

European

IM News

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Are funds VATable persons?

In a key European Court of Justice case for the investment management industry, the Advocate General has opined that SICAVs defined by the UCITS Directive 85/611 are VATable persons.

The *Banque Bruxelles Lambert* (BBL) case considered, as the primary question, whether an investment fund is carrying out “economic activities” for the purposes of VAT. Or, put another way, is a fund a “VATable person”? Until now, member states have been taking opposing views. There are enormous financial implications in situations where investment management and advisory services are provided cross-border to funds in other member states.

The Advocate General decided that SICAVs have business objectives taking into account two criteria: their activities and, more importantly, their organisation. SICAVs are established to buy and sell, on a regular basis, shares and other negotiable instruments in order to make returns to their investors. The opinion applies equally to self-managed SICAVs and to those who appoint third party managers.

The opinion supports current practices in many member states where the service provider can exempt with input tax credit most of the services rendered to foreign investment funds, as did BBL. The investment fund would then look to its domestic VAT legislation to determine if VAT needs to be imputed by the fund by way of reverse charge (in many cases no reverse charge is due so there is no VAT cost at manager or fund level).

Because of his affirmative response to the first question, the Advocate General did not need to answer the second question relating to the scope of exemption for management services rendered to investment funds. Nevertheless, he did comment that exempt management services should be defined as services that are both advice on investment recommendations and buying and selling investments on behalf of the fund.

If the ECJ ratifies the opinion, it is quite possible that tax authorities may consider extending the scope of exemption to cross border investment management services, in which case costs to the funds industry could rise.

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**Flashline****Liquidity funds flow in Luxembourg**

"Corporate cash" type liquidity funds have grown rapidly in Europe to €200 billion and in the next decade they are expected to reach €1-2 trillion in Europe (and a similar level in Asia).

Despite Luxembourg's stronghold in pan-European UCITS, the existence of an asset-based tax has hampered its participation in the rapidly growing arena of liquidity funds. Liquidity funds - more closely assimilated to the 2a-7 style money market funds prevalent in the US - are in essence vehicles used by corporates as an alternative to bank accounts or short-term deposit instruments. Such funds are highly rated money market funds which declare daily yields and provide daily liquidity to corporate clients.

At the present time, while many of the significant players in this business have chosen to establish their standard UCITS vehicles in Luxembourg, all except one have decided to split their European platforms and create their liquidity products in Dublin. A straw poll of some of the major players determined that a key reason for this split was the 1 basis point (bp) net asset tax that such funds suffered in Luxembourg.

This tax is particularly significant when considering both the high asset levels and the extremely low TERs (20bps or less) maintained by these funds. ALFI (the local industry body) successfully lobbied the government to remove the tax for such funds commencing 1 January 2004. As a result, Luxembourg is now well positioned with Dublin to benefit in the significant asset growth this market segment promises over the coming years.

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**Flashline****SICAR bill passed**

Of keen interest to foreign investors specialising in venture capital and private equity, on 12 May 2004 the Luxembourg Parliament passed the bill introducing the SICAR, a new and flexible venture capital vehicle. Details from Laurent de la Mettrie (352) 49 48 48 3204.

VAT vigilance on outsourcing needed

All fund managers (as well as service providers) should be aware of significant developments concerning the liability of outsourced investment management and supporting services under UK VAT law.

The VAT liability of outsourced investment management remains unclear due to the ambiguity of the VAT exemption in European law, which provides at Article 13B(d)(6) Sixth Directive, EC for exemption of "the management of special investment funds as defined by member states". This immediately raises the questions, when considering the implementation of Article 13B(d)(6) into domestic UK law, what is to fall within the definition of management and how are member states to define special investment funds?

The UK tax authorities have generally displayed a reluctance to concede exemption to the outsourcing of any services within the financial services industry. The UK had originally sought to restrict the exemption for fund management to the management of authorised unit trusts and OEICs when the management was undertaken by the operator or authorised corporate director (ACD), thereby imposing an irrecoverable VAT burden when such operator or ACD sought to delegate its management to a third party provider. Following the UK tax authorities' defeat in the Prudential and Abbey National cases, the exemption was extended to include such third party providers by the VAT (Finance) (No 2) Order SI 2003/1569.

The UK, like many other member states, has sought to define special investment funds in line with the UCITS directives. The consequence of this is that the management of other marketed funds, such as investment trust companies (ITCs), falls outside the exemption and arguably creates an uneven playing field where competitor funds suffer differential VAT burdens. A further instance in which the UK law might be considered to be anti-competitive is the provision of pension fund administration and management services by insurance companies, considered a class of insurance business and therefore exempted from VAT under the exemption for insurance services. The same services provided by non-life providers would not qualify for exemption.

The UK tax authorities instigated a consultation on these points in November 2002. The majority of pension fund respondents argued for a widening of the exemption for pension fund management to all providers, while most managers themselves preferred the status quo. Likewise, the majority of investment trusts argued for their inclusion within the 'special investment funds' exemption, while managers wished to maintain the status quo. The UK tax authorities concluded in January this year to take no action, but to keep the area under review. In response, the Association of Investment Trust Companies has commenced litigation against the UK tax authorities to challenge the refusal to extend VAT exemption to ITCs.

In a further development, Abbey National has brought a case before the VAT tribunal concerning whether the VAT exemption for "the management of special investment funds" includes fund administration and accounting provided by third parties. The case also addresses whether trustee and depositary services, provided within the UCITS III Directive, qualify for VAT exemption. The VAT tribunal has referred these questions to the European Court of Justice.

Service providers that might be affected by the outcome of this case should consider whether to make a protective claim for VAT repayment to the UK tax authorities to avoid falling outside the three year time limit. Funds that purchase such services should consider raising the point with their providers.



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German insurers open up to hedge funds

A recent draft decree (AnIV), which could come in force by the middle of this year, would permit 5% of the committed assets of German insurance companies to be invested in German and foreign hedge funds domiciled within the EEA.

The German insurance regulator, in its draft decree, would also permit direct investment in non-EEA domiciled hedge funds via an EEA-domiciled fund-of-hedge-funds (f-o-h-fs). This 5% limit of direct or indirect hedge fund investment would become part of the overall maximum equity quota of 35% which insurance companies can put in equity, equity-like and (in the future) hedge fund investments.

The regulatory prerequisites would be that the fund has to be supervised in its country of domicile and that the investment policy of the fund be comparable to that of the German single hedge fund or f-o-h-f. This means the single hedge fund has to allow either short selling or leverage via debt and/or derivatives. The fund must not invest in real estate, commodities or physically settled commodity derivatives. The hedge fund must have a risk management system. The foreign f-o-h-f itself must not use leverage via debt or derivatives but invest in target hedge funds only.

The German insurance regulator has indicated that insurance companies would have to apply a risk control mechanism over their domestic or foreign hedge funds investments. It is likely that this mechanism will be the equivalent of the risk control mechanism used by hedge funds under the German fund regulatory rules.

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UCITS III: EU recommendations boost local regulators

Whereas most EU countries are now dealing with the issuance of secondary regulation, three countries are trailing behind on the implementation of the UCITS III directives in their local laws. While Belgium should complete the implementation process any day now, potentially even before this article is published, the Netherlands and Greece still seem to be far from enacting their UCITS III laws.

In other countries, the past few months have seen a surge of activity among regulators. Countries like France, Germany, Portugal, Austria, Luxembourg and Ireland are now fully equipped to operate in a UCITS III environment.

The long awaited recommendations from the EU Commission on the Simplified Prospectus (SP) and on the use of derivatives have at last been adopted, in their final version at the end of April. For those countries awaiting EU guidance before issuing final regulation on the SP (e.g. Austria, Belgium, Ireland and the UK), there are no more reasons to wait. And a new round of regulation can be expected in these countries in the coming months. Although the EU recommendation on SP is not ground-breaking and still leaves many questions unanswered (it does not make clear as from when a SP is required and for which type of funds), it does clarify what the EU has in mind on the content of such a document. Some countries that have already enacted rules may have to revise their regulation, in particular on the disclosure of “fee-sharing agreements” and “soft commissions”, both topics whose inclusion is not obvious from looking at Schedule C of the Profession Directive dealing with the contents of the SP.

The lack of clarification in this recommendation regarding the first date of use of the SP and the funds to which it applies confirms Austria’s and Spain’s decision to require a SP for all of their funds, whether UCITS I or III. The French and Spanish authorities require SP for foreign UCITS I funds seeking registration, even if they emanate from countries which do not require such a document!

The second recommendation relating to the use of derivatives by UCITS III funds will inspire a round of new regulation in countries that were waiting for such EU guidance before issuing any additional rules such as Austria, Belgium, Denmark, Italy and Spain. Again, all questions are not resolved but the recommendation deals with the major issues that were put to the Contact Committee by the industry and the regulators e.g. the global risk limit when using derivatives and the overall risk exposure of a UCITS. It also provides useful guidance on the risk measurement methodologies to be used, which, as the industry demanded, can be adapted to the risk profile of the UCITS. Unfortunately, the recommendation fails to define what a “sophisticated” UCITS is, leaving this task to each regulator. The recommendation finally provides the rules applicable in order to calculate counterparty exposure for OTC instruments, a question which needed urgent clarification.

Both EU recommendations, although not “legally” binding, have to be followed by measures taken by member states no later than end of February 2005. Even with some unanswered questions, the path seems more and more clear for a UCITS III transition.

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2004 Luxembourg transfer agency services survey:

Transfer agency: moving out of the back office to centre stage

A decade ago, transfer agency (TA) was a back office activity supporting an investment fund's shareholder register. Now high quality shareholder and distributor service is a key to retaining and increasing the assets under management of fund promoters and business growth of third party fund administrators.

In this first specialised survey of the Luxembourg transfer agency (TA) scene, sponsored by PricewaterhouseCoopers, thirteen global market players (a blend of US, UK, French and German asset managers and third party administrators representing over 30% of Luxembourg's FUM) evaluated themselves on the ever-evolving global fund distribution operating platform and meeting the increasingly complex demands of the European and global fund industry. The most salient findings include:

- **Ongoing major changes expected in the global TA services landscape and the TA function as a whole.** Transfer agents are navigating through a host of organisational and operational challenges arising from recent mergers/acquisitions of asset managers and fund administration service providers. Additional change has been wrought by increasing tax and regulatory requirements. The consequences of these are dramatic changes in the current roles and responsibilities expected from the TA function and most importantly, the global TA service landscape in the very near future.
- **Shortcomings in the range and quality of TA Services? Not quite!** Historically, one could say that the Luxembourg fund industry inherited the TA function from the Anglo-Saxons (US and UK) when they entered the European fund distribution market with Luxembourg investment products. Today, we can now attest that it is Luxembourg who has mainly shaped what was a standard TA business model to a truly global TA operating platform supporting a global fund distribution framework.
- **Still no major shift away from fax and paper-based transaction processing.** There is strong market need to simplify the transaction process of the TA and

distributor and the expected widespread use of electronic media has been met by the advent of industry facilitators and lately, some European-wide fund processing standardisation initiatives. However, the integration of straight-through processing (STP) is still far from reality.

While these transaction facilities are still evolving, the integration of these various market-driven platforms have actually increased the level of operational complexity for some TAs and decreased the STP factor of TA operations. In fact, for some TAs, especially the smaller administrators, it has increased the manual intervention of processes, specifically in the transaction processing cycle.

- **Regulatory Environment.** The EU Savings Directive, Basel II, UCITS III, new and proposed disclosure and reporting requirements (e.g. Long Form & AML reporting on distribution framework), new EU entrants, AML regulations will have a dramatic impact on transfer agents and their related processes and record-keeping systems. These requirements affect transfer agents primarily in two ways.

First, significant investments in education and training of shareholders and service representatives will be necessary to communicate the impact and meaning of these new regulatory requirements.

Second, to maintain the high level of service investor and distributors have come to expect from fund companies, transfer agents will require substantial additional investment in computing capacity and data storage to comply with these regulatory requirements within stringent

time constraints imposed for achieving these by set target deadlines (e.g. EU Savings Directive in January 2005).

Many of the high-level issues that have historically driven the transfer agency business model – technology, human resources, changing regulatory requirements, and development of new products and services – continue, with varying effects among transfer agents. The industry continues to be challenged to enhance service levels through technological advances, European-wide STP standardisation initiatives, strengthening of human resources, increased focus on distributor servicing, etc..

For some time the European financial services industry has been moving towards greater levels of specialisation, mirroring the pattern of operational efficiency development in financial services globally. The TA services framework is no longer about processing and reconciliation, it is about deploying a customer-focused strategy, mastering state-of-the-art technologies, excelling in client servicing, innovating in terms of fund administration services offering.

Having said that, the TA industry must ensure that it is operationally ready and customer-focused enough to meet today's and tomorrow's investment management industry growth and ever-changing fund distribution landscape. Ultimately, the perception of the TA industry depends on its ability to provide higher quality shareholder services that must be seen to outpace the progression it is currently tackling head on.



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Savings Directive – will tomorrow arrive?

The exchange of information or withholding tax provisions of the EU Savings Directive are due to be fully implemented by 1 January 2005, but delays by individual territories in issuing legislation and detailed guidance are vexing.

The final text of the Directive was ratified by the Council of European Finance Ministers (ECOFIN) last June. EU member states were given a deadline of 31 December 2003 to incorporate provisions enacting the Directive into their national legislation; by this date only seven out of the existing member states had complied and of the defaulters, most have still not met these obligations, including Italy and Spain. Even among those countries that have passed legislation, that legislation often gives very little detail above the text of the Directive. Only three countries have given any guidance to paying agents, to clarify interpretations within the Directive. It should also be noted that EU Accession member states also have to incorporate this Directive into their national legislation.

The Directive stipulates that certain countries (Switzerland, Liechtenstein, San Marino, Monaco and Andorra) must introduce measures equivalent to those contained in the Directive (i.e. either automatic information exchange or withholding) pursuant to agreements entered into by them with the European Union. In addition, all relevant dependent territories including the Channel Islands, Isle of Man, and Caribbean dependent territories (apart from the Cayman Islands) should apply either automatic information exchange or withholding tax in relation to interest payments made by paying agents in their territory. Most of the territories concerned have indicated that they shall adopt a withholding tax model (apart from Cayman Islands). However only Switzerland, the Channel Islands and the Isle of Man have reached draft agreements with the EU to date, and it is understood that some territories,

Monaco and San Marino, are yet to begin formal discussions with the EU Commission.

ECOFIN must unanimously decide by 1 July 2004 whether these territories will have adopted equivalent measure before 1 January 2005. If ECOFIN does not decide that the conditions will be satisfied, it shall unanimously agree a new date for the implementation of the Directive. While there are clear delays in implementation, many of the larger member states are determined to address tax avoidance and will be reluctant to see the Directive implementation delayed.

Implementation process amid uncertainty

Where does this uncertainty leave the investment management industry? Given the scale of the implementation process for an investment management group with numerous products and countries impacted by the Directive, delaying action until ECOFIN have made their decision and all territories have given guidance on their interpretation of the Directive cannot be a viable option.

Many investment managers and paying agents have already reviewed the know your customer requirements of the Directive (effective from 1 January 2004), and addressed the following:

- Updated customer application processes to include the request for a passport or official identity card (or a certified copy of such);
- Staff training in processing new customer applications in the required changes and in the mechanism for handling the receipt of legal documentation such as passports; and

- Updated the format of investor records to include the extra information required by the Directive and also to distinguish between pre 1 January 2004 and post 1 January 2004 customers.

In addition, most groups have begun reviewing their fund ranges (UCITS and non-UCITS) to identify products likely to be caught by the Directive and the identity of the paying agent for those products.

However, some areas of a group's business may not yet have been considered:

- Funds based outside the EU and other affected territories with an EU-based paying agent, e.g. a Bermuda-based hedge fund with an Irish custodian.
- Private Client operations, where an individual's assets are managed by a fund manager outside a fund wrapper.
- Alternative investment products such as private equity or real estate funds.

A significant issue, that cannot be neglected, is the management of the customer relationship. Investment managers will need to ensure that their customers are aware of the Directive's implications for them and their products, e.g. if withholding tax is to be deducted at source.

Most investment managers will be reluctant to commit large resource to Directive implementation over a short timeframe at the end of 2004. This means that groups need to continue their implementation process, despite the significant uncertainty that still surrounds this issue.



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Flashline

New Swiss law:

Same business, same rules

Momentous changes will be underway in Switzerland with a draft new law which regulates all kinds of collective investment schemes under one law.

The new law would make Switzerland even more internationally competitive and create corresponding Swiss directives to UCITS III.

The published draft of the new law on collective investment schemes (CISA) foresees an enlargement of the scope of application. The IFA (current law) only regulates investment funds under contract law as jointly owned open-ended pools of assets. However, with CISA they could be under company law (like a Luxembourg SICAV). Furthermore, CISA will regulate existing investment foundations (currently supervised by the Federal Office of Social Insurance) and existing listed investment companies (currently ruled by SWX, the Swiss Stock Exchange.) Moreover, CISA will allow the launch of Swiss limited partnerships for the first time.

The draft law is driven by the principle "same business, same rules" at every level: all licence holders (fund management companies, investment foundations, SICAVs, investment companies and limited partnerships) have to comply with a Code of Conduct, which stipulates duties on loyalty, on diligence and on information. Importantly, all licence holders have the same tax treatment as the existing investment funds (no stamp duties and no income taxation for the vehicle).

The funds will be equivalent to EU-harmonised investment funds (UCITS III) and so will the fund management companies. With this harmonisation Swiss fund management companies will be able to offer asset management and investment advisory services for individual investors, deposit accounts and technical administration for other collective investment vehicles.

The initial CISA consultation period has just finished, and there are numerous steps before the law is implemented (probably late 2006). However, the magnitude of the change means fund managers need to be assessing opportunities and risks already.

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The PricewaterhouseCoopers 2004 Global Trends in Performance Measurement Publication

The development of the Global Investment Performance Standards (GIPS), facilitating better understanding of a firm's investment record, is one of the success stories of self-regulation in the investment management industry.

To document the progress of the standards and key challenges facing investment managers, the triennial PricewaterhouseCoopers 2004 Global Trends in Performance Measurement Publication probed the views of 94 investment organisations, primarily surveying the heads of performance departments. Among these survey respondents, the level of compliance with the presentation standards is high, 72%, with another 18% expecting to become compliant in the next 3 years.

Standardisation of disclosure or calculation

Performance standards to present return statistics have made progress, but increasingly investors wish to monitor the accompanying risk as well. In our survey, 84% of managers calculate risk measures. However, how they measure risk is far from uniform reflecting specifics of asset class, investment strategy and timing. Some 70% of our respondents use derivatives, and of these 65% feel that requiring Value-at-Risk ratios would make a compliant presentation unnecessarily onerous or complex. Many are also concerned that they do not have adequate IT systems for the complexities of risk measurement.

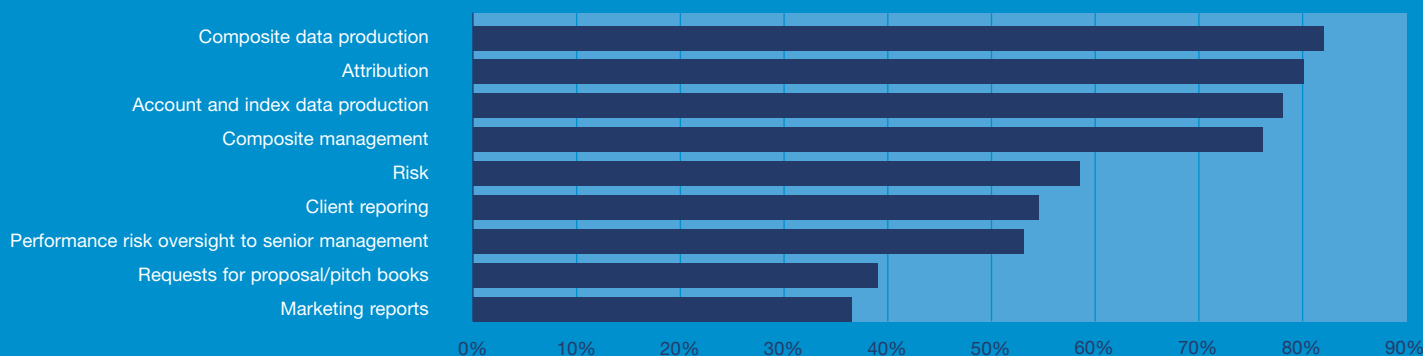
At present, of those using derivatives 37% have separate composites, while 55% do not. For those using leverage, 67% have separate composites, while 27% do not. Some managers assert that broadening composite requirements to require such risk measures could cause them to forfeit their compliance.

Another example is performance attribution, which has been embraced both internally by investment managers and externally by clients and consultants, to demonstrate exactly how a fund manager adds value. In our survey, 84% of respondents do performance attribution; most have a specialised IT system or tool to do so, but 27% are using spreadsheets. As performance attribution mirrors the manager's decision-making process, which is unique and specific to the manager, how can standardisation be achieved? If performance attribution is just return attribution, this is one level of complexity, but when one considers the interaction of return with risk, or attempts risk attribution, the challenges multiply exponentially. The answer is to distinguish between standardisation of disclosures and that of calculation. Even if calculation methodology cannot (or should not) be uniform, it is possible for each manager to disclose the same information. Nevertheless performance attribution is likely to be bound by a code of conduct, rather than performance standards, for some time to come.

Widening the net

As global multi-asset managers and institutional investors grow accustomed to the benefits of compliant performance in their traditional assets, they become exasperated with the myriad of presentation methods used in alternative investments. To meet this demand, Private Equity Provisions and Real Estate Provisions have been developed. However, it must be recognised that many managers/advisers in these fields are boutiques or stand-alone managers who have not in the past needed to be very open and have little experience of performance standards. Additionally, GIPS performance is based on the time horizon of the investor which is done through Time-Weighted Returns (TWR), while the majority of alternative investments are illiquid and assessed over the lifetime of the investment.

Figure 1:
What are the roles of the performance team?



This is particularly an issue with regard to calculation of performance. Encouragingly, among our survey respondents with private equity, 71% of those with direct private equity investments and 55% of those investing in private equity through funds indicate they are likely to comply with the Private Equity Provision Guidelines. In the Private Equity Provisions, the since inception internal rate of return (SI-IRR) has been recognised as the principle measure and this is borne out by our survey responses.

In the Real Estate Provisions, no firm decision has been made between TWR and IRR, resulting in managers needing to calculate an overwhelming array of statistics. Furthermore, the approach favoured by the manager has tended to reflect their background, with those coming from traditional asset backgrounds, and investment consultants, favouring TWRs and those from private equity or real estate backgrounds favouring IRRs. This is not only creating presentational difficulties, but investment decisions are being made on TWR grounds when the IRR conclusion would be much different. Additional real estate implementation concerns relate to requirements for an independent valuation annually, which some managers regard as an unnecessary expense and in some cases less robust than their internal valuations.

Ensuring accurate performance delivery

Noticeable since our 2001 survey is the increased recognition of the performance team as an entity, and one which delivers value. Increasingly it has gone from an administrative function to one which can contribute significantly to the investment process (as can be seen in the bar chart shown in figure 1). However, as the roles of

the performance team expand, so must recognition of potential conflicts of interest and divided loyalties. Should ex-ante risk measurement, increasingly an integral part of the investment management decision making process, and ex-post risk and performance with oversight functionality be integrated into the same performance team? Currently 54% are integrated and 46% are not.

An irony is that the better the performance team does its job, the more fund managers and other users want. Expectations and reliance on IT systems have increased, but investment in IT systems has not kept up with demand. In our survey, 64% say they do not produce performance reports frequently or fast enough for what they need. Our 2004 survey queried, "Is the infrastructure in your organisation adequate to deal with difficulties in applying the standards on a timely basis?" to which 73% responded "adequate, but some improvement necessary".

Trying to meet this demand, enterprising performance team members have vastly increased their spreadsheet use in the attribution field, which have gone from 10% in 2001 to 27% in 2004. However, there is an inherent risk of errors resulting from using spreadsheets and the low control framework surrounding their creation and use; this could have major implications in third party reporting. A best practice control framework can deal with this issue by 1) assessing the technical risk 2) reviewing management controls and 3) instituting a robust development cycle.

At present, GIPS compliance is appreciated for the internal controls it provides and the marketing advantages it gives. Even so, those with hard-earned

GIPS compliance are not making the most of it since 91% include performance results on their website, while only 38% claim compliance with standards on their website. It is feasible that very quickly GIPS compliance could become a pre-condition to even enter an investor's long list.

As GIPS compliance becomes increasingly sought-after, the industry must anticipate and prevent any possible cutting of corners which would demean the standardisation, and the time and money firms have spent achieving and maintaining compliance. However, an industry based on trust cannot afford to wait until regulators blow the whistle (and the media gets hold of wrongdoing). The industry needs to be self-policing and the only reliable way to ensure upholding of the standards is through verification, which investors over time could insist become mandatory (as it currently is in the UK). This verification would be carried out by an independent third party and those verifiers themselves need to maintain high standards of independence and rigour.

The effectiveness of the performance standard-setting process is a testimony to the hard work of many and the willingness of the industry to actively debate to find solutions. The process benefits hugely from taking a pragmatic approach, recognising that there may be difficulties in implementation but continuing to move forward, towards a destination of fair and open disclosure in an ever-evolving industry.

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2004 UK Pension Scheme Governance Survey: How trustees can improve pension scheme governance

Media attention has focused on increasing pressures on corporate governance and a series of reviews demanding higher standards of governance of corporate boards. However, this is equally true of pension scheme trustees.

The *Myners* review of institutional investment in the UK explicitly addressed governance issues relating to pension scheme trustees. This and other reviews, combined with other factors, e.g. falling stock markets, changing accounting standards and very recently the UK Pensions Bill, has led to a greatly increased focus on the governance of pension schemes.

Consequently, the impact pension arrangements can have on a company's financial position is far more visible than in the past. Furthermore, what is happening inside a pension scheme – especially when it goes wrong – has a much greater capacity to impact adversely on the company's financial position and standing within the investment community than ever before.

The *Myners* review set out a number of specific principles that relate to the investment of pension fund assets. The Government has encourage schemes to voluntarily adopt these principles – all of which have a broader application to the governance of pension schemes generally.

In the first quarter of 2004 PricewaterhouseCoopers surveyed the Chairmen of 66 of the largest UK pension schemes to gain a snapshot view of the current state of pension scheme governance.

Survey findings

A significant number of the Chairmen surveyed believe they have assessed their scheme's compliance with *Myners* and implemented the recommendations. However, there are some areas where the principles have been less readily adopted

and implemented by trustee boards, particularly, in the areas of assessing the performance of advisers and delegates and in the area of trustees' assessment of their own performance. For example, in 38% of cases, the assessment of the performance of advisers and managers is often "ad hoc and inconsistent or non-existent". Clearly, trustees have found the actual implementation of change necessary to improve governance difficult.

Other major themes to emerge from the survey results included:

- Many trustee boards have adopted and implemented changes to the running of the scheme to achieve improvements in governance. However, in a significant number of cases the changes implemented have not resulted in formal, documented processes.
- More than 45% of trustee boards have not performed any review of individual trustee's knowledge and skills.
- Dealing effectively with conflicts of interests is an area that trustees are finding difficult. Nearly a quarter of Chairmen responded that "no consideration is given to conflicts of interest".

The PricewaterhouseCoopers' view

The structures and processes established to control a pension scheme and the management of risk are all critical components of achieving good governance. However, the linchpin of good governance is "rigour of debate",

for without this governance is likely to fall down. How effectively the board of trustees consider issues and make decisions, and how rigorously they pursue exceptions and evidence of failures in internal processes are at the heart of effective governance.

The Government has indicated that it will legislate to force improvements in pension scheme governance if schemes do not voluntarily move in that direction. Trustees can consider taking a number of key actions to improve governance including:

- Benchmarking their scheme against best practice to identify strengths and weaknesses in governance;
- Assessing the skills and knowledge of trustees and developing a program to close gaps identified;
- Introducing objectives and implementing performance measurement processes for advisers and delegates; and for the trustees themselves;
- Developing principles for addressing and recognising conflicts of interest.

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UK-UK transfer pricing may spur rationalisation

Rationalisation may be in order as new UK tax legislation has extended UK transfer pricing requirements to include transactions between group companies within the UK.

Transfer pricing has long been a consideration for multinational investment management groups. Over the last few years, tax authorities have, in general, become much more aggressive in the transfer pricing arena, with a view to protecting tax revenues. Tax authorities are seeking to ensure that the charges for cross-border transactions are at “arm’s length” prices. Increasing cross-border activity of investment management groups has intensified tax authorities’ interest in the industry. Cross-border transactions typically targeted by tax authorities might include the provision of sub-advisory services, marketing and distribution, administrative support services or intragroup funding and guarantees.

As of 1 April 2004, thanks to recent UK tax legislation, groups will need to be able to demonstrate arm’s length pricing of onshore transactions as well as cross-border transactions. The potential increase in the transfer pricing management and compliance burden, when taken in conjunction with recent developments in the regulatory arena, is encouraging UK investment management groups to re-think current business models, with a view to simplification and rationalisation of group structures and intragroup transactions.

In 2003, prompted by a decision in the European Court of Justice, the UK Government took legal advice. Apparently, it was told that the UK’s transfer pricing rules may be in breach of the European Treaty. The UK Government has addressed this by introducing new tax legislation, the principal effects of which are:

- The extension of both transfer pricing and thin capitalisation rules to cover UK to UK transactions; and

- A limited exemption for “small and medium” sized enterprises (SMEs).

The response of the UK Government has been rapid. Proposals were tabled in August 2003, draft legislation was published in December 2003, and the new rules came into effect on 1 April 2004. While other European tax authorities, such as Germany, have also responded by changing thin capitalisation rules, the UK’s response is so far the most dramatic and wide reaching.

Impact for investment managers

UK investment management groups have typically structured their operations on the basis of regulatory restrictions and inherited acquisition structures. Groups which now find themselves with a proliferation of UK companies, are contemplating significant extra administrative burdens in order to comply with the new onshore transfer pricing requirements. In particular, dormant companies with potentially interest-bearing balances due from UK group companies are at risk of being reactivated under the new rules.

When the new transfer pricing rules are considered in conjunction with the recent UK regulatory changes, as well as the advent of UCITS III, there is increasing incentive for fund management groups to rationalise, eliminating dormant companies where possible and rationalising functions within a smaller number of companies, as well as streamlining group finance arrangements.

Another area worthy of attention is group service companies. It has been a common approach to centralise various activities into group service companies, thereby minimising costs and hence regulatory capital within regulated entities. The services

provided by these companies must now be priced on an arm’s length basis. Depending on the nature of the service company, there are several ways of categorising and benchmarking service companies to give groups the optimum result. For example, the return expected by a service outsourcing company will be very different from that of an “employment company”, whose real function is payroll processing.

Where to from here?

For most groups, onshore transfer pricing is merely an unwelcome extra administrative burden. At the very least, groups are having to ensure that onshore transfer pricing policies are defensible and consistent with cross-border policies. However, proactive groups are assessing what can be done to rationalise their group structure and business model in order to minimise the management and compliance burden of the new legislation while taking advantage of greater European freedom of operation.

The UK’s new legislation has been interpreted among the taxpaying community as acceptance that existing transfer pricing rules may be in breach of the EC Treaty. Spain and Germany have already acted over thin capitalisation, but have made no such announcements as yet on transfer pricing. Taxpayers await the response of other EU members. Smart taxpayers, however, are already scrutinising their transfer pricing policies in preparation for further developments within the EU, having learnt from the UK experience of how quickly the transfer pricing landscape can change.



Flashline

Italian real estate funds enjoy new tax regime

Italian real estate investment funds are benefiting from a new tax regime which was introduced starting from 1 January 2004.

In the previous tax regime, real estate investment funds were subject to a substitute tax at a rate of 1% on the “net aggregate value of the fund”. The substitute tax applied on an annual basis irrespective of whether the fund was performing at a loss rather than a profit.

Under the new tax regime, the 1% substitute tax has been abolished. Real estate funds are not subject to corporate tax (IRES) or regional tax (IRAP) and a withholding tax at a rate of 12.5% is applied to profits distributed to Italian investors in real estate funds. The withholding tax is levied as definitive taxation in the case of individual investors and as advance payment of total tax due in the case of companies.

However, foreign investors (that do not have a permanent establishment in Italy through which the investment is made) are exempt from the 12.5% withholding tax provided that they are resident of a state that allows the exchange of information with the Italian tax authorities.

The new tax regime applies to distributed profits realised from the increased value of the fund starting from 1 January 2004.

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Italy encourages small cap UCITS

Since October 2003, qualifying Italian investment funds and non-Italian UCITS distributed to Italian investors which invest in companies with a market capitalisation of less than €800 million can benefit from reduced tax on profits.

There are a number of specific conditions applying but Law Decree no. 269/03 states that the 12.5% substitute tax ordinarily applicable on the relevant assessable profits of Italian open-ended and closed-ended investment funds (which invest in transferable securities) is reduced to 5% for Italian individual investors in “companies of small or medium capitalisation” defined as no higher than €800 million if the following conditions are met:

- (i) The fund’s regulations provide that no less than two thirds of the assets of the fund are invested in shares of companies of small or medium capitalisation listed on a regulated market of an EU member state(s).
- (ii) One year after the setting up of the fund – or one year after the modification of the fund’s regulations in order to comply with the requirement under point (i) – the value of the shares of the aforementioned companies held by the fund is, during the calendar year, at least two thirds of the value of the total assets of the fund for more than a sixth of the valuation days arising in the year. Such evaluation must be made in each calendar year.

For Italian corporate investors, proceeds from these small/medium capitalisation funds will still form part of the business income subject to ordinary taxation, with an entitlement to a tax credit of 15% for investment in Italian funds subject to the 12.5% or the 5% substitute tax. An amount equal to the 9% of this tax credit would be a limited tax credit which could not generate a refundable tax credit or be carried forward.

Non-Italian residents investing in Italian investment funds subject to the reduced 5% substitute tax may benefit from the refund of a tax credit equal to 6% of the proceeds received (instead of the ordinary tax credit of 15% for Italian funds subject to the 12.5% substitute tax). However, this only applies to investors resident in states with information exchange with Italian tax authorities.

Foreign UCITS

Law Decree no. 269/03 also introduces an equivalent tax benefit for foreign UCITS that comply with (i) and (ii) above which are set up in compliance with Council Directive no. 85/611.

The 12.5% withholding tax withheld by Italian intermediaries on payments from such foreign UCITS is reduced to 5%. The withholding tax of 12.5% or 5% is levied as a final tax for individual investors and is creditable against the corporate income tax on the same income for corporate investors.

A tax benefit is also available for Italian funds (such as funds-of-funds) that invest in foreign UCITS set up under 85/611, where such UCITS specialise in investing in “companies of small and medium capitalisation” as defined in (i) and (ii). In this case, 60% of the proceeds arising from such foreign UCITS are exempt in the hands of the Italian funds. A similar 60% exemption applies to private portfolios of Italian investors managed by authorised intermediaries under the Italian “management saving” tax regime.



Flashline

German IM practice manual

The German Investment Modernisation Act has completely revised the German Investment (Tax) Act and creates new conditions, possibilities and restrictions for investment managers. We have written a practice-oriented manual giving an overview, guidance and examples on key topics, including the Derivatives Ordinance. This will be invaluable for foreign and domestic managers and is available (in German and partially in English) from Arno Kempf (tel: (49) 69 9585 2367 or arno.kempf@de.pwc.com).



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More Directives creep up on asset managers

The EU Transparency and Capital Adequacy Directives are not at the forefront of investment managers' concerns, but they should not be ignored.

The Transparency Directive introduces EU-wide standards for disclosure both by companies and by shareholders in companies. Both aspects are important for asset managers.

The Directive harmonises the information that must be disclosed on a regular basis by companies with securities listed on European exchanges, and defines when these disclosures must be made. This should make cross-European comparisons of trading statements easier to make and is complementary to the move towards harmonised accounting standards around Europe.

This part of the Directive does not apply to UCITS, even if their shares are listed on an exchange.

The Directive also harmonises rules for disclosure of holdings in the securities of a single issuer. The key article requires disclosure by a shareholder where their voting rights reaches, exceeds or falls below the threshold of 5% and other higher thresholds. The disclosure must be made to the issuer as soon as possible but not more than four trading days later.

The issuer, in turn, is required to make the information public 'upon receipt', but no later than three trading days later.

The investment management industry had argued for certain exemptions since, in general, their activities are not aimed at exercising control over companies and there are concerns about reporting requirements when holdings move quickly above and then below a threshold (or vice versa).

In the event the only concessions agreed are for banking activities, there are exemptions for custodians, clearings and settlement entities, and market makers. In addition holdings held directly by a parent need not be aggregated with holdings managed by the parent or a subsidiary on a discretionary basis. The impact of this will have to await detailed interpretations at the national level: CESR may play a role in attempting harmonisation of these interpretations.

The detail repays scrutiny and, most importantly, member states can impose more stringent requirements if they see fit. Thus from an investment manager's viewpoint the minimum requirements for companies' reporting are beneficial. But their own reporting requirements to issuers will not be able to be standardised if countries use the 'more stringent' clause to add to the Directive's requirements.

How CAD will impact investment managers

Last summer the European Council asked for an assessment to be made of the impact of the Commission proposals on the Capital Adequacy Directive (CAD 3). PricewaterhouseCoopers was chosen to carry out this work which was published by the Commission in April. PricewaterhouseCoopers' report notes that for investment managers, the retention of the expenditure-based requirements (EBR) implies little change for the majority of firms. However, it also concludes that with fewer waivers on consolidation, some firms will be exposed to substantially increased capital requirements.

The report also documents differences for asset managers versus banks and their capital needs:

- The very different risks encountered by asset managers from those faced by banks
- asset management is an agency business; the balance sheet is rarely involved
- the EBR measure is not risk sensitive; and
- that insurance could be an appropriate risk mitigant for some of the operational risk encountered in investment management.



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Flashline

Belgian foreign fund tax battle continues

The clarifications and confusion continue to rage on the new Belgian tax on foreign funds, as we raised in the March 2004 IM News.

A new Belgian tax of 0.06% on the "net amounts invested in Belgium" for foreign funds came into force on 1 January 2004. This tax is due on the net subscriptions received through financial intermediaries in Belgium. Since that article, a number of clarifications have been made by the tax authorities and the Belgian funds association.

The association has specified that the taxable basis should be similar to the taxable basis used within the framework of the annual fee paid to the Bank Commission by the foreign funds. In practice, this means that if the distributor is Belgian, the shares sold through this distributor will be considered as "an amount invested in Belgium". However, in case of a non-Belgian distributor, these shares are outside the scope of the tax. Moreover, in case of a mere "administrative" intervention of a Belgian financial intermediary, the tax will not be due since no subscription order form ("bordereau") will be drawn up.

According to the tax authorities, however, all interventions consisting of a subscription are subject to the tax. In practice, most of these subscriptions will indeed be done by a distributor.

Please also note that the 0.01% rate for institutional investors is not applicable for foreign funds.

Finally, as proposed by the funds association, the tax authorities have confirmed that for Belgian funds, only the subscriptions made by a Belgian resident should be taken into account.

This exclusion is however not applicable for foreign funds which could be considered as discriminatory.

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Jersey's expert funds excite promoters and investors

The introduction by Jersey of expert funds with effect from 3 February 2004 will substantially enhance the jurisdiction's appeal to professional, institutional and high-net-worth individuals.

The new regime of expert fund regulation aims to ease the establishment and operation of private equity, property, hedge and other alternative investment strategy funds.

The key to the new regulation focuses around two fundamental principles:

- A shift in emphasis in order to focus the regulation on the fund administrator rather than seeking to regulate on a fund by fund basis; and
- An acknowledgement that for an expert fund, as opposed to a retail structure, it is the investors themselves who are best placed to evaluate the risk of making an investment in the expert fund and all material information will be disclosed in the offering document.

Expert funds are designed as flexible investment vehicles that can take any form

recognised under Jersey law. They may be open-ended or closed-ended, there will be no investment or gearing restrictions and for the majority of expert funds there will be flexible requirements in respect of custody or prime brokerage arrangements. They will be particularly suitable for establishing hedge funds and innovative products aimed at expert investors.


It is now possible to establish expert funds in a matter of days. The Jersey Commission's proposals will enable "authorised functionaries" on the Island - for example, administrators, fund managers and trustees - to self-certify expert funds which meet criteria set down by the Commission in its expert fund guide.

The Jersey administrator can outsource elements of its administration duties in accordance with the Commission's outsourcing policy but must maintain

sufficient records in Jersey to fulfil its responsibilities including that of monitoring the investment manager.

The new regime has been introduced in response to demand from the funds industry both on and off the Island to encourage a broader range of promoters and investment strategies as well as a more streamlined approach to the regulation of expert funds.

There are an increasing number of alternative investment funds which have obtained a listing on the internationally recognised Channel Island Stock Exchange, an important factor for institutional investors when considering where to place their funds.

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