Risk

management is still not fully embedded within wealth management organisations, nor is it being monitored in outsourced operations. Regulators are no longer sympathetic, and fines or sanctions can be increasingly serious.

Above all, the survey highlights the difficulties of managing exceptional growth without compromising an excellent client experience. Wealth managers must, therefore, understand the factors that create that client experience and know how to evaluate them. Additionally, with growth primarily driven by a mixture of increased share of wallet from existing clients, new money and new clients, they must understand what their clients want from them and what they value.

MiFID moves off to an inconsistent start

With MiFID on the point of being introduced, local regulators still have different interpretations in specific areas, particularly concerning inducements

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Most fund managers have now completed their MiFID impact assessment. They have defined the appropriate course of action where needed, prior to the regulation's introduction on 1 November. By and large, they feel that although MiFID has important implications, these are limited to parts of their fund management activities.

For international fund promoters, one of the main issues now is to identify potential differences in the implementation of level 2 and level 3 that could affect their third party distributors, and therefore impact their EU distribution model. As an example, CESR's¹ recommendation on inducements has clearly confirmed that the retrocessions fund providers pay to distributors should be considered as inducements as per article 26.b) of the level 2 directive.

Inducements under the microscope

Among the different examples provided by CESR in its final recommendation is the case of an investment firm providing a portfolio management service to a client for a fee. The firm invests in financial instruments for its client and receives a commission from the product provider paid out of the product charges. Though CESR's view is that such arrangements are not altogether prohibited, some regulators in Europe are taking a different stand, and will ban the payment of such commissions in the context of discretionary portfolio management mandates. Given the current practice in many European countries, and the role played by private banks in open architecture on the continent, the implications of such decisions will need to be carefully watched.

Additional aspects of inducements subject to different interpretations among EU regulators include the level, form and timing of disclosure to clients; the eligibility of some fee arrangements such as stepped rates; and the levels of retrocession acceptable in view of the actual service provided to the investor.

Other areas of varying views

Other areas that appear to be subject to different views include the application of best execution to units of funds, and the qualification of the services rendered between the fund provider and its distributor.

While the clear intent of CESR's work is to foster supervisory convergence across the EU, and to ensure consistent implementation and application of the level 2 directive, international asset managers will need to spend considerable time and effort in the coming months to gain an accurate and complete picture of the local requirements in the different territories where they market their funds, and how these impact their distribution models.

This endeavour will be made more complex by the fact that many territories are late in the implementation of level 2 measures and that, two months before "life date", local guidance is unfortunately still often unofficial word of mouth.

¹ Committee of European Securities Regulators (CESR)

European Court of Justice broadens VAT exemption

Decision opens the door for VAT exemption to apply to a wider range of fund structures

The European Court of Justice's decision on 28 June 2007 in the JP Morgan Fleming Claverhouse case (C-363/05) has significantly expanded the scope of the VAT exemption for asset management, enabling investment funds to achieve significant ongoing VAT savings as well as opening the door for retrospective claims to recover potentially very large amounts of overpaid VAT.

While the case itself concerned whether investment trust companies (ITCs) must pay VAT on asset management fees, the guidance from the ECJ strongly suggests that the exemption covers the management of many other types of investment vehicles. JP Morgan argued that the UK's implementation of the VAT exemption for "the management of special investment funds as defined by Member States" is unfairly discriminatory. It contended that, rather than the exemption being largely limited to authorised unit trusts (AUTs) and open-ended investment companies (OEICs) it should also extend to the management of ITCs.

Limits on Member State discretion

The ECJ decided that, while the Member States do have an element of discretion to define the scope of the exemption, this discretion is fettered by both:

1. the purpose of the exemption, which the ECJ decided is to create a level playing field between investment in securities directly, as against investment via pooled funds; and
2. the principle of fiscal neutrality, which requires that competing suppliers of similar goods and services should not be treated differently for VAT purposes.

The ECJ stated categorically that Member States are not permitted to apply the exemption to certain selected types of fund and exclude other funds from benefiting from it, and gave a very clear indication that it viewed the management of ITCs to be exempt.

Broad scope of exemption

While the ECJ noted that it had not been asked whether its guidance would result in the application of the exemption to funds other than ITCs, the guidance from the ECJ strongly suggests that the exemption is much broader in scope than was previously thought. The decision has clearly opened the door for the exemption to apply to a number of different types of fund, for example venture capital trusts (VCTs), unauthorised unit trusts, unitised and unit-linked life products, and personal and occupational pension schemes. However, the exemption is probably unlikely to extend to the management of private equity and property funds / limited partnerships.

Implications

The exemption of asset management services previously treated as taxable enables funds to save ongoing irrecoverable VAT costs. As for VAT already accounted for on asset management services, clearly there is an opportunity to make very significant retrospective claims. There are also significant risk issues for asset managers and fund administrators who have provided previously taxable services. Potentially affected funds, and their fund managers and administrators, should immediately address the impact of the decision on them, and consider what steps may be taken to protect their position, maximise reclaim opportunities, and minimise VAT liabilities going forward.

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German investment managers demonstrate compliance shortfall

Many German investment companies have yet to get to grips with the measures necessary for compliance with new regulations

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German investment companies have yet to adequately implement recently introduced compliance rules, and many have yet to come to terms with the new requirements.

Often, there is no effective integration of these standards into day-to-day business operations. Above all, implementation is hampered by a shortage of time and resources.

Nevertheless, most investment companies do recognise that new regulations offer potential commercial benefits quite apart from the necessity of compliance. This is shown by a PricewaterhouseCoopers (PwC) survey of 30 German investment companies "Implementation of Compliance Standards – Taking Stock of Investment Management", published in May 2007. The survey analyses how companies rate major compliance requirements and examines what adjustments are necessary with regard to these rules. It also checks the current status of implementation of the standards among participants.

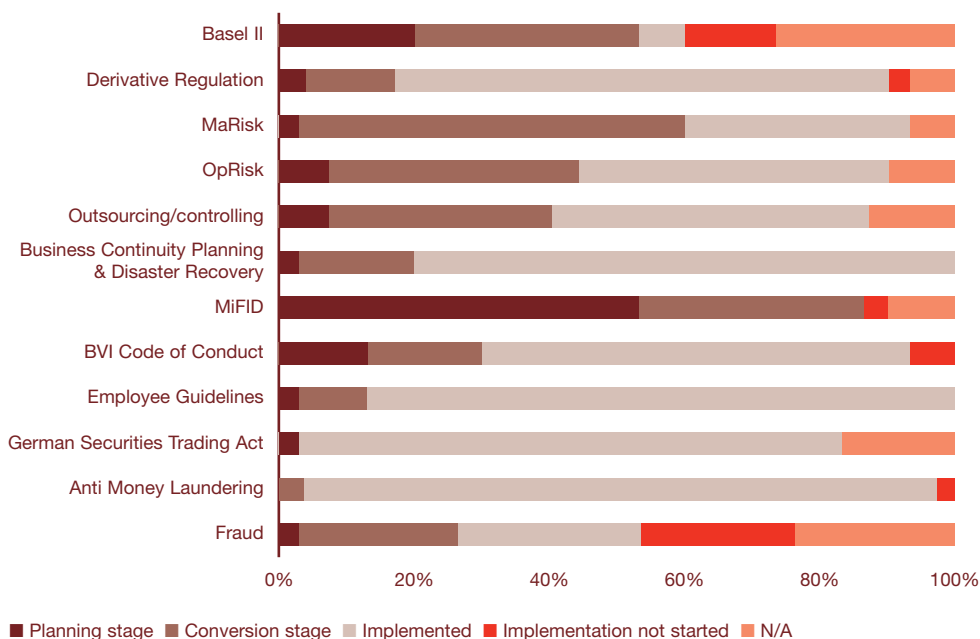
Compliance standards seen as opportunity

Polled companies regarded risk reduction, higher transparency, greater investor confidence and harmonisation as the main opportunities which could arise from the implementation of compliance standards. In addition, participants agreed that uniform standards promote the capability to respond to changing market conditions. The survey also showed an awareness of risks connected with implementation, such as costs arising from introduction of new procedures, and the risk of over-regulation.

Shortfall in implementation

While most respondents have actively familiarised themselves with the new regulations examined by this survey, sometimes there was a considerable difference between the rating of the regulations' significance and a company's current progress towards compliance. "So far, the German investment industry does not comprehensively live up to the currently increasing compliance requirements on the market," says Wulf Ley, asset management specialist at PricewaterhouseCoopers. For most of the polled companies, compliance standards play an important role with respondents rating the standards on MaRisk

Figure 1: Implementation of compliance standards (status quo)



Source: PricewaterhouseCoopers

(84%), derivative regulation (83% and BVI Code of Good Conduct (80%) as “very important” and “important”.¹

Unfortunately, this is not yet reflected in implementation. In most cases, compliance standards have not yet been implemented in full. A typical example is MaRisk where 57% of participants are still working on implementation. For some standards, the survey revealed a considerable need for action: 53% of those surveyed are still in the planning stage with MiFID and 20% with the impact of Basel II on fund reporting (see Figure 1).

The survey’s results on fraud come as a surprise: 56% of respondents do not consider this to be of particular importance. According to Arno Kempf, PwC Investment Management Industry Leader, the reason is clear: “Numerous participating companies underestimate fraud risks considerably. Apparently, fraud and related effects are not yet tangible for many participants.”

Practical ways of compliance for maximum benefit

Until now, the majority of the German investment industry has not regarded the issues of governance, risk management and compliance as strategic opportunities. For this reason,

resulting measures tend to be of a short-term nature. However, there are benefits from greater integration of compliance together with internal risk management and governance into day-to-day business operations. This can be done by applying adequate organisational structures, procedures and technologies. Over time, this reduces complexity and minimises the task of compliance.

In this way, successful integration supports ethical and sustainable business management, which is risk and value-oriented and conforms to regulations. Compliance checks which are pre-defined and embedded into existing procedures promote the development of new, customer-defined products, facilitate shorter response times to continuously changing market needs, and, consequently, help to optimise support in customer relations. “In future, companies will have to put more weight on compliance and its integration in order to be able to use it as a strategic factor for success,” concludes Kempf.

¹ MaRisk is Minimum Requirements for Risk Management, a key component of the new qualitative supervisory regime in Germany. There is a specific derivative regulation application to investment companies called Derivateverordnung. The Bundesverband Investment und Asset Management (BVI) rules of conduct cover the responsible handling of investments and investors’ rights.

Introducing vital hedge fund valuation principles

As market events have recently highlighted, valuation is key for the hedge fund industry. Ongoing development of sophisticated instruments requires the industry to continually examine and develop appropriate fair valuation tools and models

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The hedge fund industry has grown substantially over the last decade. Assets in the global hedge fund industry have almost doubled in the last five years to just over US\$2 trillion. In Europe the industry has grown to over US\$450 billion.

This rapid growth has increased the focus on the valuation of hedge funds. Institutional investors, governments, regulators and fiscal authorities are all paying attention to this ever-growing industry. Comments on hedge funds are a daily occurrence in the press.

Regulators around the globe are reappraising their duties to investors and the market. One of the first issues being tackled is to establish a clear benchmark in relation to the valuations of the investments of hedge funds.

Meanwhile, the industry itself through bodies such as the Alternative Investment Management Association (AIMA) has a desire to react to the increased focus in a responsive and realistic manner.

The enormous growth in the popularity of hedge funds, coupled with increasing investor concerns as investments become more illiquid and strategies more complex, has resulted in a specific interest in the valuations of investments held by hedge funds. The recent turbulence in financial markets has only added to this.

In March 2007, both AIMA and the International Organisation of Securities Commissions (IOSCO) published reports detailing suggested principles for valuing hedge funds. Taken together, these are setting a standard as to the expected processes and procedures to be followed in hedge fund valuations.

AIMA's – Guide to sound practices for hedge fund valuation

The key objectives of AIMA's guide to sound practices for hedge fund valuation are to reflect the changes in the industry, and to update and enhance existing recommendations.

This guide has been developed to bring clarity to the process and procedures employed by the vast majority of players in the global hedge fund industry. It contains 15 recommendations offering principles-based guidelines for sound valuation practices. It covers all aspects of the valuation spectrum – from governance, transparency, procedures, processes and systems, to sources and



the use of models for hedge fund asset valuations. It also includes an outline of a Policy Valuation Document for use by hedge funds and consideration by their investors.

Some of the issues covered include defining the asset pricing methodology with reference to sources, cut-off times for pricing and tolerance variances. Other areas discussed in the guidelines include how to define the responsibilities of different players in the valuation process and oversight matters, and setting out an escalation process to settle how a dispute about a particular asset price is resolved.

While recognising that a “one size fits all” approach is not appropriate for hedge funds, the guide seeks to provide practical direction with working examples for each recommendation.

IOSCO’s – Principles for the valuation of hedge fund portfolios

IOSCO’s principles for the valuation of hedge fund portfolios in turn approaches these issues in a similar way. The nine IOSCO principles are meant to be a practical tool for hedge fund managers and governing bodies, and those involved in the valuation process. They may also be helpful for

institutional and sophisticated investors and their representatives.

The principles describe techniques which should strengthen the valuation process thereby making it more likely that the resulting valuation is appropriate. They emphasise the importance of clear written procedures which are consistently operated and regularly reviewed, and which provide for an appropriate degree of independence to deliver effective checks and controls.

Due to the wide range of business structures adopted by hedge funds and the international mobility of capital, IOSCO believes it would be beneficial to promote a single set of valuation principles that are applicable across a wide range of jurisdictions and hedge funds business models as possible.

The future of the valuation process

The hedge fund industry is making progress towards increasing transparency, and these guides aim to assist regulators, investors, government agencies, trustees and the industry in deepening their understanding of this important topic of valuation.

Announcing a set of valuation principles/recommendations is all very

well but their effect on the hedge fund market depends on whether or not they are taken up. These principles and recommendations represent good practice in the industry and many hedge funds and their managers already adhere to practices that are consistent with them. The wider application of such practices should help to build strong processes and procedures in the valuation of hedge funds.

An internationally accepted set of good principles for the valuation of hedge fund illiquid and complex assets should assist hedge fund counterparties in evaluating and controlling their exposures to hedge funds. These principles will also increase valuation transparency and disclosure for investors.

This focus on valuation, and especially the identification of potential conflicts in the process, is an area that will be expected to remain under review.

AIMA has stated that it will continue to work closely alongside IOSCO and other regulatory bodies worldwide on this hot topic of valuation and other issues as the hedge fund industry continues to evolve.

UK REIT honeymoon turns to rollercoaster

The early part of 2007 proved to be a honeymoon period for UK REITs following the introduction of the regime on 1 January 2007

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The major property companies converted, there were more converts in the pipeline, three new entrants were due to come to market and corporate owner-occupiers were expected to spin off some property to unlock value. By March Real Estate Investment Trusts (REITs) were trading at a premium to net asset value (NAV).

However, sentiment began to change so that by mid-year most REITs were trading at a significant discount to NAV as a number of analysts called the top of the market. There were also some disappointments along the way. Two expected REITs in the hotel and residential sectors failed to materialise, and the availability of funds slowed with the collapse of the sub-prime market in the United States.

It is clearly not all bad news as many REITs have been active, taking advantage of the capital gains exemption to make disposals and reinvest in property as they become more focused on specific sectors or locations. One new entrant made it to the market and to date there are 16 REITs with a market capital value of around £30 billion (€40 billion).

Evolution expected

We expect the REIT regime to evolve. Start ups and smaller players would benefit from some feeder vehicles such as closed-ended companies either widely held or AIM listed. While Government has not yet been persuaded to introduce these, it is seeking consultation on Property Authorised Funds (PAIFs), a form of unlisted REIT, which is intended to deliver a pre-tax return to investors. The challenge will be to make this as attractive as existing unlisted vehicles.



So far no residential REIT has emerged. Such a vehicle could contribute toward a solution to the UK's housing shortage if the numbers can be made to work. This will only happen if there is a level playing field between residential and commercial property. There will have to be a change to the REIT regime for residential property to permit some level of trading to provide a blended return of capital and revenue which is attractive to investors.

In the longer term, REITs could also participate more widely in the Private Finance Initiative/Public Private Partnership sector (one REIT already has an outsourcing specialisation). For example, a REIT could be set up from nothing to own land based assets e.g. government offices or even prisons.

Rumoured takeover targets

For now a number of REITS are rumoured to be potential takeover targets given their current cheap pricing. So the REIT market may contract, like in the United States, as some of the banks and offshore funds take them private and break up their prime portfolios.

The honeymoon has turned into a roller coaster ride and REITs are not even a year old!

The PricewaterhouseCoopers real estate industry group has been liaising with Her Majesty's Revenue & Customs and the Treasury on REITs.

Emerging valuation issues for G-REITs

The establishment of G-REITs is posing questions regarding the valuation of these stock market-listed vehicles

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At the end of March 2007, the upper and lower houses of the German parliament adopted the long-discussed law launching listed German Real Estate Investment Trusts (G-REITs). Experts have estimated this may create a market with a value of up to €60 billion by 2010. This is despite the significant restriction that G-REITs cannot invest in German residential properties built before the end of 2006.

G-REITs have been introduced at a time when publicly listed real estate companies have corrected. Since the beginning of 2007, publicly-listed German real estate companies (E&G DIMAX) have fallen -6.3% (as at end June, 2007 (Figure 1)). By contrast, the DAX has risen +15.1% within the same period.

The increasing importance of valuations

Besides daily valuation of property stocks through the stock exchange, valuation issues may become significantly important due to the attractive exit tax provisions for the transfer of real estate into a G-REIT by property owners, such as open-ended and closed-ended funds as well as non-real estate companies. Consequently, potential G-REIT initiators considering IPOs are asking what price a property (or a real estate company) can fetch in the stock market?

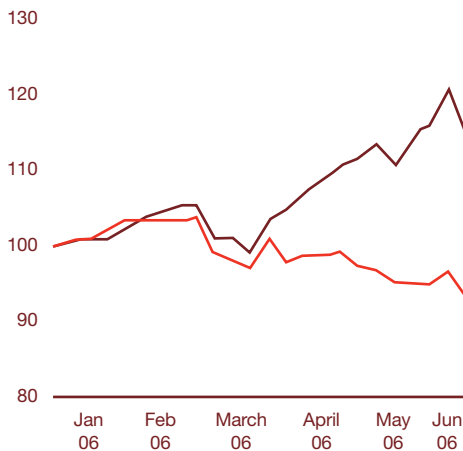
To begin with, it must be clarified what a G-REIT exactly is: A real estate asset or a company? G-REITs are required, among other things, to fall under the following guidelines: 75% of the asset must consist of properties, 75% of the gross proceeds must result from rental, leasing, land leasing and disposal of immovable assets; and 90% of the distributable earnings are to be distributed to the shareholders. Activities such as property trading and development are assumed to be less important. Therefore, for the value assessment, the underlying real estate portfolio, the quality of the management, as well as corporate governance and transparency, are of high importance.

Finding appropriate valuation benchmarks

A response to the question: "What price can a property fetch in the stock market?" can be made by comparing key capital market valuation data based on share prices of similar companies. For this, fundamental results-oriented and asset-based figures are available. The results-oriented EBITDA¹ shows earnings before interest, tax, depreciation and amortisation, and the fund from operations

¹ Earnings before interest, taxes, depreciation and amortisation

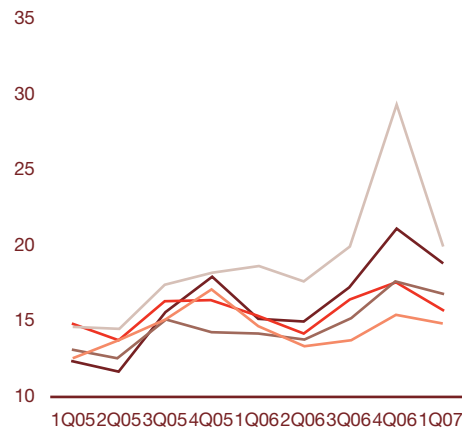
Figure 1: E&G DIMAX® vs. DAX, indexed to 05.01.2007



— DAX — E&G DIMAX

Source: Bankhaus Ellwanger & Geiger, Reuters. As at 8 June 2007

Figure 2: FFO Multiplier Trend According to Property Use 1Q 2005 until 1Q 2007



— Office — Industrial — Retail
— Prefabricated House — Apartments

Source: NAREIT REIT watch 2005 - 2007/FFO-Multiplier = Enterprise Value (EV)/FFO

Figure 3: Trend of NAV Premiums for Selected Countries 1Q 2005 until 4Q 2006



— Australia — Japan — EU excluding UK
— UK — USA

Source: CBRE Market Perspectives & Outlook 2005 & 2006
NAV = Property's open market value + value of other assets - liabilities

(FFO) displays the cash inflow from operations adjusted for extraordinary factors. But making such comparisons requires a suitable peer group. With a market capitalisation of listed German real estate companies (E&G DIMAX) of about €21 billion (by contrast, the market capitalisation of US REITs amounted to approximately US\$387 billion as at 31 March 2007), the number of similar German companies is limited.

A possible solution to this problem is to make comparisons with established REIT markets, such as the US market which offers many sources of information. For example, FFO multipliers are regularly published for listed US REITs (Figure 2). Presently, the relationships between the types of property use and their respective multipliers correspond to risk levels in the fundamental real estate investment markets.

Other than the result-oriented key data, the asset-oriented net asset value (NAV) can be used, particularly for purely property holding companies. The NAV is established from the sum of the properties' market values and other assets less liabilities (Figure 3). When this figure is computed per share and compared to the company's stock

price, it will show either a premium or a discount. The worldwide average currently amounts to a premium of 19%, in contrast to a five-year average discount of -0.5%. So, the current premium highlights that publicly traded real estate is valued more highly than directly held property. An inverse relationship in relation to the worldwide average exists currently in the US, which was reflected in the "Equity Office" REIT going private in February 2007.

This poses a question regarding the reasons for valuation differences between real estate in the stock market and the private capital market (the latter being the foundation of the property market values which is the basis for NAV computation). One explanation could be that a listed real estate company is not only an aggregation of individual properties but also an ongoing business, with a corporate strategy as well as an active portfolio and asset management. Corporate related reasons for a deviation from the NAV are growth opportunities in the rental and investment market, quality of management, corporate strategy, economies of scale within the portfolio, financing structures, overhead costs and business segments, which are not

reflected through the real estate asset and are less capital intensive, e.g. service business. Capital market related causes are, among others, regulatory issues (e.g. taxes), market inefficiencies and pricing differences in the public and private markets for the investment risk relating to the real estate portfolio.

Intelligent investor relations

In conclusion, the market valuation of listed property owners depends, besides the overall capital and real estate market environment, on the following factors: management quality, corporate and portfolio strategy as well as transparency and corporate governance. These issues must be highlighted through a correspondingly designed capital market communication. To arrive at an appropriate valuation level in capital markets, a company's communication strategy should position the company, from the investors' perception, as a managed real estate business rather than just an aggregation of individual properties.

Dutch tax regime adapted for alternatives

An improved tax regime has made the Netherlands more tax efficient both for hedge fund management activities and fund vehicles

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With the alternative investment industry growing fast, the Dutch tax authorities are competing to create an efficient environment. Recent changes in both tax practice and regulation have been designed for just this purpose. There is now a beneficial fiscal environment for both alternatives investment firms and the funds they manage.

This has helped the Dutch hedge fund industry to grow in recent years. In particular, offshore funds managed from the Netherlands are increasingly popular.

Certainty for investment managers

In particular, the Netherlands has become one of the few places in Europe to offer certainty regarding the tax treatment of offshore funds advised by investment managers based within the country. Although the Netherlands does not have a formal tax exemption embedded in law, such as the UK's investment manager exemption (IME), the local tax authorities do give favourable rulings. In several cases, they have confirmed that funds will not be treated as being onshore.

This tax status is extremely important to both hedge fund manager and investor alike. By granting positive judgments on a case-by-case basis, the Netherlands is strengthening its position as a hedge fund centre. PricewaterhouseCoopers has recently obtained several favourable tax rulings for Dutch-advised offshore funds, for both Dutch and US investment firms.

Additionally, the management of funds brought together by qualifying collective investment funds is not subject to Dutch VAT. The same applies to fund administration services.

New tax exempt onshore fund vehicle

For alternatives managers that may wish to market alternative investments onshore within Europe, there is a new more modern fund vehicle. Called the 'Vrijgestelde Beleggingsinstelling' (VBI), this is fully exempt from Dutch corporate income tax and withholding tax. It can be used for a broad range of alternative investment styles such as fund-of-funds, feeder funds, money market instruments, swaps, carbon emission rights etc.



The specifics of the VBI are explained in more detail elsewhere in this issue of European IMRE News.

More efficient platform structures

The Netherlands are increasingly popular with hedge funds as a jurisdiction for locating their investment platforms for worldwide investments.

The extensive tax treaty network, the participation exemption for equity investments, absence of capital tax and cooperative tax authorities, are key advantages for offshore funds selecting the Netherlands. Another advantage is the availability of numerous skilled investment professionals.

The Dutch Advance Tax Ruling practice for holding and finance activities with specific local substance requirements has become efficient again. Nowadays, the Advance Tax Ruling process, including a pre-filing meeting, can be completed in a couple of weeks.

Any fees charged to the Dutch platform for discretionary management and collateral administration services should be exempt from Dutch VAT.

Platforms used for growing number of securitisations

An increasing number of securitisation transactions have been set up for originators located in and outside the Netherlands using Dutch bankruptcy remote special purpose vehicles (SPVs). The resulting asset-backed securities have been sold to investors in the Netherlands and abroad through private placements.

Commonly, the SPV is established in a so-called orphan structure, where the SPV qualifies as a third party to the borrowers, note holders and managers. Importantly, in securitisation transactions the Netherlands does not levy withholding taxes on interest. Moreover, the taxable profit that a Dutch SPV has to report is generally limited to the fee charged by the trust services provider which sets up the SPV. Based upon ruling practice for securitisation vehicles, certainty can be provided in advance regarding key issues such as deductibility of interest on notes, deductibility of other expenses, absence of withholding tax and obtaining certificates of residence as required under the tax treaties with the source countries involved.

For Dutch VAT purposes, the fees for discretionary investment management services and collateral administration services rendered to SPVs can be structured to qualify for a VAT exemption. In other words, lending platforms can be set up so that discretionary asset management and collateral administration services do not incur irrecoverable VAT.

This, combined with the extensive Dutch tax treaty network, absence of capital tax, and robust legal infrastructure, has proven the Netherlands as a competitive European jurisdiction for alternatives.

New diversified products target pension funds

The shift in the pension fund industry's approach to risk is creating rich opportunities for product development that combines traditional and alternative assets

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As pension fund managers across Europe reconsider their approach to risk, so this is opening the way for considerable innovation. A new generation of investment products that package diversified groups of traditional and alternative assets is beginning to emerge, with investment management companies rushing to launch their offerings in the market place.

Called Diversified Growth Funds (DGFs), these products spread risk across a range of asset classes, including global equities, fixed income, real estate, hedge funds and infrastructure. Asset class expertise may be entirely in-house, or supplemented by specialist external support.

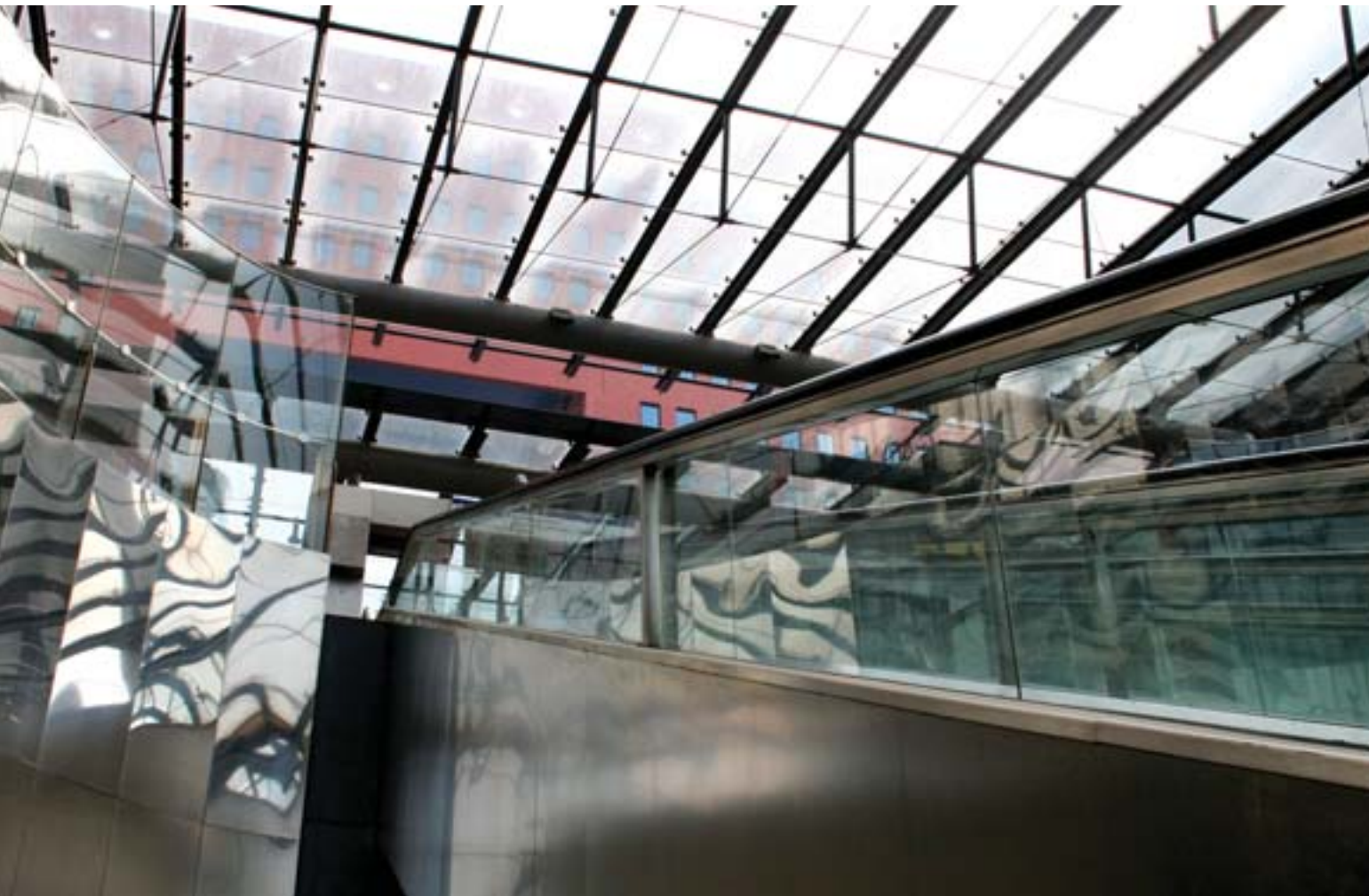
Used alongside liability hedges, these products form part of a solution set that is transforming the efficiency of pension fund management. Return potential can be maintained, with the risk of not meeting pension liabilities substantially reduced.

While DGFs effectively sub-contract the job of portfolio construction, manager selection and risk management, these products are far from homogenous. Pension fund advisers and their trustees still have work to do selecting the most suitable product provider.

Focusing on liability risk becomes commonplace

Legislative and accounting changes across Europe are forcing pension funds to re-think their approach to risk. Rather than focusing on risk relative to long-term securities returns, as was previously the case, pension funds are now considering it relative to their long-term liabilities, through so-called liability-driven investment (LDI).

De-risking using swaps and bonds is now commonplace in the Netherlands and the UK, and is becoming increasingly popular globally. Inflation and interest rate exposure can be hedged, with portfolios tailored to match the nature (duration, certainty, currency etc) of pension liabilities. Swaps also free up capital that can be invested in higher return assets, since you only need to hold collateral against default during the lifetime of the swap.



The DGF packages a diversified group of higher return traditional and alternative assets. Equities were typically the core return driver, but there is growing correlation among global equity markets. Meanwhile, there is strong evidence that diversifying into less correlated alternative investments has led to equity-type returns with significantly less risk, as measured by volatility of returns.

The pie chart inset shows a typical spread of assets, although different managers vary in their approach.

Not all DGFs are equal

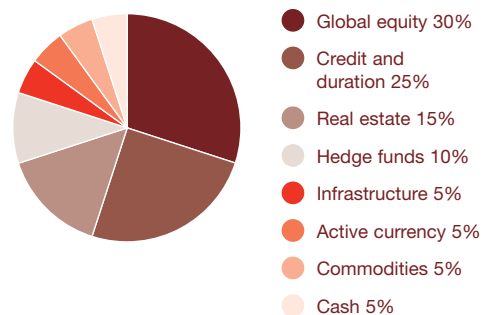
Based on the DGFs to have emerged so far, we would make the following observations:

1. The products are not homogeneous so there is good scope for providers to differentiate; analysis and attribution by advisors is much more subjective
2. Platform infrastructure is key (and so a differentiator)

3. The client wants diversification first, so is paying for the platform; higher fees, and possibly higher margins become palatable
4. Products so far accept guest funds in limited areas – in house and external excellence is combined for overall effect

The number of investment managers offering DGFs is expanding fast, with asset acquisition into these funds so far significant. Suddenly the investment management product development landscape is as exciting and varied as it has ever been. There are opportunities for almost all investment managers – whether niche or scale.

Diversified Growth Funds - sample asset allocation



Source: PricewaterhouseCoopers

Exchange Traded Funds – popularity continues to grow

The growth in these low cost funds in Europe, Asia and Latin America is replicating that already seen in the United States

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The progress of Exchange Traded Funds (ETFs) from niche product to the big time continues unabated. In an increasingly volatile investment environment, the relative stability of ETFs is becoming more attractive by the day. While much of the financial media commentary in recent months has been devoted to alternatives and other high profile products, the trading volumes and array of products available within the ETF arena has continued to expand.

In their simplest form, ETFs are straightforward, listed funds that invariably track the performance of an underlying index at low cost. They are most popular among institutional money managers seeking low cost access to a broader array of markets and asset classes. In recent months, the range of products offered through ETFs has grown to cover less accessible emerging markets and diverse asset classes such as commodities, credit and property.

The question that arises is – are ETFs nothing more than a cheap way in which to track an index or do they have more to offer the investment community? The answer would appear to be that the growing breadth and depth of the ETF product range indicates that the market supports ETFs’ move into areas previously considered the domain of active management.

Make no mistake, however, low fees are attractive to many in the current cost-sensitive environment. With many ETFs carrying a Total Expense Ratio as low as 0.10%, the desire of investors to gain exposure to a specific market, region, sector or asset class at a cost significantly less than market, means that these products are certainly here to stay.

What about Tracking Error?

Much has been made of the extent to which ETFs truly track the underlying index. There is no doubt that tracking error is a reliable measure of volatility between an ETF and the underlying index. But not all ETFs set out to track an index in full. The fact is that an ETF may opt for full or partial replication of its underlying index.



While the market is more familiar with full replication ETFs, i.e. where all the stocks are held by the ETF, partial replication is becoming more popular. Partial replication is where an ETF sets out to hold less than 100% of the stocks in index. For example, in a global market index, an ETF may hold no more than 60% of the underlying stock. Many ETF portfolio managers do this in an attempt to reduce trading costs, or to avoid specific securities lacking market liquidity (e.g. emerging market debt).

Geographical outlook

From their inception, ETFs enjoyed spectacular popularity in the US. Recently, however, we have seen significant growth in Europe, with Ireland, France and Luxembourg all acting as domiciles of choice. The index managers who had chosen Ireland and Luxembourg for their pan-European products have continued to add ETF strategies to their range, and are now successfully selling ETFs across a range of different markets in Europe, Latin America and Asia.

Industry commentators note that significant growth in ETFs is likely in the international arena in future years, thus replicating the US experience. Indeed, Morgan Stanley predicts global ETF assets under management will reach US\$2 trillion by 2011, a threefold increase from current levels.

The requirement that investors can only buy and sell through participating brokers rather than directly with the funds themselves does not appear to have impacted in any meaningful way the popularity of ETFs among institutional investors. Indeed, the fact that ETFs are products that offer liquidity in a secondary market is becoming increasingly important in the current environment and bodes well for the future of ETFs around the world.

Belgium introduces new European pension legislation

Belgium has boosted its status as a domicile for pensions through a new tax-neutral, dedicated pension fund vehicle, as well as a novel tax and legal framework for institutional investment funds

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Belgium is not one of the first EU Member States to implement the European IORP Directive of June 2003 covering pan-European pension funds (2003/41/EC). However, the legislation ultimately introduced in 2007 in response to this Directive has provided Belgian law with a distinct pension fund vehicle – the Organisation for the Financing of Pensions (OFP) – that compares well with its foreign counterparts.

At the same time as putting Belgium on the map as a preferred home country for (pan-European and international) pension funds, the government took advantage of the momentum to also introduce draft legislation for institutional investment funds that may serve as asset pooling vehicles.

While the OFP regime is already fully operational, the legislation on institutional investment funds is expected to be published in the Official Gazette in the early autumn.

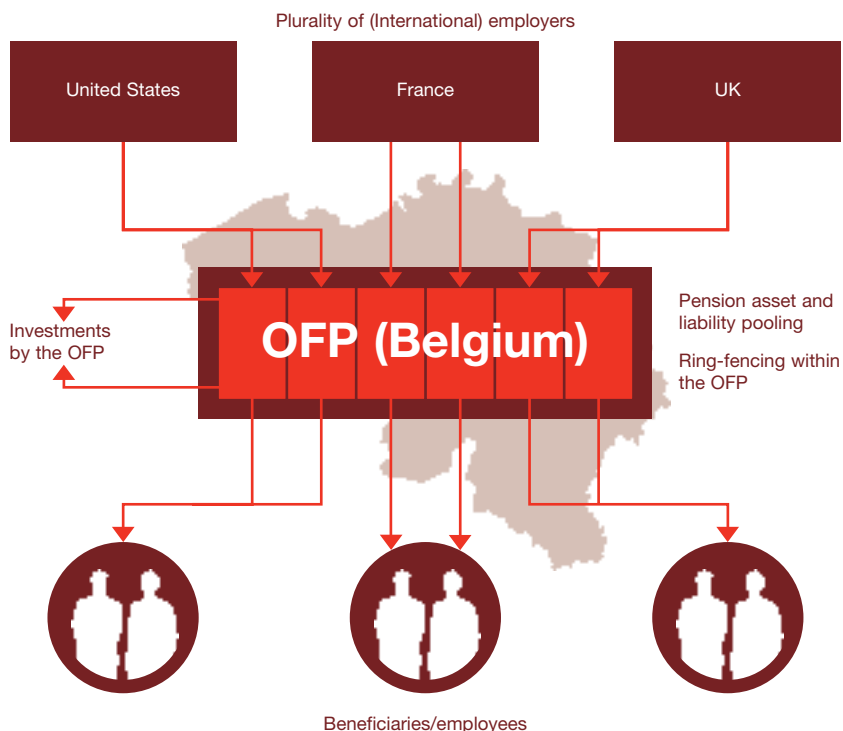
Flexible OFPs

Belgium's new OFP vehicle for pan-European and (inter)national pension funds is very flexible in legal and regulatory terms. Many aspects are not strictly regulated and are open to be treated in the articles of association of the OFP; tasks can be delegated to (specifically created) operational bodies and committees; the 'prudent man' principle guides funding requirements and prudential control; multi-employer funds with specific ring-fencing are possible, etc. As a result, the OFP is ideal for international pooling of both pension assets and liabilities.

In the wake of revamping the legal and regulatory setting for pension funds, Belgium has also reworked the tax rules applicable to the OFP, ensuring almost full tax neutrality.

From a corporate income tax point of view, it has applied the same reduced taxable basis to OFPs as for Belgian open-end investment funds (leading to the OFP being treaty entitled). Capital gains realised on investments are not taxed in the hands of an OFP, and Belgian withholding taxes are fully creditable and recoverable. Draft legislation has been passed aimed at eliminating the pre-financing such a withholding tax regime may still entail.

The OFP may be used to achieve the pooling of both pension assets and liabilities in one international pension fund



As for VAT, a new exemption for the management of pension funds was specifically introduced in the Belgian VAT Code.

Finally, all other (indirect) taxes that were applicable under the former tax regime (net asset tax, tax on stock exchange transactions, etc) were abandoned as of 1 January 2007.

Institutional investment funds for pooling

As mentioned above, Belgium took the opportunity to fill the gap in its investment fund legislation by drafting a new tax and legal framework for institutional investment funds of both a corporate nature (opaque SICAV-type) and a non-corporate nature (transparent FCP-type). Via this legislation, Belgium offers a framework for those corporations that do not (yet) want to engage in the (international) pooling of both pension assets and liabilities, instead just wishing to undertake asset pooling alone, with each pension fund remaining responsible for its own liabilities.

From a legal and regulatory perspective, the new framework will be substantially more flexible than the regime applicable to public investment funds. From a tax point of view, institutional investment vehicles' main advantage will be a 0.01% net asset tax (instead of 0.08% for public investment funds).

As far as SICAV-type institutional investment funds are concerned, a direct tax regime will in general mirror that of public SICAVs. This means that notwithstanding their largely reduced taxable basis, they will be entitled to the benefits of double tax treaties.

The Netherlands introduces a tax exempt investment vehicle

New Dutch legislation provides a more modern framework for the country's investment industry, allowing it to compete more effectively with other European jurisdictions

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In the late summer of 2007, The Netherlands took its latest steps to adapt its legislative environment to the evolving international fund industry by introducing a tax exempt investment vehicle. On 1 August 2007, legislation introduced the new VBI¹ vehicle. This now sits alongside the existing FBI² vehicle, offering investment companies the opportunity to choose the most suitable for their purposes.

This follows several other measures to improve the Dutch regulatory framework, including the recent reduction in Dutch dividend withholding tax from 25% to 15%, and the move to allow EU pension funds full refunds of Dutch dividend withholding tax.

The tax exempt VBI explained

Alternative to Luxembourg and Ireland structures

The VBI structure has been introduced as an alternative to the attractive tax structures available in Luxembourg and Ireland. As such, it has many similarities with the Luxembourg SICAV. The VBI is fully exempt from both corporate income tax and dividend withholding tax, making its income (including capital gains) fully tax exempt. Further, all income can be distributed free of Dutch dividend withholding tax to participating investors. In particular, the VBI is expected to encourage funds-of-funds and feeder funds.

Requirements

Open-end portfolio investment vehicles as defined in the Dutch Financial Supervision Act (DFSA) can use the VBI structure. The VBI regime prescribes that investments should fulfil the principle of risk diversification and should qualify as so called 'financial instruments', as defined in the MiFID Directive. Direct investments in Dutch real estate are not allowed, although direct investments in foreign real estate and indirect investments in Dutch and foreign real estate are by way of lower-tier funds. Because the Corporate Income Tax Act (CITA) does not make financing restrictions, the VBI regime enables more flexible investment strategies than the FBI.

The VBI is suitable for both retail and institutional markets, as there are no restrictions on the type of shareholders. Similarly, it is open to both domestic and

¹ Vrijgestelde Beleggingsinstelling (VBI)

² Fiscale Beleggingsinstelling (FBI)

foreign investors. In order to apply the VBI regime, the tax payer must file an application before the end of the first financial year in which the regime needs to be applied. VBIs can take the following legal forms:

- an investment company (a legal entity such as the Dutch Public Limited Company/Naamloze Vennootschap/NV);
- an investment fund (not a legal entity such as the Dutch Fund for Joint Account/Fonds voor Gemene Rekening); or
- a similar foreign entity established under the laws of an EU Member State, the Dutch Antilles, or the laws of a country that has concluded a tax treaty with the Netherlands containing a non-discrimination clause.

Withholding taxes

A VBI is not considered a tax resident for double tax treaty purposes. Consequently, it cannot benefit from favourable withholding tax rates under the Dutch tax treaties. For investments in assets generating income subject to withholding taxes (such as equity investments), the FBI regime (see below) is more attractive. However, for investments such as bonds generating income not subject to withholding tax, the VBI can be very tax efficient for foreign investors. As the VBI is not subject to Dutch corporate income tax, it is also not entitled to a refund of Dutch or foreign withholding taxes.

Substantial interest taxation of foreign investors

A foreign investor which holds a substantial interest (i.e. a shareholding of at least 5%) in a Dutch resident tax payer could become subject to Dutch corporate income tax on its shareholding provided certain requirements are met. The legislation explicitly states that a foreign corporate investor in a VBI cannot become subject to Dutch corporate income tax solely for holding a substantial interest.

Mandatory revaluation for Dutch investors

At fiscal year-end, Dutch tax payers must value their investments in VBIs at market value. The new law also states that Dutch tax payers should value

their investments in non-Dutch tax exempt investment vehicles at market value. Furthermore, Dutch tax payers having an interest in an entity which, in turn, has an interest of 10% or more in a VBI (or similar foreign vehicle) also have to value the investment in such entity at market value. In practical terms, the revaluation requirement, may force Dutch corporate tax payers to structure their investment portfolios through other investment vehicles, such as Dutch FBIs. The obligation to value investments at market value is burdensome for Dutch tax payers, since retrieving and reporting the information is a huge task.

Participation exemption applicable

In principle, the Dutch participation exemption is not applicable for participations in VBIs or FBIs. The participation exemption can, however, be applied if a VBI qualifies as a so-called 'real estate participation'. To qualify as a real estate participation, the assets of such participation must consist on a consolidated basis of at least 90% real estate assets, which are not held directly or indirectly by a Dutch FBI.

Relaxing the rules for existing FBI investment institutions

Changes in the new legislation make the Dutch FBI especially attractive to foreign investors, foreign funds with investments generating taxable income in the Netherlands and foreign pension funds. They can obtain access to the extensive Dutch double tax treaty network through FBIs. The changes to the FBI regime can be summarised as follows:

- An abolition of the specific restrictions that existed for foreign shareholders of Dutch FBIs.
- More flexible shareholder conditions also available for unlisted FBIs (previously this only applied to listed FBIs). These conditions are now applicable to investment institutions with permits under the DFSA, foreign investment institutions subject to 'adequate supervision' (as defined in the DFSA) in their EU Member State of residence, and investment institutions listed on stock exchanges.

- In addition to Dutch incorporated and resident companies (private as well as public), and mutual funds, similar foreign entities may also opt for FBI status. In this case, they must be: entities established under the laws of an EU Member State, the Dutch Antilles or under the laws of a country that has concluded a tax treaty with the Netherlands containing a non-discrimination clause.

Sustaining Guernsey's newfound listings business

Ensuring good corporate governance is vital to sustaining Guernsey's recent success as a domicile for investment funds listing on Europe's stock exchanges

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Over the last 18 months we have seen a significant number of Guernsey funds list on the London and Euronext Exchange. So what is driving the popularity of Guernsey as a platform to launching a listing on the markets?

The legal and regulatory framework in Guernsey has contributed to the success. In particular:

1. The Governing body of the London Stock Exchange has confirmed that a non-UK company (eg. Guernsey company) does not require a primary listing elsewhere to get a secondary listing on its exchange. This means Guernsey companies are not required to comply with the EU Prospectus Directive. Similarly the Euronext listing requirements for a Guernsey company are more palatable than EU domicile companies.
2. Guernsey company law allows a greater degree of flexibility than other jurisdictions. Nil par value shares give greater flexibility in relation to the method and timing of return of capital to investors. The Protected Cell Company (PCC) law is another added attraction as it allows funds to legally recognise segregation of assets to facilitate greater concentration in various sectors or geographical areas should investor's require this.
3. The fast track regime facilitates access to the regulator and regulatory consent to as little as three working days is also an advantage.

Success factors

PricewaterhouseCoopers has been involved in a variety of listings in recent months, from entities that outsource the day to day administration to another location through to structures where the ongoing administration of the fund is managed from Guernsey and a full range of Guernsey professional advisors are involved. This is good business for the finance industry, particularly as it brings so much positive attention to our jurisdiction and helps to build the Guernsey brand within the global marketplace.

Given that this demand for listings services is good news for the Island, a proactive approach to managing this sector is fundamental to ensure we protect and enhance the critical success factors for listings work.

Guernsey has been very agile in reacting to market needs. The introduction of PCCs, LP laws, enhancing the regulatory application procedures and the proposed new company law, which adds further flexibility in relation to distributions demonstrates the level of expertise and vision within the finance industry.

The approach our regulators have taken to industry developments is also likely to continue to protect and enhance listings business. Their consultative approach has put Guernsey at the forefront of developments in many regards and makes us well set to respond effectively to future market requirements.

Guernsey's reputation as a high quality jurisdiction grows with every new piece of work undertaken. This stable base of expertise together with proximity to Europe and the UK magnifies Guernsey's attractiveness as a listings location.

With all these strengths, one may easily conclude there are not any significant threats. There are some of course, and such factors, if not acknowledged and planned for, could be an Achilles heel.

Corporate governance and tax risk

There is an increasing call for greater responsibility and accountability from funds, not only to investors, but to the wider community, good corporate governance is fundamental. The need for strong corporate governance, highly skilled non executive directors that are fully familiar with the listing requirements is fundamental to the ongoing success of the structures and the reputation of Guernsey. Good corporate governance includes the management of tax risk.

Of course tax risk is inherent in all structures at top entity level and at portfolio level, and while planning at inception aims to mitigate these risks, it is fundamental that fund managers develop a strategy to manage this risk over the life of the structure. Tax rules are constantly changing and risk needs to be assessed on an ongoing basis.

A sensible approach might be to assess risk at the following levels:

Transactional – exposures innate in specific transactions or deals requiring due diligence and planning to maximise the efficiency of any structure.

Operational – exposures as a result of increased globalisation in day to day management activity requiring careful monitoring of roles and responsibilities, documentation and awareness of the commercial reality of management.

How existing companies respond to tax risk and general corporate governance risk will affect the reputation of Guernsey. If the conversations with investors are anything to go by, it could be argued that greater transparency and governance around these risks could be a selling point to investors and their confidence with using a Guernsey domicile company.

A proactive approach to mitigate these ongoing risks is advised. A tax risk monitoring strategy and a general health check for compliance with listing requirements should be regarded as another step towards enriching the value of services offered by our jurisdiction.

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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. 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.

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