

FSTP Perspectives

A publication for financial services industry
tax and transfer pricing professionals

May 2011

In this issue:

*Transfer pricing related
to algorithmic trading*

*Substance within a
captive insurer*

Latin America key issues



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“Welcome to the May 2011 issue of *FSTP Perspectives*: PwC’s market leading financial services transfer pricing publication.”



Foreword

A common theme in recent editions of *FSTP Perspectives* has been around the dramatic changes in the financial markets and the resulting consideration by local regulatory and tax authorities, and taxpayers, of how these changes impact historical transfer pricing positions and results. This edition focuses, in part, on regulatory developments that have taken place since those financial market disruptions and evaluates how these regulatory proposals may impact market participants on a go-forward basis. While not meant to be an exhaustive review of all such changes, the included articles should provide some key flags and considerations around your current transfer pricing policies.

The Dodd-Frank Act in the United States and similar regulatory proposals in the United Kingdom and other jurisdictions propose important changes around risk assessment, capital adequacy, and compensation practices. Each of these elements play an important role in intercompany pricing for banking and trading affiliates. Similarly, Solvency II proposals also raise important considerations for insurance sector participants. An added layer of complexity is that different jurisdictions appear to be taking slightly different courses of action around the application and/or customization of these rules, which can raise confusion around treatment and deductibility and could create problems in implementing a globally consistent transfer pricing model.

From a technical perspective, this issue also discusses the transfer pricing considerations around proprietary trading operations, especially those that are technology dependent. Finally, from a regional perspective, we have also provided a summary of financial services transfer pricing in Latin America based on discussions and presentations from our event in Buenos Aires late last year.

All of these issues continue to be debated and refined and we expect upcoming events in Toronto, Zurich, and Shanghai to provide more technical and regional flavor. We hope you are able to attend one of these events and please feel free to reach out to your regular financial services transfer pricing contact for more information on these or other transfer pricing matters.

Best regards,

A handwritten signature in black ink, appearing to read 'Krishnan Chandrasekhar'. The signature is fluid and cursive, with a long horizontal stroke at the end.

Krishnan Chandrasekhar
Principal, Chicago

Transfer pricing related to algorithmic trading

Peter Lee, Robert Ritter

Within the US transfer pricing regulations (US TP Regulations) the existing guidance related to intercompany trading is limited, although some guidance is provided under the 1998-issued proposed Global Dealings Regulations (Global Dealings Regulations). However, these regulations principally apply to customer flow transactions.¹ Outside the US, the OECD Report on the Attribution of Profits to Permanent Establishments (OECD Report) provides insight as to how tax authorities may evaluate transfer pricing policies related to proprietary trading models by discussing the “hedge fund” model versus other customer-based models, and distinguishing between returns for client and/or trading related activities versus capital or other assets.

Overview of electronic proprietary trading

Under a traditional proprietary trading model, traders take views on the market and develop trading and risk management strategies. The traded products can include stocks, bonds, currencies, derivatives, or other such financial instruments. In effect, proprietary traders seek

to make a profit by correctly forecasting the movement in market variables by deliberately exposing themselves to changes in these variables by taking a “proprietary position.”

Historically, proprietary trading transfer pricing models relied on quantifying and rewarding the non-routine intangibles imbedded in the traders who develop strategies and execute the trades, often via benchmarking analyses based upon a Comparable Uncontrolled Services Price (CUSP) method (i.e., 2% and 20%, for asset management and performance, respectively). In contrast, under an algorithmic trading model, the strategy and the trading parameters are programmed into the software that executes trades orders using computer algorithms. In other words, the software, under established parameters, assumes functions for executing trading strategies and managing the subsequent post trade risks. The implication is that certain non-routine intangibles are imbedded in the software in contrast to the traditional proprietary trading model that attributes non-routine intangibles to traders.

With the continued growth of algorithmic trading, the use of technology has impacted how we apply transfer pricing principles to evaluate intercompany proprietary trading transactions. Specifically, how should a taxpayer establish an arm’s-length policy related to algorithmic proprietary trading if the non-routine value is imbedded into the software program rather than in the traders?

The software, under established parameters, assumes functions for executing trading strategies and managing the subsequent post trade risks. The implication is that certain non-routine intangibles are imbedded in the software in contrast to the traditional proprietary trading model that attributes non-routine intangibles to traders.

Transfer pricing issues

Under an algorithmic trading scenario, participants from multiple jurisdictions invest in the development of new algorithms to identify profitable trades and infrastructure to increase the speed of trade execution. Programming may be as critical as trading

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¹ While the IRS has not yet issued final or temporary regulations directly applicable to global trading activities, Global Dealings Regulations are, in broad terms, reflective of US tax policy in this area.

Transfer pricing related to algorithmic trading (continued)

and while traders are present to provide oversight, their roles should be evaluated under a functional analysis to verify whether the potential for profits is driven more by trading acumen, programming expertise, technology or other drivers.

Given this disbursement of roles, a Residual Profit Split Method (RPSM) may be an alternative transfer pricing model but the application of the RPSM would need to consider the technology elements more carefully. This would include addressing the level of IT development expenses, the compensation of the programmers and traders assisting to develop the software, as well as quantifying a return for the capital utilized in trading. Certain hurdles to overcome include how to define and compensate the routine contributions, how to compensate capital, as well as to determine the appropriate allocation keys relevant in determining how to split residual profit.

Conclusion

The TP issues related to proprietary trading remains a source of uncertainty due to the nature of the business and a lack of applicable specific transfer pricing methods. With limited guidance, the introduction of technology makes this more complex.

While the appropriate transfer pricing model would depend on the facts and circumstances, clients should also be cognizant of potential tax opportunities that involve IT development, such as the R&D tax credit in the US. In addition, as with any kind of profit split that involves financial services, value-added tax (or VAT) implications should be considered.

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Insurance regulatory developments—and their impact on transfer pricing positions

Soorashree Telang

United States

The Dodd Frank Wall Street Reform and Consumer Protection Act (“DFA”)

The DFA, enacted on July 21, 2010, has important implications for the US insurance industry. The DFA established the Federal Insurance Office (FIO) to monitor the insurance and reinsurance markets. The FIO will also be responsible for identifying regulatory gaps, deal with international insurance matters, and monitor the extent to which underserved communities have access to affordable insurance. Although the FIO will not have supervisory or regulatory powers, it will have the powers to work with other countries and preempt certain state regulations with respect to specific international insurance matters. (Also see related article on impact of DFA on executive compensation and transfer pricing.)

Green book 2011

The US Treasury Department released its General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals (“the Greenbook”) on February 14, 2011. One of the proposals under the Greenbook limits deductions for reinsurance

premiums paid by a US insurance company to its foreign affiliates.

If enacted into the law, the proposal would disregard a reinsurance treaty signed between a US insurer and its affiliated foreign reinsurer, unless the affiliated reinsurer is subject to tax or elects to subject to tax the premiums it receives from the US insurer under the subject reinsurance treaty. This would be achieved by two actions: (1) by denying the US insurer a deduction for the reinsurance premiums paid to the affiliated foreign reinsurer to the extent that the foreign reinsurer or its parent company is not subject to US income tax on the premiums received, and (2) by excluding from the US insurer’s income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered under the subject reinsurance policy.

If enacted, this provision would be effective for policies issued in taxable years beginning after December 31, 2011.

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Regulatory reforms in light of the recent financial crises are likely to reshape the global insurance industry. The following paragraphs discuss key regulatory changes—enacted and proposed—and their potential impact on transfer pricing positions.

The Dodd Frank Act has added a regulatory body with an aim to have a ‘systemic’ view on insurance regulations from a federal perspective.

If the reinsurance proposals in the Greenbook are enacted, insurers ceding to affiliated reinsurers would need to re-evaluate their current transfer pricing arrangements.

Insurance regulatory developments—and their impact on transfer pricing positions (continued)

Europe

Solvency II

Solvency II is one of the largest insurance reforms expected to take place in the European market, with a target implementation date of January 2013.

Solvency II has been designed to protect policy holders by ensuring capital adequacy, and aims to create a more harmonized, risk-orientated solvency regime resulting in capital requirements that are more reflective of the risks assumed. It is structured around three Pillars:

Pillar 1 defines the financial resources that a company needs to hold in order to be considered solvent, including guidance on the valuation of assets, liabilities and capital requirements and defining the minimum capital requirement (MCR) and the solvency capital requirement (SCR).

Pillar 2 focuses on the governance and risk management systems together with the requirements for supervision of these systems and controls.

Pillar 3 revolves around the disclosure requirements of a firm's financial condition, including descriptions

of the firm's business, governance procedures, risk exposures and valuation bases.

Solvency II will especially have an impact on insurance branch structures. With MCR and SCR components of risk based capital requirements affecting the amount of capital required to be held by branches under their existing regulatory structures, capital allocations to branches under the asset allocation methodologies are likely to change. The Organization for Economic Cooperation and Development ("OECD") uses the authorized OECD approach to attribute risk and investment assets in accordance with arm's length principles. Therefore, it is essential to ensure that regulatory changes do not undermine the reliability of using regulatory capital as a proxy to measure the risks attributable to an Insurance PE under the arm's length principle.

In summary

The regulatory developments discussed above may require changes to intercompany agreements, and changes in the identification/determination of additional capital and data requirements in order to implement arm's length pricing between insurance affiliates.

Solvency II impact on transfer pricing positions

- Capital allocation between branches is likely to be modified, impacting profit allocations under authorized OECD approach
- Review of captive reinsurers may be warranted to ensure compliance with Solvency II requirements
- Enhanced risk assessments will support transfer pricing analysis

Moreover, the changes in regulatory environment are likely to result in increased scrutiny by Revenue Authorities, especially given the potential for changes in the resulting profit results in various jurisdictions.

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Substance within a captive insurer

Erin Hathaway, Craig Scalise

Transfer pricing of transactions with a captive (re)insurer represents only one element of the required support around such structures. Increasingly, tax authorities are also raising questions around substance behind such affiliated (re)insurers, though there is considerable ambiguity on what this means in practice.

From an OECD perspective, the taxpayer needs to demonstrate management control, i.e., an appropriate corporate structure and qualified personnel with necessary empowerment and skills, to credibly manage the risks associated with a captive (re)insurer. The entity also needs to have the financial capacity to bear the relevant risks on a stand-alone basis. The exact nature and importance of these functions (and who performs them) will vary depending on the facts and circumstances, including the type of risks that are reinsured.

Management of risk

In the context of a captive (re)insurer, the importance of decisions about managing underwriting risk is similar to the importance of decisions about assuming the risk to begin with. Because taxpayer/parent entity policies and decisions may impact the initial assumption of risk, the captive's underwriting role may be more oriented towards the management of the underwriting risk. Specific examples could include personnel acting as Chief Underwriting Officer, with the ability to sign relevant contracts locally and with responsibility for setting underwriting policies and making decisions associated with accepting (re)insured risk. Underwriting sub-functions to be performed locally could include final acceptance and approval around pricing and risk retention analyses with an ability to do so with minimal supervision.

Personnel

Although the number of employees is generally not a decisive criterion as such to assess substance, tax authorities often refer to this as a first test. However, captive activities typically do not require a substantial number of employees and therefore it is important to ensure that the taxpayer's employees have the appropriate competencies. Moreover, it is important to demonstrate that these employees are qualified and are playing a central role in making the decisions with respect to these activities.

Shareholder meeting and Board of Directors (BoD) requirements

It is recommended that shareholder and BoD meetings be held locally, with the majority of members physically attending. It is important that actual decisions be made by these directors and the use of proxies should be avoided as much as possible. Any specific required qualifications under local law should be considered. Having predominantly people with an explicit tax profile on the board should be avoided.

Financial requirements

It is recommended that the captive have the necessary financial resources to conduct business independently, and the reserves and necessary

surplus to absorb any losses or benefits in excess of reserves from the realization of those insured risks. It is also recommended for the captive to have compliance with thin capitalization requirements.

Documentation requirements

All relevant documentation should point out that management and BoD meetings have effectively taken place locally. Documents such as contracts and letters should be signed by local management and correctly identify the functional and risk profile of the captive and its counterparts. Other examples of items which should be maintained locally include office infrastructure, books of accounts, minute books and share registers, bank accounts and signatory power for bank accounts.

The above list is a non-exhaustive list of criteria to be considered in order to build up a robust case for defending the substance of a captive (re)insurance company.

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The potential claw-back or deferment of compensation (including bonuses) resulting from DFA makes it difficult to discern the true economics of the contributions of key employees for the application of the RPSM in a specific year.

Dodd-Frank, executive compensation and transfer pricing

Yvonne Mellor, Robert Ritter

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) was signed by President Barack Obama on July 21, 2010, representing a sweeping change to financial regulation in the United States. The DFA's purpose is to restore responsibility and accountability in the US financial system by addressing various issues in relation to independence, bailouts, transparency, executive pay plus others. This article focuses on the proposals around executive pay and the impact that this has on the practical implementation of transfer pricing methods, namely, the residual profit split method (RPSM).

The DFA and Executive Compensation

Much of the DFA focuses on limiting and/or managing the risks taken by financial companies. One area identified by the DFA is executive compensation, specifically the relationship between compensation policies and incentives for risk taking within financial institutions..

The DFA calls on federal regulators to jointly prescribe regulations for: 1) disclosure of incentive-based compensation structures at covered

institutions; and 2) prohibiting pay arrangements that incentivize inappropriate risk-taking by employees, directors or principal shareholders that could lead to material financial loss.

Current proposals included in the DFA include deferment and/or claw-back of compensation in certain cases, intended to incentivize a longer term horizon on decisions and a mechanism to tie adverse firm results to executive compensation results.

Transfer pricing implications of DFA

The RPSM is frequently applied to financial service companies, as a means to allocate profits/losses on an arm's-length basis between entities operating as an integrated global business. Among other steps, the RPSM relies on a reasonable allocation mechanism to determine the proportion of residual profit (or loss) to be allocated amongst the participating entities, one of the most common of which is compensation of the key personnel in the non-routine function identified.

The potential claw-back or deferment of compensation (including bonuses) resulting from DFA makes it difficult to discern the true economics of the contributions of key employees

for the application of the RPSM in a specific year. Given the proposed requirements of the DFA, total compensation in a specific year could only include an element of the compensation due to the activity in that year and may include elements of compensation from prior years. As a result, the appropriateness of compensation as an allocation key and the annual application of the RPSM would need to be revisited under the DFA.

For example, the proposed changes may warrant evaluating RPSM models over an 'appropriate' time horizon, perhaps three-to-five years,¹ rather than on a year-by-year basis, depending on the nature of compensation contracts. This approach may more accurately reflect the compensation of key employees; however, it is likely to lead to other issues, for example, where single years come under local tax audit. As an alternative, other value drivers can be considered (e.g., assets under management, headcount of key personnel).

Conclusion

At this time, there is no clear guidance as to the exact provisions that may be enacted related to deferment

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¹ An appropriate horizon would be based on the facts and circumstance of each particular transfer pricing study.

Dodd-Frank, executive compensation and transfer pricing (continued)

or claw-back of compensation and regulators need to specify what events would trigger the claw-backs (e.g., bankruptcy, extraordinary government assistance).

In addition to the DFA, in March 2009, the Financial Services Authority (FSA), the UK's financial regulatory body, released a Consultation Paper² on remuneration practices in financial institutions, expressing concern about remuneration practices which may pose risks to the firm and may be inconsistent with effective risk management. The Consultation Paper lists several principles that aim to align compensation with taxpayers including ensuring that compensation is based on longer term performance (Principle 5) as well as that the majority of any significant bonus be deferred with a minimum vesting period (Principle 9).

The appropriateness of compensation as a RPSM allocation key has been the focus of much discussion following the losses companies have realized in recent years and whether it's still appropriate to allocate losses using the same driver. The DFA adds to this ongoing discussion from another perspective.

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At this time, there is no clear guidance as to the exact provisions that may be enacted related to deferment or claw-back of compensation and regulators need to specify what events would trigger the claw-backs (e.g., bankruptcy, extraordinary government assistance).

² Financial Services Authority, Consultation Paper 09/10, Reforming remuneration practices in financial services, March 2009.

Audit experience in the region indicates that particular attention must be paid to intercompany funding (inbound and outbound) and cash pooling schemes, which are currently a key focus of the regional tax authorities.

Latin-America—key issues

Jose Maria Segura

On November 18, 2010, PwC Argentina hosted the first Latin American Transfer Pricing Masters Series in Buenos Aires. There were more than 50 client participants from the financial services industry from across the region that attended this conference. In addition, this full-day Masters Series was led by the financial services (FS) transfer pricing (TP) specialists of our network from Argentina, Brazil, Chile, Colombia, Peru, UK, USA and Uruguay.

The event included a number of interactive sessions focused on transfer pricing best practices within the industry, and highlighted the current transfer pricing approach taken by the tax authorities of the major financial services hubs, as well as the tax authorities in the region. This article notes some key observations raised in the various sessions around FSTP developments in the region.

Key FSTP considerations in the context of LATAM

Regulations and tax authority expertise

TP regulations have been introduced in the region since the late 90s. Even though there has not been much audit activity within the financial services industry, during the last ten years the tax authorities have gained a lot of experience in dealing with transfer pricing issues and related matters (such

as PE issues) via audits, trainings, and, in some cases, participating as a non-member in many of the working groups of the OECD's Committee on Fiscal Affairs. Further, it is noted that while most jurisdictions have adopted the arm's-length standard, Brazil has certain unique requirements that aren't always consistent with this standard.

Hot topics and audit experience

Situations that have been observed in the region and should be evaluated by the regional financial industry taxpayers include (among others):

- The existence, or not, of key value driving functions in business referral schemes;
- How to document and price the rendering of advisory services within trading activities; and
- Transfer pricing policies for proprietary trading (see related article in this issue) and considerations related to the ownership and licensing of trading software and underlying software programming activities.

In addition, audit experience in the region indicates that particular attention must be paid to intercompany funding (inbound and outbound)

and cash pooling schemes, which are currently a key focus of the regional tax authorities. Audits in the region have also led to challenges to the interest rates agreed upon by affiliated parties, and have also involved challenging the characterization of the transaction itself, often re-characterizing the transactions to either reject the deductibility of interest paid and/or foreign exchange losses or assert increased interest rates on interest earned locally.

Documentation

Information required by the regional tax authorities during tax audits include any risk assessment and opportunity cost analyses done by the taxpayer before deciding to enter a transaction or market. Regional tax authorities also require that the available documentation outlines how the pricing complies with arm's length terms and conditions and that the parties adhere to these terms and conditions. Finally, a detailed description of the process and sources of information used to obtain comparable transactions is also needed during audits.

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Latin-America—key issues (continued)

Summary

The LATAM FSTP Masters Series highlighted the increased attention that regional tax authorities are paying to the financial services industry and affiliated financial transactions. It is expected that their focus will become more sophisticated in the years to come as they audit more transactions and get more exposure. Experience indicates that strong supporting documentation of the transfer pricing policy and a clear understanding of its implementation are key elements in order to succeed in presenting and defending transfer pricing arrangements.

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Pricing Knowledge Network (PKN) and upcoming events

PKN Alert India	Supreme Court annuls high court's directions on technical transfer pricing issues relating to marketing intangibles	October 7, 2010
PKN Alert Australia	Australian Taxation Office releases finalised taxation ruling on the interaction between the thin capitalisation and transfer pricing provisions	October 27, 2010
PKN Alert Italy	Tax Authority Circular on TP Documentation	December 23, 2010
PKN Alert Canada	Guarantee fees—Federal Court of Appeal confirms GE Capital Canada Inc. decision	December 23, 2010
PKN Alert China	China issues its first-ever APA report	December 31, 2010
PKN Stop Press Venezuela	Venezuelan Tax Administration established new procedure for the calculation of the arm's length range	January 21, 2011
PKN Alert Finland	Finnish Supreme Administrative Court rules on intercompany interest	January 25, 2011
PKN Alert China	Chinese tax authorities stepping up anti-tax avoidance enforcement of corporate restructurings through valuation	January 27, 2011
PKN Stop Press OECD	OECD tackles the difficult issue of scope of its project on transfer pricing and intangibles	February 1, 2011
PKN Alert Luxembourg	Luxembourg guidance on transfer pricing	March 4, 2011
PKN Alert Netherlands	New Dutch decree on the Attribution of Profits to Permanent Establishments	March 4, 2011
PKN Alert India	Transfer pricing amendments in India - Finance Bill 2011	March 7, 2011
PKN Alert United States	IRS issues Chief Counsel Advisory discussing application of valuation methods under cost sharing regulations to other intangible property transactions	March 29, 2011
PKN Alert Qatar	New tax law with specific transfer pricing provisions	April 7, 2011

To view any of the articles listed above, or any other contributions to the Pricing Knowledge Network, please click [viewPKN](#) and select the archive tab

Upcoming events

FSTP Masters Series, Toronto	May 17, 2011
Central European FSTP Conference , Zurich	June 7, 2011
FSTP Masters Series, Shanghai	July 12, 2011
TP 11 Global Transfer Pricing Conference, Singapore	October 19-21, 2011

For further information about any of these events, please contact your local transfer pricing specialist.

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