

Performance

A triannual topical digest for investment management professionals, issue 7, January 2012



Market buzz

Fund analytics, regulatory requirement or business opportunity?
 Investing in Château Lafite, Picasso or Patek Philippe — The rise of collectible assets
 GIPS — A 'necessary' evil
 Corporate governance in investment funds
 Duties and responsibilities of directors revisited
 Brazilian investment funds
 Wealth management trends
 Swing pricing and the challenge of fair cost allocation in distressed financial markets

Tax perspective

New tax reporting requirements for foreign investment funds distributed in Italy
 New tax rules put pressure on offshore jurisdictions
 Financial transactions tax

Regulatory angle

Managing risks under UCITS IV
 New release or fountain of youth?
 IASB and FASB issue Exposure Drafts (ED) on investment entities
 Reform of 'MiFID'
 Spotlight on the 'inducements' section

In this issue

6



14



20



26



32



40



4 Foreword

5 Editorial

Market buzz

6 Fund analytics, regulatory requirement or business opportunity?

14 Investing in Château Lafite, Picasso or Patek Philippe
The rise of collectible assets

20 GIPS — A 'necessary' evil

26 Corporate governance in investment funds
Duties and responsibilities of directors revisited

32 Brazilian investment funds

40 Wealth management trends

46 Swing pricing and the challenge of fair cost allocation in distressed financial markets

46

54

60

68

80

86

92



Tax perspective

- 54 New tax reporting requirements for foreign investment funds distributed in Italy
- 60 New tax rules put pressure on offshore jurisdictions
- 68 Financial transactions tax

Regulatory angle

- 80 Managing risks under UCITS IV
New release or fountain of youth?
- 86 IASB and FASB Issue Exposure Drafts (ED)
on investment entities
- 92 Reform of 'MiFID'
Spotlight on the 'inducements' section
- 96 Hot off the press
- 98 Contacts

Foreword



Dear investment management practitioners, faithful readers and new-comers of our magazine, we are glad to present you the seventh edition of *Performance*, Deloitte's worldwide digest covering the current topics of the Investment Management industry. First of all, we wish you a successful year in 2012 at both personal and professional levels. This edition of *Performance* actually kicks off the third calendar year of existence for our publication. We continue to believe that offering an international and common platform to the worldwide Investment Management industry professionals is a challenge that turns out to be of great interest for our clients, prospects and Deloitte practitioners. Thank you again for your inspiring support.

2011 has been everything but a quiet year in Investment Management. Worldwide consumer confidence is not at its highest, this is the least one can say. Who is to blame? Did the market expect investors to fully erase 2008 and the Lehman collapse driven crisis from their memory? Is it not a natural reaction to anxiously anticipate the reminiscence of this uncomfortable time for asset management now that even the eurozone, the world leading economy, is as fragile as it ever was? We nevertheless do not paint everything in black. Let us remember that from a statistical perspective, global markets cyclically going down for a straight period, as it has been the case towards the end of 2011, are generally followed by a period of potential appreciation.

Macro perspectives tell us that 2012 could well become a difficult year for the EMEA region. A recession scenario will be difficult to avoid for the eurozone, this factor will obviously have a non-stimulating effect for the region, especially considering the rather moderate GDP growth in emerging EMEA countries. According to Deloitte's Asia Pacific Economic Outlook Report, this region barely has economies recovered from the 2008 crisis that it was faced with the Euro and U.S. debt crises. APAC economies have in no way been insulated from these crises, while other political-social factors have affected performances and will shape future growth. China's economy, for example, has grown less in 2011 than in 2010 while India has been subject to 9% inflation at its peaks. For the U.S., the persistent high unemployment rate has slowed down the GDP recovery since the 2008 financial crisis recovery.

Looking at our very industry, similarly to last year, worldwide regulation is still a key driver in asset management. Asset servicing providers will again have, major readiness projects on their bill while margins are still under pressure. Active product profitability management should remain on the agenda of all global asset managers. All in all, we are still confident on the prosperity of Investment Management. We warmly invite you to take up contact with our industry specialists and subject matter experts to share thoughts, practices and expectations. Together, we will continue shaping this great economic segment of ours.

We wish you a pleasant time with *Performance*, and deeply thank you for your permanent inspiration.

A handwritten signature in black ink, appearing to read 'Vincent Gouverneur'.

Vincent Gouverneur
Partner - Tax & Consulting
EMEA Investment Management Leader

A handwritten signature in black ink, appearing to read 'Nick Sandall'.

Nick Sandall
Partner - Advisory & Consulting
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Performance is a triannual magazine that gathers our most important or 'hot topic' articles. The various articles will reflect Deloitte's multidisciplinary approach and combine advisory & consulting, audit, and tax expertise in analysing the latest developments in the industry. Each article will also provide an external expert's or our own perspective on the different challenges and opportunities being faced by the investment management community. As such, the distribution of Performance will be broad and we hope to provide insightful and interesting information to all actors and players of the asset servicing and investment management value chains.

Editorial

Happy New Year 2012, and welcome to this seventh edition of *Performance*, Deloitte's international digest from, and to, Investment Management professionals. The entire editorial team is excited to enter the third year of publication of what has become Deloitte's main communication channel for our industry.

Our reader's base has grown to over 20,000 spread around more than 30 countries. Looking back at the beginning of the adventure, we can humbly be overwhelmed by the growing success and positive feedback *Performance* is subject to.

For this first edition of a new and challenging year for Investment Management, we decided to treat subjects such as the financial transactions tax, anti-dilution techniques, analytics, collectible assets, risk management in UCITS IV, GIPS or corporate governance. Usually, we try to present our articles from a non-country centric

perspective. For this edition, we thought it would be interesting to present the asset management trends for Brazil, one of the world's most dynamic economy.

As usual, do not hesitate to contact us to exchange views and ideas on any topic of your choice. I wish you, on behalf of the editorial team, a pleasant reading of *Performance*. Thank you for your support!

Sincerely,



Simon Ramos
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Fund analytics, regulatory requirement or business opportunity?

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For many years, fund analytics have been perceived as a necessity of doing business and a cumbersome way of calculating the metrics required by the regulator and sought by the investment community in order to understand performance.

While these factors represent important reasons for the production of fund analytics, especially as the recent market turmoil prompted regulators to have a closer look at financial products such as investment funds, analytics can be much more than this: they can act as active revenue drivers throughout the asset servicing value chain. Whether they are used in profitability assessments or for marketing purposes, the production of analytics is shifting from being regulatory-driven towards a strategic element in business management.

A key driver of this has been the technological advances achieved in the last few years, which have led to the development of more complex analytics capabilities. These include the exponential increase in raw computing power and data capacity, alongside

the introduction of much more powerful software to handle data (particularly unstructured data), increasingly sophisticated techniques such as predictive modelling and sentiment analyses. The ability to leverage a variable cost, or 'elastic' capacity, available through cloud computing, provides opportunities to perform 'big data' analyses that were inconceivable a few years ago.

In what follows, we will discuss regulatory as well as business trends in producing analytics. First, we highlight a highly volatile market environment that calls for the quick and efficient production of analytics, and discuss fund analytics under UCITS IV. We then introduce analytics as a valuable marketing and business management tool before concluding with recent business trends in analytics production.



A high market volatility environment requires faster insights into available choices and outcomes

Quick decisions are more important when markets change direction frequently; a brilliant decision today could look less than smart tomorrow. Predictive analytics and scenario generation are critical for asset managers in decision modelling. Asset managers have various platforms and processes for sensitivity analysis and stress testing, but often assets are on highly specialised, disparate platforms. Moreover, scenario outcome analysis and stress testing often involve major efforts in terms of data collection, analysis and simulations, which can span many weeks and represent part of a formal reporting process rather than an element of holistic decision-making. This makes it difficult to see the overall impact of market swings or individual key factors across all portfolios, and hampers dynamic decision-making.

In our experience, what drives success or failure here is not the size or complexity of an asset manager or its product range, but the degree to which various platforms are integrated using a single analytics framework shared by various investment groups, such as a scenario generation tool that includes stress factor models, valuation models, a factor correlation matrix, a data warehouse and a reporting platform. This is more common in asset managers who have evolved organically and asset managers with a simpler product range.

UCITS IV and KIIDs: fund analytics at the service of the end investor and the regulator

UCITS IV creates the obligation for investment funds to produce a Key Investor Information Document (KIID). KIIDs contain a series of fund analytics that are aimed at informing the investor about different key aspects of the fund in a concise way. Examples include the Synthetic Risk and Reward Indicator (SRRI), the past performance of the fund and the fund's ongoing charges.

While the industry argues the shortcomings of the SRRI, some refer to the ultimate *raison d'être* of the KIID. True, the metrics introduced by the KIID seem, to some extent, to over-simplify a complex reality. For instance, the SRRI does not take into account liquidity and counterparty risk. These are important risk dimensions for the investor, especially in light of the recent market turmoil. This may lead to a false sense of security for the investor. For funds with a track record of under five years, proxies are used to calculate the SRRI. Inconsistencies in SRRI calculation, and hence, a lack of comparability are the outcome here. This is more of an issue when considering the aim of KIIDs: comparability and standardisation of investor information. However, the fund analytics used in KIIDs also provide important benefits. For the first time, they provide a standardised method of informing investors about the key elements of an investment fund. The value added of the KIID for the investor is its simplicity and intuitiveness. Is it then realistic to expect exhaustiveness from KIIDs and their analytics?

Quick decisions are more important when markets change direction frequently; a brilliant decision today could look less than smart tomorrow.

The production of KIID-related fund analytics can be challenging. The initial setup of the KIID requires substantial operational efforts, especially as the proper distribution of the document to end investors must be demonstrated. Revising existing distribution contracts to transfer the responsibility of proper KIID distribution to the fund distributor is just one step in the distribution process. Considering fund analytics for instance,

incomplete time series or the lack of track record can vastly increase the complexity of the SRRI calculation, as proxies must be used. However, the real challenge may lay in maintaining the KIID. Substantial changes in market conditions may trigger modifications of the SRRI and hence an update of the KIID, meaning a production-focused approach to creating KIIDs is essential. In this sense, technology clearly has an important role to play, as it can enable asset managers to quickly adapt the KIID and distribute it in an efficient way. A variety of techniques could be used to remind the end investor of a KIID update, ranging from electronic alert reminders that include a link to the new KIID, to the systematic inclusion of KIIDs in the annual statements of the fund promoter.

UCITS IV also introduces a series of fund analytics aimed at informing the regulator about a fund's various risk-related aspects. Examples include stress-testing metrics, Value at Risk (VaR) measures and backtesting reports, as well as liquidity, currency and counterparty risk metrics. But although VaR, for example, is a commonly-reported risk metric, UCITS IV gives no clear indication of how to calculate it. Different methods, such as Monte Carlo simulations or historical models can be used, with the results of the calculations also being different. This creates inconsistencies in the way the regulator approaches risk management at the fund level. The same reasoning applies to stress testing and liquidity risk measurement.

Besides UCITS IV, the Alternative Investment Fund Market Directive (AIFMD) creates a new framework for alternative fund supervision.

While the AIFMD has yet to take its definitive shape (the grandfathering period is scheduled to end in March 2014), one thing seems clear: the directive introduces a series of analytics over and above those currently produced under UCITS IV.



At the level of investor disclosure, for instance, the percentage of illiquid assets and the past performance of the fund must be disclosed, whereas at the regulatory authority level, relevant supplementary analytics must be disclosed in relation to a fund's leverage (e.g. leverage employed, maximum level of leverage).

As AIFMD introduces an enhanced framework for fund supervision, we may wonder whether the next generation of UCITS will reflect this in increased use of fund analytics.

Marketing and client reporting: fund analytics as a differentiating element

The emergence of social networks provides a new medium for attracting and connecting with investors and customers. Social networks are humming with unstructured data — valuable information about customer preferences, behaviours and recommendations (word of mouth). Making sense of the continuous flow of data is a daunting task, and while retail asset managers have not yet made significant investments in this field, companies in other sectors (e.g. consumer products) are starting to leverage emerging solutions.

For example, by using Salesforce.com, companies monitor the limitless supply of customer opinions about their products, and structure this data into meaningful metrics (e.g. customer mood and product hype) to supplement traditional client analytics (e.g. client lifetime value, segmentation, share of wallet, preferred channels, service model).

Many asset managers may not have decided on a social media strategy, but most have established a presence. While institutional investors have simply created profiles with general background and company history, most retail-oriented investors have thousands of followers and a new, low-cost channel for communications and marketing.

ETFs and other low-fee products have seen a rapid rise in investor demand in recent times. The compound annual growth rate for global ETF AuM over the last 10 years is 30%. This success can undoubtedly be attributed to low fees and the ongoing debate over whether passive investment strategies provide better returns than active approaches. However, we can see a recent shift towards higher fee alternatives among high net worth individuals and institutional investors.

Fund analytics can play a role in positioning active investment strategies against passive ones. Investment managers can use analytics such as the Sharpe ratio, alpha and the Treynor measure to show their investors that a fund is worth its money compared to passive investment strategies (e.g. through providing investors with a detailed factsheet).

A series of more or less sophisticated performance indicators can be used to set an actively managed fund apart from a passively managed one. Alpha generation, for example, is one way of demonstrating a fund manager's stock-picking capabilities. Actively communicating this analytic can therefore represent a valuable marketing tool for fund promoters to position their funds on the market. Another commonly-used performance metric is the Sharpe ratio (i.e. a risk-adjusted performance indicator).

Fund performance metrics are a valuable tool for fund managers too. This is one of the key metrics used by investors to benchmark an investment fund against other funds or benchmarks. However, neither the production nor the interpretation of this metric is standardised. The main challenge in producing fund performance analytics lies in precise position keeping in order to manage intermediary gains and losses. Moreover, accurate valuation of the different positions is crucial whenever performance is calculated.

Besides the overall fund performance, fund managers are interested in performance attribution. Performance attribution analysis enables managers, *inter alia*, to distinguish performance relating to currency effects from asset-intrinsic performance.

While currency-induced performance is often only a by-product of the security selection process, asset-intrinsic performance is a valuable indicator of the quality of the security selection process. In addition to the usual challenges in performance calculation (i.e. data collection, valuation, position keeping, etc.), the outcome of the attribution analysis depends on the attribution methodology used. Although there are a number of different approaches (e.g. adjusting for deviations from the portfolio base currency via an equity risk premium), there is still no clear-cut solution for accurately attributing performance in a multi-currency portfolio.

Substantial amounts have been invested in performance attribution systems over the last few years. While these tools were initially developed for portfolio managers, they can be equally useful for senior management, client relationship specialists, risk controllers and marketing personnel. Senior management, as well as clients, for instance, are concerned that the rewards received must be worth the risks taken. This is not only true at total fund level, but at every step of the decision process. It is therefore advisable for risk management teams to work closely with performance measurers, as both elements should be assessed in a consistent way.

Another good reason for fund managers to adopt a set of fund analytics is the rating eligibility of the fund. Fund ratings such as Morningstar or Lipper are established quality indicators for private as well as institutional investors. Scoring a high rating with these companies is therefore an important selling point for investment funds. The methodology used to establish these ratings is, to a large extent, based on a set of analytics such as Morningstar's Risk-Adjusted Return (MRAR), which uses a fund's annualised historical excess return adjusted for the fund's historical volatility. Fund managers targeting good ratings have to constantly monitor the parameters underlying the ratings.

Social networks are humming with unstructured data — valuable information about customer preferences, behaviours and recommendations (word of mouth).

Business management: fund analytics as profitability gauges

Product profitability analytics are critical for enabling asset managers to decide which products to discontinue, reprice, or bundle, with a view to eliminating products that have a negative impact on their bottom line and improving pricing strategy by product (e.g. passing on the high cost of customisation, setting pricing floors). Profitability analytics also enable informed decisions to be made on pricing for new product launches, revenue-sharing agreements and custom mandate negotiations, and provide insight into the required scale for each product. This allows asset managers to develop a set of criteria and be proactive in pruning products that have not reached the required scale in the target timeline, or are simply not profitable in the current cost structure.

In our experience, product profitability is more difficult in practice than it initially appears. For example, while many asset managers present fund profitability information to their board of directors each year, this information is very detailed but not easily actionable, as asset managers monitor their performance most often by strategy and not on a fund-by-fund basis. Most often, product profitability assessments represent one-off efforts. When product profitability is not a regular, well-established process, it is likely that there is no universally-accepted approach for a product's P&L, and no mechanisms for attributing the costs of shared functions. As a result, significant heroics are required to collect data and obtain consistency across business lines, often hindered by low levels of transparency in relation to the unprofitable businesses or product lines. However, in the asset management organisations where this process is more mature and takes place quarterly, repeatable profitability assessments are in place, leveraging a suite of enterprise applications in which allocation models are integrated and reviewed periodically.



Net revenue per assets under management has been in continued decline, especially for institutional investors, due to the shift in preferences towards passive strategies and investors' flight to quality and therefore lower-yielding products. This has resulted in significant pricing pressure and deteriorating margins, and in declining economies of scale — a trend that has been further exacerbated by increased regulatory compliance costs.

As a result, asset managers have increased their focus on cost, and analytics play a key role in providing the transparency required for effective cost management. As key success factors and core competencies vary significantly between providers of alpha or beta, the relevance of analytics also differs. For providers of beta, given that operational efficiency is a key success factor,

analytic needs to cover execution capabilities and related issues, e.g. transaction processing metrics, breaks and errors, volume information and service level agreement compliance. Collection of these analytics is done weekly or monthly, often in operational excellence reporting packages. These analytics are frequently supplemented with one-off analysis of cost drivers, scalability of operations and operational risk sensitivity. Asset servicing institutions share a similar focus on operational efficiency and process metrics analytics, supplemented by strong client service analytics, e.g. response times, aggressive monitoring of service level agreement performance and root cause analysis for issues, and service costs by client category. For providers of alpha, portfolio and performance analytics are the most relevant.

In addition, the advent of cloud services and virtualisation enables the large amounts of data required for analytics to be processed on a pay-as-you-use basis, providing for a lean infrastructure and lower costs while supplying all the advantages of significant processing power. In our experience, many large asset servicing companies are pursuing partnerships with leading data mining and analytics companies to meet their analytics needs while keeping infrastructure costs down.

The recent market turmoil and its effects on end investors have prompted increased supervision and regulation of financial market instruments by market authorities.

Business trends: fund analytics as a means of extending the service range

The asset management industry is not the only sector to have suffered margin erosion; asset servicers have also been affected. The asset servicing industry is increasingly moving away from the traditional bundled service offering model. The ongoing commoditisation of services favouring plain vanilla products and the ever-increasing interest in sophisticated alternative investments are forcing asset servicers to reconsider their pricing grid, moving towards unbundled *à la carte* pricing. Through unbundling, asset servicers can achieve better margin management by charging greater margins on highly sophisticated products, and being flexible enough to react to price pressure on the plain vanilla side.

Nevertheless, the increased interest in alternative investments (and hence asset servicing solutions for alternative investments) seems to be insufficient to offset the revenue loss on the plain vanilla side. Meanwhile, there does not appear to be much scope left for differentiation in investment management core services. Asset managers are therefore endeavouring to find alternative revenue sources in asset management.

On the other hand, the current market environment is pushing asset managers towards an increased use of fund analytics for better risk and performance management. Fund analytics can therefore be a valuable means of extending the service range towards higher margin services.

We may see a greater tendency among asset servicing firms to offer value-added services related to the production of fund analytics. The analytics produced range from performance measurement and attribution (e.g. return, portfolio, attribution or risk/return analytics) to regulatory risk reporting under UCITS IV, and to fairly sophisticated investment analytics, such as security level attribution or fixed income analytics.

The production of regular fund industry reports using a series of fund metrics (e.g. fund returns) is another example of using analytics to extend a company's service offering.

Conclusion

Advances in IT increasingly enable companies to collect and process massive amounts of often heterogeneous and unstructured data in a way that supports decision-making at firm level. Increased computational power, virtualisation and cloud computing are but three of the multiple innovations that enable decision-makers to have quick access to relevant information in a highly volatile market environment.

Four main drivers are encouraging fund promoters and service providers to make greater use of fund analytics: fund sales strategies, regulatory requirements, management support and the search for new revenue streams.

Fund analytics can be actively used as a marketing tool by investment fund promoters: communicating a comprehensive set of fund analytics can be an effective way of indicating the strength of an investment fund to the potential end investor.

The recent market turmoil and its effects on end investors have prompted increased supervision and regulation of financial market instruments by market

authorities. Several directives have been put in place by European market authorities to enhance investor protection and increase financial product transparency. Two directives, UCITS IV and AIFMD, have had a particular impact on the production of a series of fund analytics. These metrics can either be produced for the regulator or the end investor.

Fund analytics can be a valuable management support tool too. For example, they can play an important role in risk management and profitability analysis. In light of this, the position of the performance measurer within the asset management firm should be reconsidered in order to achieve a closer link to risk management functions.

The production of fund analytics can be a mean of extending the range of services offered by a service provider, and can help firms mitigate the increasingly strong pressures on margins in the fund industry.

In light of the above, our answer to the question posed in the title of this article is: yes, producing fund analytics is a worthwhile task.



Investing in Château Lafite, Picasso or Patek Philippe

The rise of collectible assets

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What do Bill Gates, Queen Elizabeth II and Brad Pitt have in common?

Beyond being worldwide celebrities, each in their own way, these three people are passionate collectors. The American business magnate drives a 1999 Porsche 911 convertible, while the movie star has gathered an impressive contemporary art collection, and the Queen owns rare stamps.



Celebrities are not alone. Today, collectibles represent sizeable assets for many High Net Worth Individuals (HNWIs). Whether it is 18th century art, cases of Mouton Rothschild, Aston Martin cars or Swiss watches, investors are adding collectible assets to their portfolio in order to own things they love and — this is a growing trend — holding them for diversification purposes. Over time, many collectibles have earned higher returns than traditional investments such as stocks.

In line with this trend, recent years have seen the emergence of investment vehicles dedicated to collectibles. The current economic crisis has led many investors to seek investments outside of traditional financial vehicles.

This article is divided into two sections: first, a definition of collectible assets and an attempt to understand why they are increasingly recognised as real asset classes; and second, a focus on art investment funds, chosen because they have a longer track record than other collectibles funds — such as wine, violin or luxury car funds.

The growing recognition of collectibles as asset classes

In 1959, before he was elected as President of the United States, John F. Kennedy gave a now famous definition of a crisis, outlining the fact that difficult times also open doors to alternative opportunities: *“When written in Chinese the word crisis is composed of two characters. One represents danger, and the other represents opportunity”*.

The current economic crisis is no different. **With equity returns being eroded by market volatility and bond yields at record lows, a trend toward investors putting money into collectible assets has been observed.** While the term 'collectibles' covers a very diverse range of assets, they all possess similar DNA. They are tangible, meaning that they have a physical presence. They also have longevity, are transportable and can be stored relatively easily. But what really differentiates them from other items such as luxury goods or precious metals, is that **they are scarce and non-fungible.** Their rarity makes prices wholly demand-determined and transactions in such assets very infrequent compared to the daily trading of traditional securities.

Owing to these unique attributes, **collectibles provide a hedge against inflation and currency devaluation, and have a low correlation with other financial assets,** which makes them a safe haven in the current economic turmoil. For these reasons, **High Net Worth Individuals (HNWIs) and Ultra-High Net Worth Individuals (Ultra HNWIs)¹, are increasingly investing in collectibles.** According to the CapGemini and Merrill Lynch World Wealth Report 2011, the 10.9 million HNWIs around the globe allocate a significant part of their wealth to 'passion investments', including luxury collectibles (luxury cars, boats, jets), art, jewellery, gems and watches, sports investments and other collectibles (coins, antiques and wines)².

¹ HNWIs are defined as having investable assets of US\$1 million or more, excluding primary residence, collectibles, consumables and consumer durables. Ultra-HNWIs are defined as having investable assets of US\$30 million or more, excluding primary residence, collectibles, consumables and consumer durables

² 2001 World Wealth Report, CapGemini/Merrill Lynch, published June 2011

The fascination people hold for luxury collectibles — accounting for 29% of HNWI's total passion investments — was clearly demonstrated at the aeronautics sale held by the Artcurial auction house in October 2010, during which a 1971 Mirage V expected to go for between €30,000 and €35,000 was sold for €102,153. In second place is art, accounting for 22% of passion investments, driven by an upturn in the art market, which rose 52% from its lowest point in 2009 to reach a total of US\$60 billion in 2010³. Other collectibles are taking their place as real investment classes. The Liv-ex Fine Wine 500 Index, which tracks wine trades between merchants on the Live-ex exchange in London was up 4.52% in the year to 31 December 2011⁴. Record prices for diamonds were also reached at international auctions in 2011, where a huge diamond known as the 'Sun-Drop Diamond' sold for US\$12.36 million, a world record for a yellow diamond. Demand for fine and rare watches is also evident, with every watch sale hosted at Christie's salerooms in Dubai, Hong Kong, Geneva and New York achieving sell-through rates above 90% by value in 2010.

But who are these HNWI's investing in collectibles?

The typical art collector would be between 45 and 65 years old, well-educated, successful (probably working in the financial, medical or law sector), well-travelled, and has probably been collecting for over 30 years⁵. Chinese investors are generally younger: 73% are under 45, and 45% are 18-34 years old⁶. With regard to art, it is noteworthy that some of those collectors have invested astonishing amounts in their collections. Together, the top 14 art collectors around the world hold collections worth a total of US\$75,200 billion⁷. As an example, François Pinault, the renowned French businessman, owns an art collection worth US\$1.4 billion, representing

12% of his total net worth⁸. A new trend is that bankers, hedge funders and, financiers and more generally, Wall Street titans are also becoming collectors. Pierre LaGrange⁹, J. Tomilson Hill¹⁰, Andrew Saul¹¹, Robert Menschel¹² and Raymond Leary¹³ have been ranked as the top five Wall Street collectors by 'Business Insider'¹⁴.

The last decade has also seen the rise of a new type of collector. **China is emerging as a major market for collectible products.** This growth is driven by the increase in the number of Chinese millionaires. Statistics from the World Wealth Report show that in 2011, the Asia-Pacific HNWI population expanded by 9.7% to 3.3 million, thus becoming the second-largest in the world behind North America (3.4 million HNWI's), and ahead of Europe for the first time (3.1 million HNWI's). Many of these HNWI's have a passion for collectible goods. As a consequence, the forecast for 2014 is for Chinese wine consumption to grow by a further 19.6%. At this point, China will be the sixth largest wine-consuming country in the world¹⁵. Similarly, the Federation of the Swiss Watch Industry (FH) recently reported that Asia absorbed 52.6% of the value of Swiss watch exports in 2010. It also registered the highest growth, with a rate of increase of 34.6% compared to 2009, the leading market in absolute terms being Hong Kong (+46.9%)¹⁶.

Today, collectibles represent sizeable assets for many High Net Worth Individuals (HNWI's).

3 *The Global Art Market 2010 – Crisis and Recovery*, TEFAF, Maastricht, published March 2011

4 www.liv-ex.com, 31 December 2011

5 *The Global Art Market 2010 – Crisis and Recovery*, TEFAF, Maastricht, published March 2011

6 *2010-2011 World Luxury Association Annual Report*

7 *Forbes Top Art Collectors, 2011*

8 *Idem*

9 *Belgian hedge fund manager and co-founder of GLG Partners*

10 *Vice-Chairman of the Blackstone Group*

11 *Chairman of the Federal Retirement Thrift Investment Board (FRTIB)*

12 *Goldman Sachs Group Senior Director*

13 *Spent his working career in the international commodities field trading in physical commodities*

14 *'Wall Street's 25 Art Collectors', Business Insider, 7 February 2011*

15 *VINEXPO – The IWSR/21 February 2011*

16 *'The Swiss and World Watchmaking Industry in 2010', Federation of the Swiss Watch Industry (FH), http://www.fhs.ch/statistics/watchmaking_2010*



Individual preferences play a large part in HNWIs' decisions to commit to investment of collectibles, especially given emotive variables such as aesthetic value and lifestyle appeal. But purchases of items like these are no longer just about indulging an expensive hobby. HNWIs are increasingly using these items **to preserve and appreciate their capital over time, diversify their portfolio exposure or even capture short-term speculative gains**. Fine wine, for example, yielded a return of 14.97% for the period September 1991-September 2011¹⁷.

Following the rise of collectors seeing collectibles as real investment classes, and not just beautiful objects, dedicated investment vehicles have emerged. In the second section of this paper, we will examine the art fund industry and see how it has evolved to answer the demand of more and more HNWIs.

Investing in collectibles: the rise of art investment funds

There are different ways to invest money in the art market: non-profit funds, collectors clubs and charities have existed for decades or even centuries. But today, art funds, defined as *"privately offered investment funds dedicated to the generation of returns through the purchase and sale of works of art"*¹⁸, offer investors a new opportunity to purchase high-end artworks and at the same time make a return.

The history of art investment funds began in 1904 with André Level, a French financier, who persuaded twelve investors to contribute to a new investment fund called *La Peau de l'Ours* (Skin of the Bear). The fund acquired more than 100 artworks from famous artists such as Picasso, Matisse and Van Gogh, before selling them at auction in 1914, quadrupling the initial investment¹⁹. After this, almost nothing happened in the art fund industry until **the 1970s, and the entry of institutional**

¹⁷ http://www.liv-ex.com/pages/static_page.jsp?pagelid=210 pdf, 25 November 2011

¹⁸ www.artfundassociation.com, 29 November 2011

¹⁹ 'Cash for canvas', *The New Yorker*, 17 October 2005



investment funds, with the most notable example being the British Rail using 2.5% of its total pension fund to acquire some 2,500 artworks. The whole collection of the British Rail Pension Fund was sold between 1987 and 1999, offering investors an overall return of 11.3% (compounded) between 1974 and 1999²⁰. Some of the paintings far exceeded expectations, with, for example, a Renoir pastel portrait of Cezanne purchased for US\$230,000 being sold for US\$2.4 million²¹.

It was not until 30 years later that the art fund industry boom really began to take hold, with a number of funds appearing in the late 1990s and early 2000s. These new ventures started investing money in hard assets such as artworks as a diversification strategy, using a new type of organisation: **the dedicated fund structure for artworks**. The emergence of art funds in this period was underpinned by **increased access to information about the art market**, with the establishment of art price service providers and market analysts, and a range of fine art price indexes such as Artnet, ArtPrice and Art Market Research. According to the Deloitte/ArtTactic 2011 Art & Finance report, **the art fund market then went through three cycles from 2000 to date²². In the initial phase, between 2000 and 2005**, many funds were created, including the Fine Art Fund Group, launched in 2001 by Christie's former finance director, Philip Hoffman. As at 30 June 2011, the fund had assets of approximately US\$100 million under management and a track record Internal Rate of Return (IRR) of 24.5% per annum²³. But aside from this successful fund, almost

all art funds launched in this period did not see the light of day. **A second cycle, beginning in 2005** and during which a number of art funds emerged in India and South Korea, ended in 2008, when the global financial crisis hit the market.

In 2009, we entered the third cycle of the art fund industry. This involves survivors of the previous two cycles and newly-established funds such as Artemundi, Dionysos Art Fund and the Brazilian Golden Art Fund, which are administrated by professional fund managers with experience of both the art and investment sectors. Apart from the typical tasks that accompany fund administration, they are in charge of identifying and buying artworks, supervising all the logistics related to transport, storage and insurance, liaising with cultural institutions if the fund collection is to be showcased²⁴, and selling the artworks at the closing of the fund. The global investment fund market was worth an **estimated US\$960 million in 2011**. It has also gone global, with 44 art funds and art investment trusts in operation in countries such as Luxembourg, the United States, Singapore and Switzerland. Many more are waiting in the wings: at least eight new art funds are planning to launch in 2011-2012²⁵.

There are different ways to invest money in the art market: non-profit funds, collectors clubs and charities have existed for decades or even centuries.

²⁰ 'Betting on genius', *The Economist*, 21 August 2003

²¹ 'British Pension Fund Sells US\$65.6 Million in Artworks', *The New York Times*, 5 April 1989

²² Art & Finance Report 2011, Deloitte/ArtTactic, published December 2011

²³ www.thefineartfund.com, 30 November 2011. 'Track record on all sold assets from The Fine Art Fund, The Fine Art Fund II, The Middle Eastern Fine Art Fund and The Fine Art Fund III as at 30th June 2011'

²⁴ Market reports have clearly shown that the exhibition of artworks, especially in renowned international museums and galleries, has a direct correlation with the increase of their value

²⁵ Art & Finance Report 2011, Deloitte/ArtTactic, published December 2011



It is interesting to note that, among these 44 art funds, 21 are Chinese. In fact, in the last five years, Asia, and more specifically China, has become the leading player in the art fund industry. China's art fund and art investment trust market reached just over US\$320 million in 2011, and US\$300 million are in the process of being raised in the second half of 2011 and the first half of 2012²⁶. These art funds coincide with the birth of a new HNWI generation in this part of the world, willing to demonstrate they are sophisticated and in the same league as some of the world's best collectors. However, Chinese investors differ in their preference for Chinese artists. Chinese art funds are therefore focusing on native artists, such as Fanzhi Zeng, Xiaogang Zhang, Yifei Chen, Yidong Wang or Chunya Zhou²⁷. Chinese art funds are also driven by the willingness of banks to participate in the art fund industry. In 2007, China Minsheng Bank, China's first privately-owned bank, initiated an art investment plan, becoming the first banking institution in China licensed by the China Banking Regulatory Commission to get into the area of art funds. The fund was successful, producing returns up to 25% according to the bank, and leading Minsheng to launch its 'No 2 Product, Works of Art Investment Scheme' at the beginning of 2010, which was fully subscribed in just one week²⁸.

Conclusion

Although the art fund industry has survived the crisis and has seen positive development in the last three years, **it is still a niche market, and great obstacles need to be overcome before art becomes a mainstream asset class**. For now, capital raising remains a challenge to the majority of art funds, especially in a context where these funds have to meet standards like the New Alternative Investment Fund Managers Directive (AIFMD), which requires alternative investment managers to report to financial regulators and meet minimum capital requirements. With the financial crisis, investors have also grown more prudent and now conduct deeper fund evaluations than ever before.

However, with the continued global economic uncertainty combined with low interest rates, **we can expect more alternative financial vehicles to come to the market**. As the alternative fund industry matures, it is likely that there will be an increasing move towards consolidation taking place among offshore tax jurisdictions such as Jersey, Guernsey, the Cayman Islands, the British Virgin Islands, Ireland, Singapore and Luxembourg.

²⁶ *Art & Finance Report 2011, Deloitte/ArtTactic, published December 2011*

²⁷ *All 5 ranked among the top 10 artists by auction sales turnover in 2011 by the Contemporary Art Market Report 2010/2011, ArtPrice/FIAC, Published October 2011*

²⁸ *'The Art Market: A False Leonardo', Financial Times, 22 January 2010*



GIPS

A 'necessary' evil

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It is well-known in the asset management industry that "*past performance is not an indication of future results*". However, the reality is that investors, when seeking to hire new managers, primarily focus on managers' track records.

For many years, performance measurement and reporting lacked consistency and integrity. The Global Investment Performance Standards (GIPS) address these issues as they are a set of “*standardised, industry-wide ethical principles*” that provide investment firms with guidance on how to calculate and report their investment results to prospective and existing clients. Released in 1993 in North America as AIMR-PPS, today GIPS represent a global benchmark for performance measurement and reporting. They represent industry best practice, and are “*designed to provide assurance for investors who want reliable performance metrics based on the principles of fair representation and full disclosure*”.

The financial crisis and accompanying fraud issues have led to a collapse in investor confidence. Investors now expect more consistency and transparency. As Warren Buffet said: “*If I do not understand it, I won’t buy it*”. Today’s investors want to understand what type of products they are buying, the past performance of similar investments, comparatives, what fees they will be paying, etc. All these requirements, and more, are part of fully-compliant GIPS presentations.

According to a 2008 survey of U.S. and Canadian institutional managers conducted by Vincent Performance Services, 96% of respondents claim compliance with the GIPS standards, 2% do not currently claim compliance, but plan to become compliant in the near future, and 2% were not compliant and have no plans to become compliant.

In the U.S. and Canada, there is now evidence to suggest that compliance with GIPS is becoming the industry standard for institutional asset managers. Few institutional investors in North America issue Requests For Proposals (RFPs) without asking if the manager is GIPS-compliant, as do most databases. Consultants assisting institutional investors in performing manager

searches in the U.S. and Canada usually start their questionnaires with the following three questions:

1. Are you in compliance with GIPS?
2. Are you verified?
3. Who are your verifiers?

Managers not in compliance with GIPS feel that a answering 'no' to the first question reduces their chances of being selected, even if they have strong returns.

Another reason that makes GIPS compliance so popular in the institutional investment industry is that institutional investors have a fiduciary responsibility to understand their investments. They need various elements to analyse their investments and report to their boards and audit committees. Prior to making any selection, they want to make sure that historical performance was calculated and presented according to a rigorous set of standards. Being GIPS compliant goes beyond the use of a standardised calculation formula. A firm claiming compliance is a firm which has policies and procedures designed to calculate and present performance in a certain fashion. It is also a firm which has been consistent with, *inter alia*, valuation, benchmarks, data inputs and controls. It also means that the firm can support comprehensive reporting of returns, assets, dispersion and risk, etc. In other words, a GIPS compliant firm provides the necessary policies, procedures and reporting material that institutional investors would like to have for selecting managers and reporting to their boards.

The GIPS standards are also taken seriously from a regulatory perspective. Securities commissions in North America put value on the standards, especially when compliance has been assessed by auditing firms. They pay particular attention to policies and procedures, as well as to the fully-compliant disclosures, and release a list of any compliance deficiencies observed on an annual basis.

Lastly, it is important to mention that one of the reasons for the popularity of GIPS is that they have always been progressive regarding market developments. For example, hedge funds have now regained the total value they had reached in September 2008, just before the economic crisis. Because of the inflow of institutional assets, hedge fund managers are subject to enhanced due diligence and a greater demand for comparability. To achieve the required transparency, hedge fund managers are looking to the GIPS standards for guidance on how to measure and disclose performance.

To respond to these requirements, the GIPS Executive Committee has released an exposure draft of the Guidance Statement on Alternative Investment Strategies and Structures. This guidance statement is expected to become effective on 1 January 2012.

Although North American asset managers have broadly adopted GIPS as a 'must have', some European players appear to be reluctant to do so, as illustrated by the following random comments made by a number of Paris-based managers:

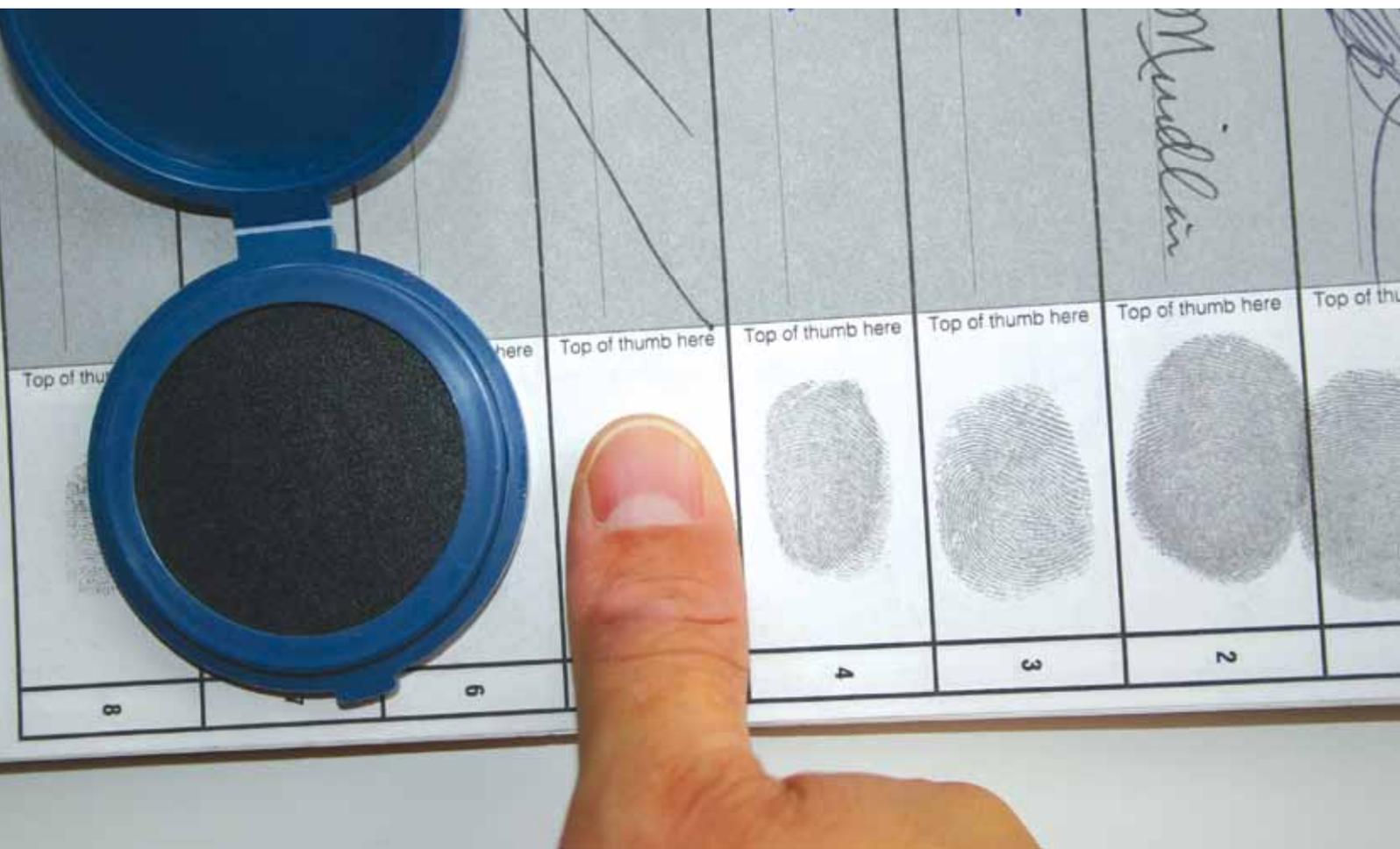
"The cost of implementation, administration and maintenance is too high compared to the customer benefit."

"Our domestic clients are not interested."

"The cost of the verifier is a recurring charge."

"Being GIPS compliant is not a decisive pre-selection criterion for the local consultant."

They are not mistaken.



The preference of French institutional investors for this reporting framework is outdated and they are not being encouraged to change their position by local consultants. The tender questionnaires that they initiate are usually limited to a single, binary question (compliant or non-compliant). They no longer seem to comprehend these standards, and some still refer to them under the AIMR name, which changed over ten years ago. Cost is an issue — especially if you do not have value, product and indicator reference bases, performance calculation and reporting tools and a team dedicated to determining external performance.

Is there any management company today that does not have an internal or external reporting chain?

The cost of having a verifier is a recommendation rather than an obligation, and a large portion of the North Atlantic players who claim they are compliant are not audited. It is an acceptable cost in my opinion (as demonstrated by Moroccan management companies, who are closer to the third and fourth quartiles of French management companies in terms of assets under management, and adopted systematic compliance verification in the 2000s).

However, France's four leading asset managers (Amundi, BNPPIP, Natixis AM, AXA IM) have applied GIPS since their publication in Europe (1997), either as willing participants, with the aim of adopting best market practice and enhancing their performance chains, or to improve their chances of winning international tenders. Other players, with a more domestic clientele, and in the constant search for excellence, (e.g. CPR AM, Rothschild & Cie Gestion) have followed suit. They remain the exception however; contrary to the situation in the U.S. where these standards have been adopted extensively (some studies reveal that more than 80% of U.S. management companies report that they are compliant or in the process of becoming compliant).



Lastly, it is important to mention that one of the reasons for the popularity of GIPS is that they have always been progressive regarding market developments.

In order of importance, U.S. firms cited the following reasons for seeking compliance:

- Marketing advantage
- Inconvenience of not being compliant
- Improved internal controls
- Pressure from consultants
- Pressure from new clients

For the most part, these factors would also apply to European management companies. The question is why there is no general move to adopt GIPS in France/ Europe. Is it solely the giant asset managers that feel any enthusiasm?

And yet, Europe has a regulatory and accounting framework that favours the implementation of GIPS (accounting standards or frameworks for accounting mechanisms and portfolio structures that are standardised and reviewed by a third party) and fully takes account of data quality issues (more so than in North America, where players largely use mandates to support their investment strategies).

Is it because these standards are not European in their essence, in that they involve a code of ethics based on common sense with minimal mandatory rules? It is true that certain obligations would seem to be inappropriate with respect to European management practices (e.g.

the obligation to value portfolios on the last trading day of the month while maintaining the use of estimated performance methods, an indication of a hierarchy of financial instrument valuation policies that are extensively regulated in relation to European certified vehicles).

However, some management companies have benefited from some of the features of the standards:

- Definition of a consensual management scope and therefore an AUM amount based on an established and audited methodology
- Determination of the management team's performance (calculation of gross management fees, total assets under management for the desk: portfolio composite and carve-out)
- Resilience of the reporting chain: data collection, processing and materialisation, reporting)
- Governance of composites and process formalisation

These elements help them achieve their goals of optimising business management and operational efficiency in relation to certain processes, and of determining variable management team bonuses accurately and transparently.

Despite their presence in France for nearly fifteen years, the international GIPS performance presentation standards have been hampered by a poor image and development has been slow. They still represent a 'holy grail' that is not easily achievable for medium-sized management companies. Their need to keep up with international competitors by seeking clients outside their traditional markets will perhaps prompt them to make the step. They will then notice that they were already applying GIPS without being aware of it.



Some insights from Spain and Italy

The Spanish asset management market has close links with commercial banks and retail investors. Nearly 90% of assets under management are distributed to retail investors through commercial bank networks using both mutual funds and pension funds as investment vehicles.

Although being a GIPS-verified asset manager is not a competitive advantage for the retail investor segment, the biggest players in the Spanish asset management industry claim GIPS compliance and conduct a third-party GIPS verification for their mutual and pension fund divisions.

In terms of institutional investors and the local market, these players use their GIPS reports as a commercial tool to present their performance to the boards of directors of occupational pension funds, with the aim of gaining mandates in this segment.

They are also considering whether to extend their claims of GIPS compliance to their branches in other countries (mainly LATAM) or establish a global asset management division, as their expertise and local capabilities could be a competitive advantage, helping to strengthen their institutional client bases and win new institutional clients with mandates related to LATAM investments.

Antonio Rios Cid
Partner
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Since their first publication in 1999 and the introduction in Italy of the Italian version of GIPS in July 2002, awareness of these standards among institutional investors has increased considerably. As a result, they have been adopted by more and more asset managers seeking to compete in the managing institutional accounts.

Furthermore, firms implementing the GIPS standards, because of strengthened internal processes and controls, and improved risk management, are recognised for their adherence to industry best practice. Although firms that do not report their investment performances according to the GIPS standards are not excluded from competitive bids, institutional investors and their advisors attach a greater level of confidence to the integrity and reliability of performance presentations submitted by those asset managers who have decided to comply with GIPS, even when they do not have a specific composite consistent with the mandate or sub-fund for which they are bidding.

Consequently, the widespread opinion among personnel working in the departments responsible for managing relationships with institutional clients of Italian asset management companies (and of the representative offices or branches in Italy of non-Italian companies), is that GIPS compliance can be marketed as a competitive advantage — or at least can serve to avoid a competitive disadvantage.

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Corporate governance in investment funds

Duties and responsibilities of directors revisited

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Becoming a director of an investment fund is a specialised occupation bringing with it many expectations and responsibilities. The investor community is highly focused on the standards of board-level governance at the funds¹ in which they seek to invest and their expectations have increased dramatically in the post-Madoff world.

Fund investors now have far higher expectations with respect to the corporate governance of the funds in which they invest. Many investors are actively calling for changes in the way fund boards are constituted, and in the role played by directors on those boards. In a recent investor survey by Carne², 91% of fund allocators agreed that poor governance would cause them to avoid investing in a fund, even if it met other operational and performance criteria.

The obligations that apply to directors in this regard are set out in a combination of statutory requirements (including company law), regulatory obligations and common law fiduciary and other duties of directors. Statutory obligations generally include, *inter alia*, an obligation to ensure that proper records are maintained, whereas common law duties are more general in nature, requiring directors to act with due skill, care and diligence and a duty to act in the best interests of the company.

Increasingly, regulators are seeking to codify these requirements and add to them, generally in the form of corporate governance codes of conduct. These codes borrow from more established codes such as the UK corporate governance code, while tailoring the requirements to the investment funds industry. Recent examples include the 'Voluntary Corporate Governance

Code for the Funds Industry' issued by the Irish Funds Industry Association (the '**Irish Code**') and the more principles-based 'Code of Conduct for Luxembourg Investment Funds' drafted by the Association of the Luxembourg Fund Industry (the '**Luxembourg Code**').

Most fund launches these days have at least one independent director on the board, indeed certain jurisdictions require it, and frequently the independent director(s) will be located offshore. As the corporate governance demands for independent directors on the boards of funds has grown, a number of institutions and individuals have stepped forward to offer their skills and expertise as directors. This is certainly the case in a number of offshore locations where funds have a wide choice when it comes to appointing directors, ranging from corporate groups that hire out their senior staff to serve on fund boards, through to sole practitioners who possess significant experience in the fund industry.

In the current environment, being a director of a fund is challenging and requires specialist knowledge and expertise. Both the law and industry practice place significant corporate governance responsibilities on aspiring directors, and a director ignores those responsibilities at his or her peril.

¹ The term 'fund' is used throughout this article to refer to all collective investment schemes, including, but not limited to, hedge funds, investment funds, mutual funds, managed funds and private equity funds

² Corporate governance in hedge funds: Investor Survey 2011 (Carne Global Financial Services)

Directors' corporate governance requirements

There are certain features of being an offshore fund director which are very different from being a director of a regular onshore company. These features have a direct impact on directors' corporate governance requirements. Some of the most important features are that a typical fund has no employees, no executive directors³ and no premises. Instead it will delegate its day-to-day activities to the investment manager, administrator, and other third party providers.

These unique features raise the important question: if all the day-to-day activities of a fund are delegated to the investment manager and other service providers, does this mean there is nothing left for the fund's directors to do and that the concept of corporate governance is irrelevant in the offshore fund world? In the authors' opinion that is certainly not the case, and any fund or director who feels it is, is walking a very dangerous path.

For the time being there are no legally binding codes of conduct that dictate how boards should function, but a number of voluntary codes have been implemented, such as those adopted by the Cayman Islands Directors Association (CIDA) and the Irish and Luxembourg Codes. Although membership in CIDA is voluntary, and not all individuals who are currently serving as directors on Cayman Islands funds are members, those that are must comply with CIDA's code of professional conduct, which is based on the Code of Professional Conduct adopted by the UK Institute of Directors in August of 2008. The Irish Code operates on a 'comply or explain' basis whereby departure from the code must be disclosed in the director's report or published through a publicly available medium detailed in the annual report. In essence, the Irish Code codifies a number of existing Irish requirements while introducing new requirements in respect of the composition and role of the board as well as addressing the role of the chairman, independent directors and board committees. The Luxembourg Code is less prescriptive in this regard and notes that it is good practice to note adherence to the code in the annual statements.

The recent EU Green Paper entitled 'The EU corporate governance framework' shows a similar trend. While the focus is primarily on listed entities, the paper does also consider applying similar requirements to unlisted entities. In addition, the Green Paper examines requirements in respect of board diversity, directors' remuneration and risk management. While this is unlikely to have any immediate impact on the fund industry, it is interesting to see that a significant proportion of the Green Paper is focused on asset managers and implementing systems that prevent short-termism, improve transparency and prevent conflicts of interest. The Green Paper is currently subject to consultation and we understand that a number of submissions have been made requesting that the fund industry be excluded from its ambit.

Aside from these evolving corporate governance codes some interesting case law has recently emerged in this area. While the case discussed below focuses on governance of hedge funds in the Cayman Islands, its applicability to investment funds in other common law jurisdictions is a matter of hot debate.

Recent developments in directors' duties

On 26 August 2011 the Financial Services Division of the Grand Court in the Cayman Islands delivered a highly influential judgment on the subject of directors' duties in the context of offshore hedge funds. In the Weaving Macro Fixed Income Fund Limited (in liquidation) judgment, the Grand Court found the fund's two former directors guilty of wilful default in the discharge of their duties, and ordered them to pay damages to the fund's liquidators in the sum of US\$111 million. These damages represented the losses suffered by the fund that were caused by the directors' default.

Some of the most important features are that a typical fund has no employees, no executive directors³ and no premises.

³ By executive directors the author is referring to full-time working directors engaged under an employment contract. The terms of appointment of a fund director will invariably stipulate that the role is a part-time one, and their remuneration will also reflect this situation



This was an extreme case and it is important when reviewing the background to note that the directors in question were not Cayman resident nor members of the CIDA. The fund's investment manager, Weaving Capital (UK) Limited, controlled by Magnus Peterson, appointed Mr. Peterson's younger brother and elderly stepfather to serve as directors of the fund. In its ruling the Grand Court found that their appointment was made with the intention of demonstrating compliance with minimum legal requirements, rather than to form a real board of directors providing any kind of corporate governance and oversight. For six years, they did nothing to discharge their duties as directors beyond signing multiple documents at the investment manager's request.

The Grand Court also found that this facade of corporate governance enabled the investment manager to fraudulently inflate the fund's NAV by booking fictitious interest rate swap transactions to disguise substantial losses that the fund had suffered. The counterparty to the interest rate swap agreements was a shell company incorporated in the BVI, of which the Weaving directors were also directors. By the time this scheme was uncovered and the fund placed into liquidation, over \$141 million had been incorrectly paid out to investors in redemptions based on NAVs that were artificially inflated.

In these specific circumstances, the Grand Court found the directors guilty of wilful default. This ruling prevented the directors from accessing the standard indemnities provided by the fund, which would otherwise have negated the liquidators' claim against them.

Directors' duties clarified

The Weaving judgment could have far-reaching implications for the fund industry as the judge made a number of broad statements of principle about the duties of fund directors. In particular, a number of principles more commonly applied to non-executive directors in a conventional company structure were adapted to the unique structure of a hedge fund. Although it is based on a Cayman Islands judgment, these statements will likely be persuasive in other common law jurisdictions.

The key statements from the judgment were as follows:

- At the fund formation stage, directors must satisfy themselves that the offering document complies with local law, that the terms of the service providers' contracts are reasonable and consistent with industry standards, and that the overall structure of the fund will ensure a proper division of responsibility among service providers. Directors must act in the best interests of the fund which, in this context, means its future investors
- The investment fund industry operates on the basis that the investment management, administration and accounting functions will be delegated to professional service providers and a fund's independent non-executive directors will exercise a 'high level supervisory role'. While independent directors rarely have the technical expertise and experience to be able to monitor sophisticated investment strategies and trading techniques in a direct, hands-on manner, they are expected to satisfy themselves (on an ongoing basis) that the fund is complying with investment restrictions set out in the offering documents

- It is the directors' duty to satisfy themselves that there is an appropriate division of function and responsibility between the investment manager and administrator
- Independent directors must do more than simply react to whatever problems may be brought to their attention by other professional service providers. They must continually apply their minds and exercise independent judgment in respect of all matters falling within the scope of their supervisory responsibilities. Directors must not simply 'rubber stamp' minutes or resolutions, or any other documents, prepared by counsel or the investment manager
- Reviews of financial accounts must be conducted in an inquisitorial manner, meaning that the directors must make appropriate enquiries of the administrator and auditor. Independent directors are expected to be able to read financial statements and have a basic understanding of the audit process
- Fund directors should meet regularly to hold meaningful discussions of the activities of the relevant fund, an agenda of the items to be discussed should be circulated prior to each board meeting and the directors should record proper minutes of these discussions

Accordingly this judgment is likely to impose a greater obligation on directors to take a more active role, particularly during a fund's start-up phase, than many directors may have previously understood. For instance, going forward, directors may wish to seek additional documentary representations from investment managers, administrators and other service providers as to the verification process that has been undertaken on the offering documents.

Directors' reliance on indemnities

Where directors have the benefit of an indemnity for loss-causing conduct other than that constituting "*wilful neglect or default*", it is well-established that liability can only exist where they know that they are committing, and intend to commit, a breach of duty, or are recklessly careless in the sense of not caring whether their act or omission is a breach of duty.

In the *Weaving* case, the Grand Court determined that directors who effectively do nothing, while knowing they have a duty to supervise, will be found to have intentionally neglected their duties and consequently found to be liable. Although the judgment did not directly address dishonesty, the judge did indicate that signing fictitious minutes of meetings that never took place meant that the directors knew perfectly well that their behaviour was wrong.

Issues arising from the *Weaving* judgment

The Grand Court had little difficulty in applying its statements of general principle in the *Weaving* case, because the directors in question "*consciously chose not to perform their duties to the fund*" while they also "*knew perfectly well that their behaviour was wrong*". In future cases, the open-ended question of what constitutes a "*high level of supervision*" will doubtless be subject to more rigorous scrutiny.

In particular, the level of interaction between directors and other key service providers merits closer attention. At one point in the *Weaving* judgment, the Grand Court indicated that the directors were entitled to rely on the fund's administrator and auditor to use reasonable skill, care and professional judgment while preparing financial statements and conducting audits of those statements. Nevertheless, it is still not entirely clear what directors can safely rely on, if it is also "*their duty to exercise an independent judgment in satisfying themselves that the financial statements do present fairly the fund's financial condition*".

The Weaving judgment also stated that administrators and auditors *"are entitled to rely upon the directors to perform their role"*. This raises a number of questions about the question of contribution and third-party claims in situations where a number of parties are involved in the preparation, issue and approval of financial statements that later turn out to be incorrect. In future cases, clearer distinctions will likely need to be drawn between supervision of the process by which other service providers perform their functions and the content of what they produce as a result.

Conclusions

The Weaving judgment represents the first, rather than the last, word on hedge fund directors' duties. The decision is currently subject to an appeal, and at the time of writing, no other courts have yet had an opportunity to comment on its findings, or apply its statements of general principle.

Recently developed voluntary corporate governance codes in certain jurisdictions aim to impose new structural and behavioural obligations on the members of the boards of funds. Whether this is the beginning of a wider trend that will be followed by other regulators remains to be seen, but we understand that a governance code along the lines of the Irish Code is currently being developed in Guernsey. The Cayman Islands Monetary Authority has also begun work on a corporate governance policy review and, at the time of writing this article, it remains to be seen what will emerge. What is certain is that the role, responsibilities and expectations of fund directors will continue to evolve and be codified. Many observers believe that these developments will cause the delicate issue of directorship numbers to resurface and there are already growing calls for details of fund directors to be made public.

There is no doubt that the role of the modern day fund director is a demanding one. It seems inevitable that there will be a continued transformation and maturity of the directorship industry in the coming years as the corporate governance practices of fund boards continue to be more closely scrutinised. However, those funds which do adapt to the changing fund governance environment will be best placed to protect and serve the interests of their investors.





Brazilian investment funds

Future opportunities, challenges and regulation

Gilberto Souza
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Brazil's stability during the global economic crisis represented an attractive and safe environment for investments in funds, which benefited the Brazilian economy.

The entity responsible for the supervision and performance regulation of Brazilian funds, together with investor protection, is the Securities and Exchange Commission (CVM). Although the crisis impacted domestic growth, Brazil's GDP reached US\$1.5 trillion in 2009. The monetary policies adopted by the Brazilian central bank (BACEN), the expansion of the middle class, which should boost domestic consumption, and the huge investment in a number of industries have fuelled positive expectations for private equity companies and funds in general.

The Open Market National Association (ANBIMA) assists the CVM in drafting and improving fund regulations, and helps industry players explore growth opportunities.

Brazil also has non-profit associations, which operate as investment promoters and provide information for stakeholders with an interest in investing in the country, such as the Brazilian Association of Private Equity and Venture Capital (ABVCAP). This association acts as a facilitator in the relationship between established members of the Brazilian investment community, and represents the majority of private equity and venture capital participants.

Brazil has many types of funds, divided into the following categories according to CVM classification

Short-term: funds with an investment portfolio comprising fixed income securities with a maximum maturity of 360 days

Long-term: funds with an investment portfolio comprising fixed income securities with a minimum maturity of 360 days

Benchmark: funds that aim to provide a return linked to a financial index with a portfolio 95%-invested in fixed income securities

Fixed income: funds with a portfolio 80%-invested in fixed income securities (pre-fixed or post-fixed)

Multimarket: funds that aim to provide a return primarily from transactions in financial derivatives

Stocks: funds with a minimum of 67% of the portfolio invested in listed stocks

Forex: funds that aim to provide a return linked to a foreign currency, with a portfolio 80%-invested in fixed income securities

External debt: funds with a minimum of 80% of the portfolio invested in securities issued by the Brazilian government that are traded on the international market



Receivables: funds with a portfolio invested entirely in securities that represent transactions carried out in the financial, commercial, industrial, real estate, leasing and services segments (these funds have their own CVM regulations)

Pension funds: funds designed to receive resources raised by PGBLs (free benefit generator plans)

Real estate: funds for investment in real estate (these funds have their own CVM regulations)

The market for investment funds in Brazil

The difficulties faced by other countries was the main reason for investors to shift their investment strategies towards the most promising markets, especially the BRIC countries of Brazil, Russia, India and China. The consolidation of this trend is providing a range of investment opportunities in Brazil, owing to the many

advantages that have made the country a safer market for investors. Education, infrastructure, services and consumer sectors are receiving particular attention from stakeholders and foreign investors. This appealing scenario should attract new investors to Brazil, making the market increasingly competitive.

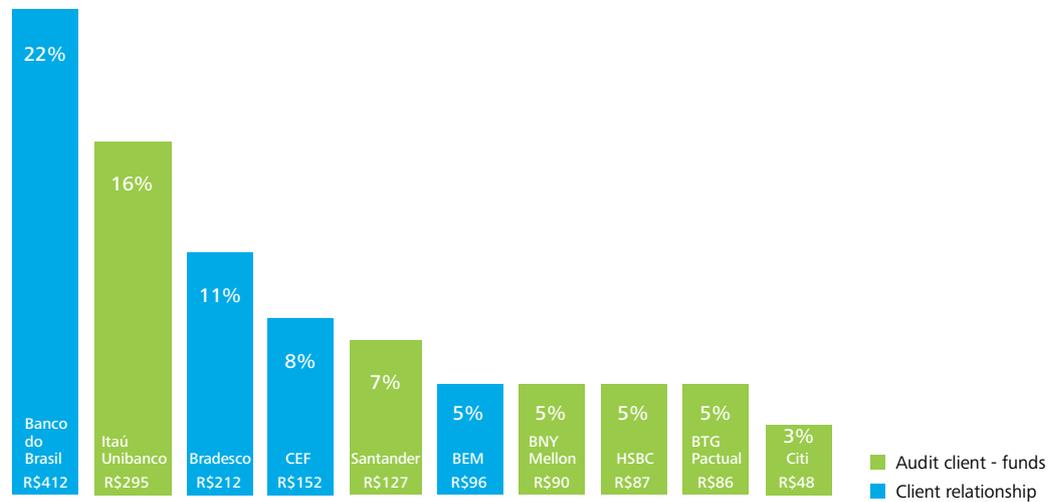
The main reason that several global private equity firms and institutional investors are investing in Brazil is that the country is set to host two major sporting events in 2014 and 2016: the FIFA World Cup and Olympic Games (in Rio de Janeiro) respectively. These two events have created a considerable demand for infrastructure projects such as the modernisation of ports, airports, roads and hotels, further attracting foreign investors. As a result, a number of new players are likely to seek entry to the market, by acquiring local asset management operations, and/or investing in product development. Research by the Emerging Markets Private Equity

Although the crisis impacted domestic growth, Brazil's GDP reached US\$1.5 trillion in 2009.

Association (EMPEA) reported inflows of US\$22.6 billion into 89 funds in the first half of 2011, compared to a total of US\$23.5 billion for the whole of 2010. If this growth rate in investment continues, it would take total inflows in 2011 to twice the amount recorded in 2010.

The largest asset managers in Brazil by assets - August 2011 (R\$ billion)

In Brazil, the 10 biggest investment funds represent 87% of the assets of the financial system with R\$1,855



Source: National Association of the Investment Banks (ANBIMA) - November 2010



Another positive factor is the significant increase in demand for financial solutions relating to investments and savings accounts, thanks to the improvement in per capita income of the middle class (which currently represents approximately 35 million people). At present, the main marketing and distribution channel for Brazilian investment funds is branch-based. The concentration of sales of asset management products through financial institutions in Brazil represents a major challenge for new players entering the market.

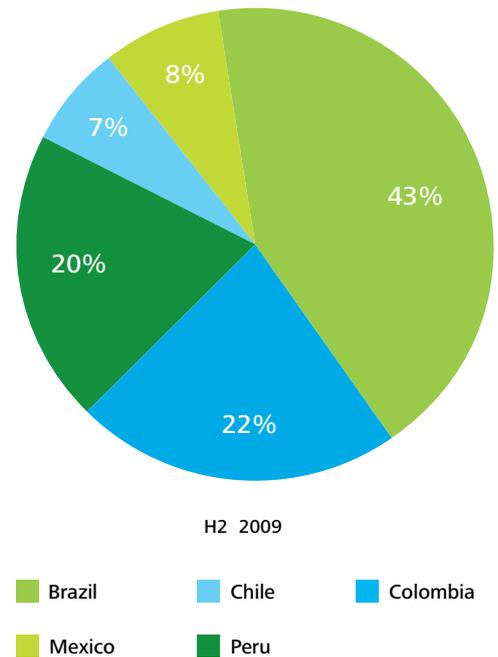
Private equity investments in Brazil

Private equity investments in Brazil amounted to US\$4.6 billion in 2010, representing 69% of total investments in Latin America.

Favourable macroeconomic aspects, successful IPOs, excellent exit options and the considerable presence of international investors indicate that the Brazilian private equity and venture capital sectors have grown significantly and are ready to take a big leap, reaching dimensions similar to those of other countries and a level approaching maturity.

According to the 'Latin American Private Equity Confidence Survey', conducted by Deloitte in January 2010, Brazil was the first country mentioned by respondents in terms of potential investment in Latin America.

Which city/region do you see as the most exciting prospect for the future and why?



The difficulties faced by other countries was the main reason for investors to shift their investment strategies towards the most promising markets, especially the BRIC countries of Brazil, Russia, India and China.

In another survey entitled 'Confidence in a Risky Scenario', conducted by Deloitte Brazil in partnership with Brazilian Investor Relations Institute (IBRI), investors and executives in charge of investor relations departments in Brazilian companies were interviewed in 2009. 15% said that there will be private equity participation in the capital market in the short term, while 38% said that this will happen in the long term, and 47% believe that this participation will be in three years.

Another major factor for the sector was the introduction of the New Market segment of the São Paulo stock market (BM&FBOVESPA), which boosted investor interest in listed companies and had a positive impact on the private equity sector. Between 2004 and September 2010, there were 122 IPOs totalling R\$344 billion, with 59 companies backed by private equity and venture capital representing R\$35 billion, almost 10% of the total.

Private equity investments in Brazil amounted to US\$4.6 billion in 2010, representing 69% of total investments in Latin America.

Brazil: land of opportunities

Several factors contribute to Brazil's economic growth. The big sport events that will take place in the country and the government's growth acceleration programme (PAC II) should boost the development of strategic sectors of the economy such as construction, tourism, energy and others over the next few years, which will represent new opportunities for the country and attract investors to Brazil. As an example, investment in the energy industry should reach R\$879 billion, with the electricity sector accounting for R\$136.6 billion. Investments should reach R\$1.09 trillion in several sectors.

Brazil's central bank estimates GDP of US\$2.5 trillion for 2011. With growth set to continue, Brazil is expected to become the world's fifth largest economy by 2025, overtaking Britain and France, with São Paulo ranking higher than Paris and Shanghai as the world's sixth wealthiest city.

Conclusion

Given these increasingly turbulent times, following in the wake of the global economic crisis — which could still worsen for Europe and possibly the United States — we conclude that all the macroeconomic indicators point to Brazil being a safe haven for long-term investments, not just in the asset management sector, but in all kinds of investment management markets, due to the rise in middle class consumption and savings and the infrastructure projects that are to be implemented over the next five years, as well as to the fundamentals of the Brazilian economy.



Wealth management trends

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Wealthy clients are now asking for high value-added services that can optimise their return on investment, along with low cost/income ratios.

Wealth management players in general — and private banks in particular — have been facing an array of new challenges since the 2008 financial crisis, and a number of factors have had a major impact on their business models.

We can summarise these as follows:

- Loss of confidence due to inappropriate selling rules and inappropriate advice on asset allocation
- Increasing cross-border tax cooperation and agreements on the exchange of information on request
- New regulatory constraints (Basel III, FATCA, etc.)
- New types of customers (old money vs. new money, impact of entrepreneurs), with new expectations to be met
- Private banking is no longer an insider industry owing to the availability of a huge amount of information on markets, trends and products on the internet, with products and services evolving as a result
- Deeper fiscal knowledge and wealth structuring skills are needed for entry into new markets
- Difficulty of retaining and developing key wealth managers



Banking revenues and fees have come under pressure as a result of these factors:

- Assets have shrunk as a consequence of the market crisis
- Return On Assets (ROA) has decreased as clients are shifting investments from complex products with high entry fees to simple and cash-based products with low fees
- Private banks can no longer rely on banking secrecy
- The financial crisis is not over

These pressures have forced private banks to look for new business models that can attract and retain wealthy clients. New business models mean new services and products dedicated to satisfying client expectations.

In order to meet their clients' needs, private banks now have to be in a position to offer comprehensive and competitive solutions that take account of the new fiscal environment and market trends.

How concretely are private banks answering those needs? Wealthy clients are requesting tailor-made solutions and services from their private banks to facilitate, for instance, tax/consolidation reporting, and are looking for innovative and easy-to-understand products such as investments in tangible assets.

Among the solutions developed by private banks, we have noticed an important development in the setup of tax matrices for asset allocation purposes.

Asset allocation now has to be tax driven. European countries and the United States are heavily in debt and money creation has been used to stimulate investment and consumption. This will lead to higher taxation rates and inflation. In this context, asset managers need to consider the tax consequences of the investments they make for private clients.

Moreover, managing withholding tax and tax liabilities on investment income, together with the possibility of reclaiming withholding tax paid are key services that have to be offered.

Nowadays, buying and selling financial products such as equities, bonds, UCIs, etc., will trigger the following tax consequences:

- Potential withholding tax in the source country
- Taxation at the investor level, where there are two issues to consider:



- Tax liability on income from securities
Asset managers can invest in securities that are invested in the same underlying asset and could deliver approximately the same return, but the tax liability on the income from different securities could vary (e.g. dividend income, interest, etc.)
- Distinction between direct and indirect holdings
Direct holdings: taxation will be at investor level, and the main areas for consideration will be the tax liability on income and the possibility of reclaiming withholding tax (if any)
Indirect holdings (i.e. through an investment vehicle such as an investment company, private investment fund, life insurance policy, etc.): the analysis has to be done at the level of the vehicle and the final investor

As described above, investment decisions can lead to multiple and complex tax consequences. In this respect, asset managers have to be in a position to design a portfolio that will (i) best meet the risk and return expectations of private clients and (ii) minimise the tax leakage that will occur at the different layers between the underlying asset and the wealthy client's wallet.

In order to manage such complexity, private banks can design tax matrices that will analyse tax leakage and take into account eligibility under double tax treaties signed between the residence country of the underlying asset and the residence country of the private investor.

Asset allocation now has to be tax driven. European countries and the United States are heavily in debt and money creation has been used to stimulate investment and consumption.



In order to meet their clients' needs, private banks now have to be in a position to offer comprehensive and competitive solutions that take account of the new fiscal environment and market trends.

The tax matrix is also a powerful tool that can be used in developing tailored financial reporting for wealthy clients which meets their expectations in these days of greater tax transparency and increasing cooperation between tax authorities.

In this context, the ability to define an asset allocation that handles tax issues at the client level is a clear advantage for private banks targeting a sophisticated clientele.

A second solution developed by private banks and asset managers is the offering of investment advice on collectible investments such as wine, paintings, cars, watches and jewellery. Art and collectible assets could constitute an alternative to traditional asset classes.

Investment in collectible assets is being driven by the 'lost decade' on the stock markets and wealth creation in emerging countries:

- Wealthy clients are looking for investments that they easily understand and are confident to discuss
- Some private banks have been accused of overselling financial products that were unsuited to their clients' needs and are seeking to regain their confidence
- The market crisis of 2008 is not yet over and continues to impact almost all asset classes
- Wealthy clients in China, Eastern Europe, India and Brazil have adopted the same lifestyle as their 'old' Europe and U.S. peers

In this context, collectible or 'passion' investments are booming and constitute a particular asset class that has to be considered by asset managers. The challenge for private banks that wish to offer such services is to ensure they have the expertise (i.e. art experts, tax specialists, art custodians, etc.) to enable them to deliver high-end advice.

The risk of the overselling of products and services in this area is clearly present, and some of the mistakes made during the previous years could be repeated.

As a consequence, private banks can develop the following services in relation to collectible asset investments:

- Financing of collectible assets
- Selection of dedicated investment funds
- Selection of specialised service providers
- Liaison with museums and foundations

The development of specific teams focusing on collectible assets for wealthy clients will surely be one of the next steps taken to address their needs.

In addition, private banks and wealth managers are developing asset pooling vehicles in order to manage wealthy clients' assets in an efficient regulatory, operational and tax environment. Such vehicles can take the form of investment funds, enabling wealthy clients to have access to premium asset management and wealth structuring solutions with a competitive fee structure compared to other regulated structures or wrapping.

Asset pooling vehicles are now competitive solutions for wealthy clients (economies of scale) and for private banks/wealth managers (ability to sell a broad range of products and services related to these vehicles).

In conclusion, private banks are facing challenges that require a significant change in their business models. New areas such as asset onshoring and passion investments are creating opportunities for private banks to reinvent themselves and attract and retain wealthy clients.

These high value-added services will produce new sources of revenue, but players seeking to benefit from these will have to invest in skilled resources in order to be able to meet current and future challenges.

Investment decisions can lead to multiple and complex tax consequences.



Swing pricing and the challenge of fair cost allocation in distressed financial markets

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Five years ago, the Association of the Luxembourg Fund Industry (ALFI) published its first set of guidelines on swing pricing. A working group studied its pros, cons, implementation requirements and overall functioning as a way of compensating funds for the dilution effect of frequent trading.

In a period that immediately followed the U.S. mutual fund scandal involving illegal late trading and market timing practices, a wide consensus emerged around the need for best practice in pricing activities and shareholder protection.

Since the publication of these guidelines, anti-dilution measures have to be designed in a new market environment characterised by growing volatility and wider trading spreads. In line with liquidity, not only have these spreads widened, they have even

contaminated markets previously known as 'frictionless', i.e. where liquidity was so high that spreads were nil. Against this background, this article analyses the development and uptake of swing pricing as a way of controlling the dilution impact of daily shareholder flows in relation to investment funds. We then turn to the practical issues associated with swing pricing, with a particular focus on the necessary trade-off between performance, shareholder protection, constraints from distribution partners and the realistic capabilities of operational units.



Our conclusion stresses the importance of weighting the multiple facets of swing pricing in order to optimise its implementation and secure its expected benefits over time. Inadequate or poorly monitored swing parameters can often lead to perverse consequences which either fail to protect shareholders or discourage distributors from selecting a fund due to high tracking error. The new financial market environment strongly challenges the adoption of swing pricing, not to mention its daily implementation. And yet, ironically, it calls for a stronger alignment between the daily liquidity offered by funds to shareholders, and the actual liquidity available in underlying securities markets.

Stating the problem

Dilution is an intrinsic feature of daily priced, open-ended investment funds. The volume and size of daily capital flows have a direct impact on the trading required in response to shareholder activity. As trading increases, a growing mismatch occurs between the value of a fund's assets, reflecting the price at which investors buy and sell the fund's shares, and the cost of securities trading as a result of shareholder money flowing in or out.

The problem clearly arose during the 2003 U.S. mutual fund scandal, which resulted from the discovery of illegal late trading and market timing practices. Although arbitrage was the key concern of the U.S. Federal Court in charge of the trial, it is the dilution impact of these practices on shareholders that ultimately justified the charges and penalties that followed the settlement.

In a nutshell, market players leveraged price discrepancies between the value at which a fund share was priced and the value of its underlying assets. This allowed arbitrageurs to subscribe at an understated NAV or redeem at an overstated NAV, thereby diluting the interests of the remaining shareholders. To complicate the issue further, certain types of investor legitimately employed short-term trading strategies without the intention of engaging in market timing (e.g. asset allocation vehicles), thus blurring the line between arbitrageurs and genuine investors. While the result of both scenarios was the same for shareholders, it already suggested a limit to the use of systematic spreads and dilution levies as a way to prevent dilution.

The 2008 financial crisis further exacerbated the impact of dilution on shareholders in two ways:

- Unstable market liquidity and higher volatility: the mortgage-related assets that led to the subprime crisis perfectly illustrate how value can suddenly become impossible to determine. In a constant attempt to anticipate adverse selection and toxicity, market makers regularly adjust their trading ranges, thereby increasing the band of price oscillation (the '2010 Flash Crash' was an extreme illustration of this phenomenon)



- Shorter investment horizon: herding behaviour and recency bias are increasingly associated with investors switching in/out of investment products based on latest news and performance. These behavioural biases, widely supported by real-time financial information and high-speed technology, significantly increase levels of capital activity in a fund

The combined effect of these events (2003 U.S. mutual fund scandal and 2008 financial crisis) gradually reinforced the impact of dilution on costs, which can be summarised as follows:

- Direct costs mainly result from trading spreads, which can be particularly relevant during times of low liquidity volumes. Other direct costs include broker commissions, clearing fees, custody fees, foreign exchange fees and tax
- Indirect costs are more difficult to quantify, and result from the opportunity cost of trading a security that would not have been traded in the absence of shareholder activity

By extending the principle of the dilution levy to the entire NAV, swing pricing avoids the complexities of applying a bid/offer price at single transaction level. Although it does not eliminate the transfer of costs/benefits between shareholders, it spreads them more equitably between categories of investors, and isolates shareholders from the future costs associated with capital activity. As a compromise between operational efficiency, commercial tolerability and effective shareholder protection, several regulators and associations have adopted swing pricing as a standard (e.g. UK and Switzerland).

While taking a firm position against late trading and market timing, Luxembourg identified swing pricing as one possible way of compensating a fund for the dilution effect of frequent trading. In a recent survey

of 18 Luxembourg-domiciled fund management companies, ALFI points out that 4 players adopted swing pricing prior to its 2006 guidance paper, while 9 adopted swing pricing after the 2006 guidance paper. This uptake is mainly attributed to Swiss and U.S. promoters, while German players remain reluctant to adopt swing pricing given the inability to apply the method to their domestic fund range.

Full or partial?

In a full swing approach, the NAV is adjusted every dealing day, regardless of the size of net capital activity. The direction of the swing is determined by the net capital activity of the day. In the partial swing, the NAV is swung only when a predetermined net capital activity threshold (i.e. the swing threshold) is exceeded.

The following table summarises the respective impact of each swing methodology, from the perspective of the fund and the investor/distributor:

	Full swing pricing	Partial swing pricing
Fund perspective	<ul style="list-style-type: none"> • A consistent approach that always benefits the fund. However, the NAV is also swung when the fund does not incur any trading costs, especially when a small cash balance is retained in the fund • Under normal circumstances, this mechanism will increase NAV volatility as the price is swung on each dealing date. Under exceptional circumstances (i.e. fund consistently experiencing net capital activity in one direction), full swing pricing would reduce NAV volatility 	<ul style="list-style-type: none"> • Introduces an element of discretion while mitigating the drag on performance caused by dilution. This approach avoids swinging the NAV if no (or negligible) costs have been incurred by the fund • Thresholds and factors must be correctly determined and regularly adapted to prevailing market conditions • Daily capital activity must be closely monitored so that swinging can be triggered
Distributor perspective	<ul style="list-style-type: none"> • Joiners or leavers (but not both) will systematically bear the anti-dilution costs, depending on the direction of the net capital activity • The systematic use of price swinging can discourage certain investors from selecting the fund 	<ul style="list-style-type: none"> • Joiners or leavers will bear the anti-dilution costs only when the threshold has been reached. This less systematic use of price swinging may be preferred to full swinging by investors • Until the threshold has been reached and the price has been swung, shareholders will bear the dilution cost

From an operational perspective, several elements may drive the decision of an asset manager. In partnership with their fund administrator, asset managers would typically consider the following areas:

- As swing pricing introduces an additional step in the process, one must carefully assess its implications for the production and publication of NAV prices to avoid adverse consequences for recipients further down the chain (e.g. late publication or incorrect content)
- The consolidation of all capital activity on any given day will not only depend on the number

of orders received. The level of automation reached in the transfer agency process will be crucial, as will the operational behaviour of a fund's main distribution partners (e.g. dealing close to cut-off time, or need for lengthy investigations on transactions)

- The accounting treatment can be performed within the NAV calculation process, or outside of the main fund accounting systems on the valuation date. While both methodologies are equally valid, they will be largely dependent on internal workflows and system limitations

The table below summarises these considerations and highlights the trade-off between operational complexity and the expected impact on dilution:

Swing pricing technique	Price adjustment mechanism	Operational complexity	Impact on dilution
No swing	0 Mid-market portfolio pricing	Low	Low High
Full swing	1 Swing factor	Low	Low High
	2 Bid/offer spread + costs incurred	Low to High	Low High
Partial swing	3 Swing factor	Low to High	Low High
	4 Bid/offer spread + costs incurred	Low to High	Low High

Dilution is an intrinsic feature of daily priced, open-ended investment funds. The volume and size of daily capital flows have a direct impact on the trading required in response to shareholder activity.

Swing parameters: where is the benchmark?

The swing threshold will typically be influenced by the following factors:

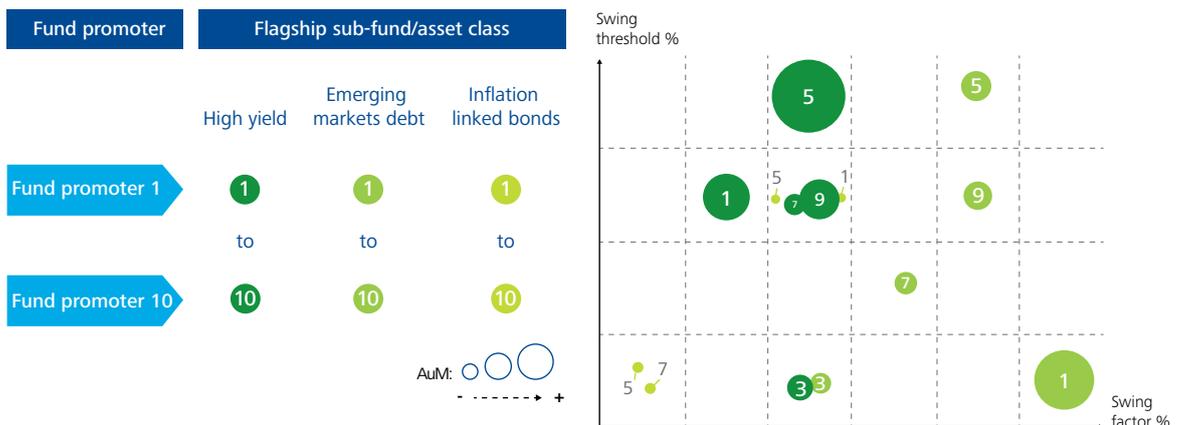
- **Fund size:** larger funds are expected to have higher threshold levels
- **Type and liquidity of the securities held by the fund:** the presence of illiquid securities is expected to bring the threshold down
- **Trading costs associated with the markets in which the fund invests:** higher brokerage and custody fees, together with high local taxes, will encourage the adoption of lower thresholds
- The extent to which a fund can retain cash (vs. always being fully invested) will usually push thresholds upwards

In practice, threshold levels should reflect the point at which net capital activity prompts the investment manager to trade a fund's security. Each fund has a unique relationship between capital activity and underlying investments. This relationship needs to be correctly understood and monitored on an ongoing basis in order to set the appropriate threshold level.

The swing factor will be influenced by the following factors:

- Bid/offer spreads: an estimate of the spread applicable to the market in which the securities are traded is usually applied. Wide spreads usually push the factor level upwards
- Net broker commissions and custody charges paid by the fund would also have an upward influence on the swing factor
- The presence of fiscal charges in any given market (e.g. UK stamp duty) would push the factor upwards

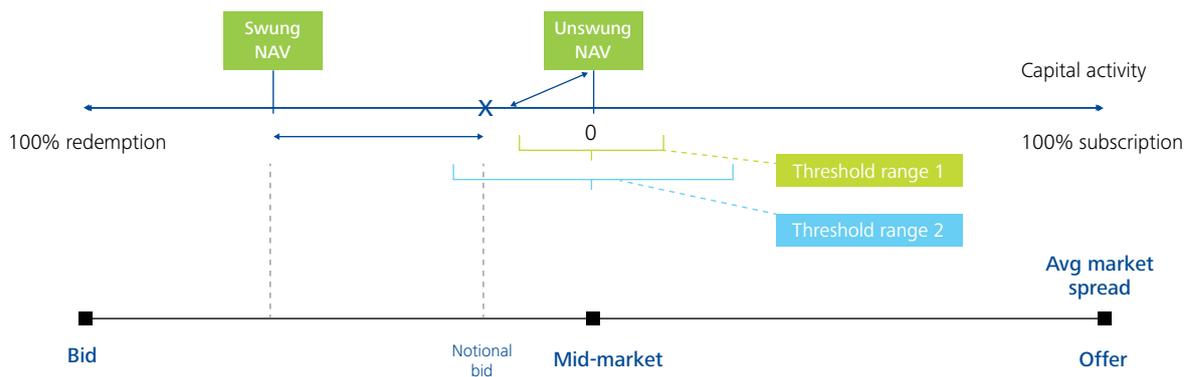
In a recent industry study, Deloitte analysed the approach adopted by a selection of players across three types of asset classes (high yield bonds, emerging market debt and inflation linked bonds). While some degree of correlation was observed between fund size, investment strategies and swing parameters, the analysis highlighted a variety of approaches adopted by market players.



The dilution affecting each fund is unique and must be carefully understood prior to defining the swing parameters. A strong monitoring process and appropriate governance structures will facilitate periodic reviews and speed up the adjustment of these parameters to the market environment.

Conclusion: if you do it, do it right!

A simple illustration will facilitate understanding of the adverse effect that can result from poorly implemented swing policies:



While the upper line shows the size and direction of shareholder activity on a given day, the bottom line shows its dilution impact for the fund, i.e. we assume a linear correspondence between shareholder activity and dilution.

In this example, 'X' indicates a negative capital flow, i.e. more redemptions vs. subscriptions. The 'notional bid' shows the resulting level of dilution experienced by the fund for this net capital activity.

Depending on the threshold level, a fund promoter may decide not to swing the NAV and tolerate the dilution. Assuming the threshold was correctly set, this level of dilution should remain negligible for the fund.

With a lower swing threshold, the same fund promoter would swing the NAV towards the notional bid price. The representation illustrates the risk of exaggerating the swing factor, and reaching an outcome far less favourable than not swinging at all. In other words, the swing factor harms the fund performance to a much higher degree than dilution itself.



This paper presents some of the key challenges associated with the adoption of swing pricing. External challenges mainly result from new financial market conditions, characterised by unstable liquidity and return volatility. Increased short-termism in investment behaviour partly results from these new circumstances, and further exacerbates their effect on shareholder dilution and swinging policies. As we have learned from the 2003 U.S. experience, a generalised use of arbitrage can significantly increase the levels of dilution experienced by shareholders.

From the perspective of fund promoters, the challenge clearly lies in managing the trade-off between shareholder protection, commercial acceptability and operational constraints. Swing policies can differ in their scope, in their implementation process, and most importantly, in their consequences. It is therefore crucial to perform a thorough impact assessment ahead of implementing any given approach.

In practice, threshold levels should reflect the point at which net capital activity prompts the investment manager to trade a fund's security.

New tax reporting requirements for foreign investment funds distributed in Italy

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In September 2011, the Italian parliament ratified a decree law introducing measures aimed at providing financial stability and boosting growth in Italy. These measures form part of Italy's anti-crisis package and included tax reform. Although the tax reform was not specifically intended to impose new Italian tax reporting requirements on investment funds, such requirements have been created because of the tax differentiation between direct investment in certain types of securities and indirect investment in the same type of securities through investment funds.

Italian tax reform on financial instruments

In order to simplify Italian taxation and increase tax revenues, the Italian government has introduced, as from 1 January 2012, a single harmonised 20% withholding tax rate on income and gains arising from financial instruments, which will replace the rates currently applicable (12.5% and 27%).



There is, however, a major exception: a rate of 12.5% will continue to apply to income arising from government bonds and similar securities including, *inter alia*:

- Italian government bonds
- Italian public debt instruments
- Government bonds issued by foreign countries that have agreed to exchange information with the Italian tax authorities
- Securities issued by international organisations incorporated in accordance with international treaties
- *Piani di risparmio a lungo termine*, which are newly-created instruments in Italy that are comparable to French *Plans d'Epargne en Actions* or UK 'Individual Savings Accounts'

The existing 12.5% tax rate was not modified by the tax reform, with a view to promoting investment in government bonds (Italian or foreign) and other Italian public debt instruments, which are popular with private investors in Italy.

Impact of this new measure on foreign investment funds

1. Impact on the performance of foreign investment funds distributed in Italy in relation to their direct investments in Italian securities

- a. The performance of an investment fund would be impacted in relation to its investments in corporate bonds issued by listed Italian companies

Until 31 December 2011, a 12.5% tax rate was apply on income arising from these bonds. As from 1 January 2012, it will be replaced by the 20% rate (the application of the new tax rate on an accrual basis has been extended to all types of bonds by Law Decree No. 216 of 29 December 2011).

A cut-off mechanism will apply to interest accrued until the end of 2011, which will be taxed at the 12.5% tax rate (this mechanism is the subject of a ministerial decree issued by the Italian finance and economy ministry, published in the Official Gazette on 16 December 2011).

The performance of a foreign investment fund would be directly impacted in relation to its investments in shares held in Italian companies. Such investments already carried a tax liability in relation to dividends, but this will increase to 20% under the reform, with the application of the single

withholding tax rate of 20%. Italian investment funds, however, will continue to receive gross dividends on shares in Italian companies.

This may be seen as an incentive to Italian private investors to invest in Italian rather than foreign investment funds, particularly for funds solely invested in the shares of Italian companies.

As a result, this situation may be considered discriminatory (despite the pre-existing difference in tax treatment), and could give rise to infringement proceedings against Italy at the European Court of Justice.

2. Impact on Italian private investors holding units in foreign investment funds (indirect investment)

As a consequence of the Italian tax reform, from 1 January 2012, distributed income, capital gains and liquidation profits due to private investors resident in Italy from Italian or foreign investment funds, either UCITS or non-UCITS, provided they are subject to regulatory supervision in the country of establishment and the country concerned is an EU or EEA country allowing an adequate exchange of information with the Italian tax authorities, will be subject to 20% taxation. This will represent an increase of the tax burden on private investors resident in Italy from 12.5% to 20%.

a. Treatment of profits accrued until 31 December 2011

The 20% taxation will apply to profits accrued until 31 December 2011 in relation to units sold after 1 January 2012. This issue has an impact on both Italian and foreign investment funds. Both Italian and foreign investment funds are impacted in the same manner in this respect.

A mechanism allowing a step-up in value as at 31 December 2011 has been created, which would operate as a deemed sale as at this date for tax purposes in order to neutralise the adverse implications of the increased tax rate.

The step-up mechanism is an option granted to Italian private investors, who could exercise it prior to a particular date in 2012, where appropriate, depending on the overall position of their portfolios.

The application of the step-up mechanism is subject to a decree issued by the Italian finance and economy ministry, published in the Official Gazette on 16 December 2011.

b. New tax reporting requirements for foreign investment funds distributed in Italy from 1 January 2012

Income arising from foreign investment funds that invest in government bonds and similar securities will be subject to 12.5% taxation on the portion of the income deemed to pertain to the investment in government bonds and assimilated securities.

The determination of that portion is based on an asset test that would need to be calculated by Italian and foreign investment funds.

Fund administrators and fund distributors will therefore have to consider implementing tax reporting for Italian tax purposes as from 1 January 2012.

A decree to this effect has been issued by the Italian finance and economy ministry and has been published in the Official Gazette on 16 December 2011.

Comments on the Italian asset test to be applied for the purpose of Italian tax reporting

The measures from the Italian finance and economy ministry were long-awaited and the country's investment management industry has been actively proposing implementation solutions to the Minister. Overall, it seems that the proposals of the Italian asset management industry have been accepted, including, in particular, the use of an asset test for the purpose of Italian tax reporting.

Based on the decree as interpreted by the Italian asset management industry, the main features of the asset test would be as follows:

- It would be calculated on the basis of the average percentage of government bonds directly or indirectly (through funds of funds) held by an investment fund compared to the total of its assets as per its balance sheet

- It would be calculated every six months on the basis of the arithmetic average of the last two sets of annual and semi-annual financial statements and applicable as from the first day of the following six-month period preceding that in which the income was received
- It is envisaged that information on the asset test would be made available in investment fund prospectuses, published on the website of the fund or its management company and sent to the information providers, and/or that ad-hoc information would be provided by the investment fund on request



Comments on the asset test

1. The Italian tax reform implementation measures have been published only a couple of weeks before their entry into force (1 January 2012). This has created some concerns both in Italy and in other countries with a significant investment fund industry, such as Luxembourg.

Although no official guidelines were published until late December 2011, foreign investment funds with units distributed in Italy have already received requests from their Italian correspondents in order to provide tax reporting figures for early December 2011.

2. The asset test would be calculated every six months on the basis of the simple arithmetic average of the last two sets of available financial statements, and would be applicable as from the first day of the following six-month period preceding that in which the income was received.

Currently no specific anti-abuse measures have been issued or seem to be envisaged. Indeed, the longer the period for the purpose of the calculation of the required percentages, the greater the possibility of taking undue advantage of the reduced 12.5% rate.

3. Although derivatives are very commonly used by investment funds, no particular rules seem to be covered by the decree at present in respect of the use of derivatives. It does not take into consideration the complexity of investment policies and investment management practices carried out by investment funds (e.g. the situation of exchange-traded funds is not considered).

Conclusion

As from 1 January 2012, tax reporting will be required of foreign investment funds seeking to distribute their units in the Italian retail market.

The ministerial decree has outlined the principles for the application of the legal framework.

Market practice will, however, be key to the new Italian tax reporting regime.



New tax rules put pressure on offshore jurisdictions

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Tax developments in the United States and other jurisdictions where funds invest have the potential to dramatically alter fund structuring and investment decision processes.

As the global economic malaise continues, countries are scrambling to increase tax revenue by taxing more inbound investments and cracking down on the loss of tax dollars from abusive transactions. This raises the stakes for hedge fund investors and managers who may be exposed to increasing tax risk in an environment where jurisdictions are also imposing new reporting regimes with significant penalties for compliance failures.

Other jurisdictions are choosing to improve their economic situation by competing for business, passing laws that make it more attractive to be the domicile of choice for offshore funds, which changes the landscape by offering planning opportunities for funds to minimise tax costs. All of these tax changes are taking place as major jurisdictions are refining their regulatory regimes to gain greater insight into fund activities.

Hedge fund investors need to be familiar with these developments and make appropriate inquiries of fund managers as to how tax exposure is being managed. At the same time, since taxes are a drag on performance, and reduce performance and management fees (the latter simply because taxes withheld or paid by the fund reduce assets under management), hedge fund managers should be looking at ways of minimising tax exposure through a variety of means, including use of the most favourable jurisdiction(s).

This article will focus on the more significant tax developments and point to the issues investment managers need to focus on to keep tax costs low. In particular, we will address the influence of 'FIN 48' on funds and the treaty networks on investment decisions. This article will also consider how these developments may impact fund structures going forward.



FIN 48

The implementation of ASC 740 (known as 'FIN 48') by hedge funds in 2009 caused significant consternation for many hedge fund managers who had not previously acknowledged local country capital gains taxes. The frustration arose primarily because most fund managers believed that while there may be taxes on the books in various countries, no fund was ever likely to pay such taxes.

Jurisdictions that pose particular concern for auditors, and as a result, for fund managers include Spain, Portugal, Australia and China, to name a few. Each of these jurisdictions impose some sort of capital gains tax on non-residents trading in securities in the local country, even if such trading is through a non-resident broker and so the connection to the taxing state is far removed from the beneficial ownership. Even more commonly, these

and other jurisdictions also have rules that impose tax on transactions in securities deemed to be 'land rich', i.e. where the primary value of the security is derived from real estate assets, or in the case of debt instruments, where the collateral for such debt is a real estate asset. Land rich companies generally include traditional real estate firms but may also include mining companies and other natural resource producers. Developed nations such as the United States, the United Kingdom and Germany also impose taxes on these transactions. Funds making investments that may be more appropriately characterised as private equity type investments may also find themselves facing local country capital gains taxes, as the process of managing a company and exiting through a public offering or strategic sale may give rise to a permanent establishment under local country rules, thus creating nexus for the imposition of tax.

Compliance with FIN 48 has been further complicated by a patchwork of local country tax rules, and a tremendous amount of uncertainty about how specific rules are to be applied. Some countries impose a capital gains tax on gross profits, while others allow the netting of gains and losses from trading in a specific product, and others again allow netting across products. Some countries may allow expenses to be claimed against gains, thus lowering the tax bite. In certain cases, the relevant question has been whether the local rules view the fund or the broker as the beneficial owner. In many cases, the rules are simply unclear in their application, adding to fund managers' frustration.

As countries across the globe continue to struggle with poor economic conditions, some have chosen to implement new, or enhance existing, capital gains taxes. Countries choosing this route include Greece, Iceland, Peru and Pakistan. Brazil has introduced a new levy on the proceeds from certain transactions with the stated goal of raising revenue to pay for infrastructure needed to host the 2016 World Cup. Furthermore, as a result of inquiries made by attorneys, accountants and even fund managers themselves, various jurisdictions have responded to the 'sleeping issue' of capital gains withholding taxes. While nothing formal has been announced, we understand that Spain, which has neglected capital gains tax in the past, has begun to develop more specific tax compliance rules and even tax forums, with a view to collecting the previously-ignored tax. At the other end of the spectrum, responding to industry pressure after FIN 48 was first promulgated, the Australian tax authorities recently announced they had no intention of pursuing the capital gains tax, which has been part of their tax code since 1974, on offshore funds trading in Australian listed securities through a non-resident broker. Indeed, the Australians have committed to modernising the tax law in this area, recognising the negative impact on their capital markets this FIN 48 uncertainty has had.

In applying FIN 48, considerations should be given to how the local country tax rules apply to a transaction or payment. If the jurisdiction in which the transaction or payment occurs imposes the tax on the entity, then FIN 48 may require accrual of an uncertain tax. If, however, the jurisdiction imposes the tax on the beneficial owner of the fund, FIN 48 generally does not require accrual.

With FIN 48 as part of the permanent landscape, we expect fund managers to pay more attention to local country tax exposure and find ways to minimise the issue for investors. This can often be done through the use of derivatives, structural changes, or a combination of both. Fund managers would also be well-served to consider the correlative impact of fund performance drag resulting from taxes on performance fees. Best practice in this area may be that fund managers reduce their performance fees for taxes that represent a true economic cost to investors, but in cases where an investor is able to obtain a tax credit or reclaim and is thus not impacted by the local country tax, performance fee should be grossed up for these taxes so that the manager is not unduly disadvantaged. Finally, we are happy to report that hedge fund managers have begun to hire tax directors in unprecedented numbers since the implementation of FIN 48, recognising the value that in-house tax talent can bring to a global investment manager.

Jurisdictions that pose particular concern for auditors, and as a result, for fund managers include Spain, Portugal, Australia and China, to name a few.

Withholding tax and swaps

As part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, offshore funds will be subject to a 30% withholding tax on certain dividend equivalent payments. Under the statute, the tax only applies to dividend equivalents paid under a repurchase agreement, or under a Notional Principal Contract (NPC). An NPC is essentially a swap under which payments are made by one or both parties to the contract at regular intervals of one year or less. Because NPCs are defined in this way, not all swaps are NPCs. Congress has authorised the Treasury to expand the scope of this new rule to include other types of derivative contracts, which may include 'bullet swaps' and put/call combinations. We understand that the Treasury is actively considering taking action.

Fund managers will need to analyse their swap agreements to determine which of these are subject to the withholding tax. In the new rules, there are very narrow definitions of what constitutes a dividend equivalent payment. Only payments that fit the scope of this definition are then characterised as U.S. source income subject to the withholding tax.¹

A description of the targeted transactions:

Dividend payments are generally based on the residence of the payer, so dividends paid by U.S. companies to offshore funds structured as corporations for tax purposes are subject to the statutory 30% withholding tax. In contrast, payments made on swap contracts including NPCs are generally based on the residence of the taxpayer/recipient, which means an offshore fund entering into a swap contract deriving value from a U.S. corporate dividend payment was not subject to the statutory 30% withholding tax.² These sourcing rules have presented the opportunity for offshore funds to favour swap contracts to obtain economic exposure to a U.S. company (or basket of companies) and avoid withholding tax. Between 14 September 2010 and 13 March 2012, the new HIRE Act provisions only target payments as part of a swap contract where there is



ownership of the underlying security before or after a dividend payment so economic exposure is diminished. After 13 March 2012 all substitute payments made in relation to equity NPCs will be subject to the tax. While various types of investment transactions will attract withholding tax under the new rules, a description of certain targeted transactions is provided below.

In one of the most common forms of this type of transaction, a few days before a stock is scheduled to declare a dividend, an offshore hedge fund holding the stock sells it to a financial institution and simultaneously enters into a swap agreement with the financial institution, thus temporarily replacing its stock holdings with a swap agreement tied to the economic performance of the same stock. After the dividend is paid, the offshore hedge fund receives from the financial

¹ 871 (8m)

² 1,863-7 (b) 1

institution, under the swap agreement, a 'dividend equivalent' payment of the full dividend amount less a fee. The fee, charged by the financial institution, usually relates to the tax savings, and is generally between 3% and 8% of the dividend amount. The end result is that the offshore hedge fund receives 92%-97% of the dividend amount instead of the 70% that it would have received if the 30% in taxes had been withheld on an actual dividend. A few days after the dividend date, the offshore hedge fund terminates the swap agreement and repurchases the stock, leaving the offshore hedge fund in the same financial position as before the swap transaction was undertaken.

Another method for avoiding payment of U.S. dividend taxes uses stock lending transactions. In a typical transaction, a U.S. financial institution uses an offshore corporation it owns and controls to borrow U.S. stock from an offshore hedge fund. The offshore corporation borrows the stock a few days before a dividend is issued, sells the stock, and simultaneously enters into a swap agreement with its affiliated financial institution. After receiving a tax-free 'dividend equivalent' payment under the swap agreement, the offshore corporation passes

the payment (now called a 'substitute dividend') back to the offshore hedge fund from which it had borrowed the stock. Relying on an interpretation of an unclear IRS notice on substitute dividends, the parties then claim that no withholding of the substitute dividend payment is required and the payment can be made tax-free. A few days after the dividend payment, the offshore corporation returns the borrowed stock to the offshore hedge fund which then regains the same status as before the stock loan took place.³

The IRS has been pursuing financial institutions and offshore hedge funds that have engaged in these specific transactions for several years, using rules in existence prior to the HIRE Act, which focus on the fact that these transactions may lack a business purpose other than tax evasion. We understand that a number of taxpayers have written large cheques to the IRS to settle the issue. It should also be noted that other jurisdictions are considering whether derivatives are being used to evade their tax regimes, but are much further behind in this regard. Therefore, derivatives may be an appropriate way to minimise non-US taxes for years to come.



Deloitte perspective

The intention of the Congressional tax writers was to maintain the tax base on dividends paid from U.S. corporations. With this in mind, fund managers need to examine transactions and be in agreement with withholding agents (brokers) about which payments are subject to the rules, since the withholding tax is often not creditable to the beneficial owners of the fund. Managers may wish to use derivatives other than NPCs to minimise the withholding tax bite, but should only do so with full recognition that the IRS intends to expand the rules at some point to cover derivatives other than NPCs.

Tax havens and treaty access

As a way to be competitive in a global economy and encourage cross-border trade, most developed nations have entered into 'double tax treaties' whereby various types of income may only be taxed in one of the two jurisdictions. Treaty provisions override local country law. For example, the U.S. imposes a statutory withholding tax of 30% on dividends and interest from U.S. sources, which effectively means from U.S. payers. In many cases, interest payments end up qualifying for one of several exceptions to the 30% tax, leaving dividends as the primary issue to contend with. The U.S. has entered into many treaties that reduce the rate of tax on U.S. source dividends. While each treaty has subtle differences, most U.S. treaties in force operate identically. To qualify for treaty benefits, the income recipient generally must be deemed resident in the other treaty country. Residency is defined in each treaty. Many U.S. treaties also contain a Limitation On Benefits (LOB) provision which goes beyond the residency test, and requires a 'look-through' to the beneficial owner of a payment. These LOB provisions are designed to prevent the establishment of an entity that meets the residency test of a particular treaty, when in fact this entity is beneficially owned by a

person or persons in a third, non-treaty country.

Fundamental to the concept of a double tax treaty is that both countries, under local law, have a right to tax some or all of the income in question. As a result, the most common offshore jurisdictions favoured by fund managers cannot enter into double tax treaties because they do not tax income. Thus, for example, U.S. sourced dividends paid to a Cayman, Bermuda or British Virgin Islands fund that is treated as a corporation for U.S. tax purposes are subject to the 30% withholding rate. The same can be said for dividends paid to a Jersey or Guernsey company.

Ireland and Luxembourg are two jurisdictions that have become attractive places to domicile an offshore fund for business reasons, including what are generally considered favourable regulatory regimes (i.e. not too tough or punitive, rather 'just right'). Both countries also have double tax treaties with dozens of developed nations, including the U.S. Technically, both countries also impose an entity level tax on certain types of investment entities, which can generally be managed to a very low amount. These entities therefore generally qualify under treaty provisions, and are therefore considered to have 'treaty access'. Because of this treaty access, both Irish and Luxembourg-based entities have been used for years to establish special purpose vehicles (SPVs) by both private equity and hedge funds to make country-specific investments. More recently, because of regulatory developments and changes in the business environment, as well as a recognition of the potential tax benefits arising from treaty access since FIN 48 was implemented, fund managers are considering using an entity in one of these countries as the fund itself rather than an entity in a tax haven coupled with an Irish or Luxembourg-based SPV.

These European jurisdictions are competing hard with the Caribbean countries and other tax havens for fund business because there is a direct correlation between fund domiciles and job opportunities for service providers to those funds. For example, in December 2009, Ireland passed a law which significantly reduced the effort required to redomicile an existing fund from another jurisdiction to Ireland. What used to be a very complex, multi-step process can now be accomplished by the filing of one form, which is typically approved by the Irish government in 24 hours.

Tax Information Exchange Agreement

As outlined above, the real and perceived advantages afforded in double taxation treaties are not available to all countries, particularly certain offshore fund domiciles such as Bermuda, BVI and the Cayman Islands. As an alternative, these, and other countries, may choose to enter into a Tax Information Exchange Agreement (TIEA).

The main purpose of a TIEA is to promote cooperation in tax matters through the exchange of information in order to administer and enforce tax laws. As with double taxation treaties, the agreements are usually based on a model created by the Organisation for Economic

Cooperation and Development (OECD). The model used for TIEAs was drafted in response to the OECD's initiative to combat harmful tax practices and ultimately created the framework for a legal instrument that could be used to establish the effective exchange of tax information. In a similar way to double taxation treaties, TIEAs between two countries may vary slightly, although most agreements will follow the general framework of the OECD model agreement. Fundamentally, it should be understood that a TIEA does not reduce or eliminate local country withholding taxes.

At its very basic level, a TIEA will generally be guided by the mandate of exchanging any *"information that is relevant to the determination, assessment, verification, enforcement, recovery or collection of tax claims with respect to persons subject to such taxes, or the investigation or prosecution of tax matters in relation to such persons"*. One party to a TIEA is obliged to provide, upon request by the other party, information held by banks and other financial institutions, and information held by any person including nominees and trustees. The requesting party is also allowed to request information regarding the legal and beneficial ownership of companies, partnerships, trusts and other persons.

Of course, the TIEA will usually state that *"all information provided and received by the competent authorities of the contracting parties shall be kept confidential and shall be disclosed only to persons or authorities officially concerned with the purposes of the agreement"*.

How does the OECD classify jurisdictions and what do those classifications mean?

The OECD has three categories that are used to classify jurisdictions based on their commitment to international tax standards, which include cooperation and transparency in the area of information exchange.



The categories are commonly referred to as the white, grey and black list:

- The **white list** will highlight jurisdictions that have substantially implemented the internationally agreed-upon standards. In order to be placed on the white list, a jurisdiction must have a minimum of 12 bilateral agreements to exchange tax information with foreign governments
- The **grey list** is for jurisdictions that have committed to the standards, but have not yet substantially implemented them
- The **black list** includes jurisdictions that have not committed to the internationally agreed tax standard. Bermuda, The Cayman Islands and the British Virgin Islands are white-listed countries

What offshore jurisdictions should be considering

As noted above, Ireland and Luxembourg are competing with the traditional tax havens for offshore fund business. Their regulatory regimes and treaty access are strategic advantages, and their proximity to London makes them attractive to some from an operational perspective. The treaty networks Ireland and Luxembourg have provide a real competitive advantage. These two countries also have entities that are traditionally respected as partnerships for legal and tax purposes. By contrast, the typical tax haven country has a very light regulatory regime and no treaty access. Furthermore, most tax havens do not have the legal concept of a partnership that is treated as distinct from its owners.

In order to level the playing field and reinvigorate their status as significant offshore financial centres, it is critical that these tax haven countries continue to demonstrate their commitment to an effective and transparent regulatory environment, which may include regular inspections of funds. These countries should continue to enter into TIEAs, but should also embrace more fully the legal concepts of a partnership. Furthermore, they should

consider implementing a mechanism by which existing company funds can easily convert their legal status to become partnerships. In taking these last two steps, the tax haven countries will help minimise the actual tax cost borne by investors, as well as the 'perceived' tax cost of FIN 48, by providing them with better treaty access and tax minimisation on a look-through basis.

Managers investing outside the United States should consider the following questions:

1. Have I assessed what FATCA means for my funds and developed an action plan to achieve compliance?
2. Am I properly managing the tax cost and tax risk in my funds?
3. Can I use a partnership for my master fund and/or offshore fund to get better treaty access for my investors?
4. Are any of the taxes my fund pays reclaimable?
5. Is my performance fee calculated net or gross of taxes for which my investors can claim a credit?
6. Should I be thinking about Ireland or Luxembourg to further minimise the tax cost?
7. Would the use of derivatives be appropriate to avoid local country withholding taxes?

The old saying in our business is "*the tax tail should never wag the trading dog*". What this means is that while decisions on investments or structures should never be made on the basis of taxes alone, prudent fund managers can do better for their investors and themselves by properly managing tax costs.

Financial transaction tax

Something in the air

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With the recent regulatory reform targeting the financial sector, asset management practitioners have had the opportunity to familiarise themselves with a few new abbreviations that are likely to have a significant impact on operating models (FATCA, UCITS IV, AIFMD, RDR)¹. As of 28 September 2011 we can add FTT to the list: asset management practitioners will need to take note, as a financial transaction tax would impact profitability, operations and the financial centres map.

¹ On this topic, see Performance issue 6, September 2011, 'The impacts of regulatory changes on asset management operating models'



Readers may have already noticed in screening the news every day that there is 'something in the air', and unfortunately for the tech-lover, 'FTT' is not a new teaser campaign from Apple® promising new revolutionary hardware. Instead, it is a proposal issued by the European Commission for a Financial Transaction Tax (FTT) in the 27 member states of the European Union (EU) to ensure that the financial sector makes a fair contribution to public finances, for the benefit of citizens, enterprises and member states².

With the world slowly recovering from the 2008 financial crisis and concerns about rising government debt levels increasing across the globe, a heady idea drifts through the air that the financial sector largely contributed to the economic crisis while laying the cost at the door of present and future taxpayers.

The initiative of an FTT can be viewed as a budgetary measure within a broader regulatory reform package aimed at reforming the financial sector and preventing risks of future systemic failure³. The primary objective of the proposed FTT is to raise revenues from financial transactions in an effort to what could be considered a 're-privatisation'⁴ of the costs of the economic crisis and an effort to build new revenue sources to cover the costs of future crises.

The European Commission estimated that as a consequence of rescue packages for the financial sector (e.g. capital injections, loans, guarantees) the EU-average public deficit increased from 0.9% of GDP in 2007 to 6.4% in 2010, and public debt is likely to exceed 80% in the coming years (EU Commission, 2011 Spring Economic Forecast).

On that basis, the EU Commission revived the idea of a new tax on the financial sector as a tool to ensure a substantial and fair contribution to public finances and limit undesirable behaviours and distortions. The idea is not new but somewhat countercyclical; it accompanies every financial crisis⁵. What is new today is the extent of the crisis, its global reach and the unprecedented budgetary pressures faced by governments across the world.

Several countries have already implemented financial transaction taxes⁶ and one of the main challenges faced by the EU Commission is the implementation of a financial transaction tax on a sector characterised by innovation, complexity, very high degrees of mobility and the increasing move of trades from hectic trading floors to the quiet digital world (e.g. Direct Edge or BATS Exchange, examples of state-of-the-art electronic securities exchanges).

Implementation of harmonised rules is therefore crucial to the effectiveness of a financial transaction tax within the European Union. Unfortunately, as regards indirect taxation, Article 113 of the Treaty on the Functioning of the European Union (TFEU) requires the unanimity of the 27 member states that form the Council of the EU and some member states are already opposed to the EU Commission's proposal, mainly through fear of relocation and a lack of global coordination.

Looking at the policy and political context, this article reviews the EU Commission's proposal in light of its impact for the asset management industry.

² COM(2011) 594 final

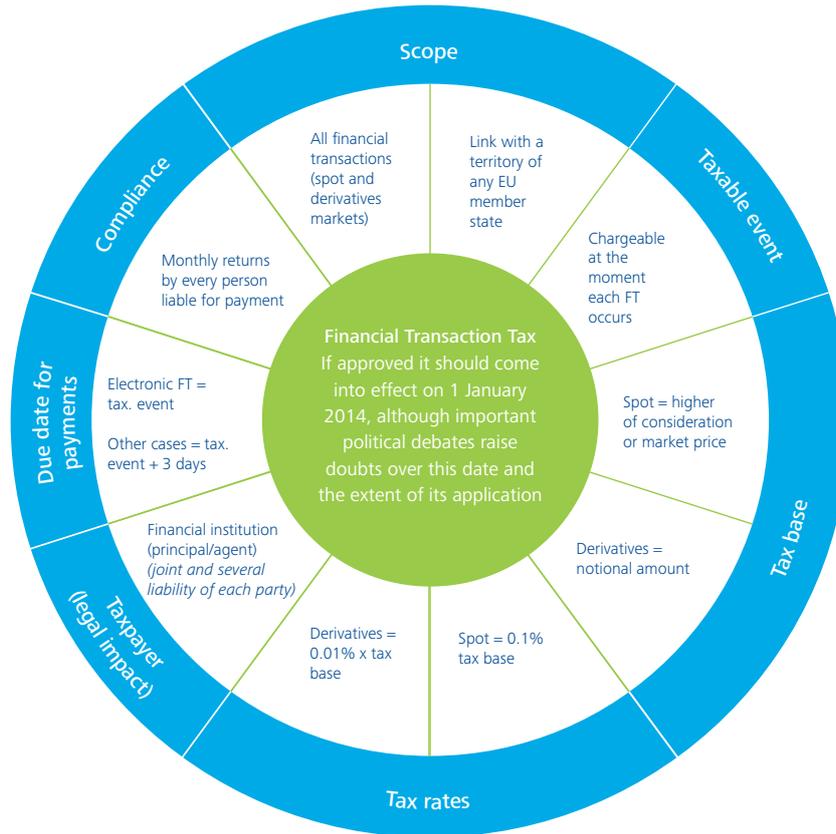
³ To support its initiative, the EU Commission points to the underlying causes of the crisis: (i) proliferation of derivatives and structured products that have masked the systemic risks associated with rapid expansion of lower quality subprime mortgages, (ii) excessive leverage and distortion in the tax treatment of debt vs. equity in most corporate income tax systems, (iii) compensation packages rewarding short-term and excessive risk taking, (iv) short-term speculation (e.g. high-frequency trading), and with reference to the VAT exemption of financial services, the opinion that (vi) the financial sector is currently under-taxed

⁴ The author kindly asks the reader to excuse this barbarism

⁵ For example, it was proposed by John Maynard Keynes in 1936 after the Great Depression in an attempt to discourage excessive speculation, further discussed in 1972 by James Tobin in terms of a tax on spot currency transactions, and re-examined by Paul Bernd Spahn at the time of the devaluation of the Mexican peso in December 1994

⁶ One of the most relevant examples is the 50bps tax levied by Sweden in the 1980s on all Swedish equity security trades and stock options using local brokerage services, and the wave of relocation that followed

The proposal



Scope

Subject matter

The FTT will apply to all financial transactions, which are defined as the trading of financial instruments (purchase and sale), the transfer of risk associated with the financial instrument and the conclusion or modification of derivatives agreements. As relocation and EU market distortions are key challenges for the EU Commission, the approach was taken of using well-established definitions from other directives relevant to the financial sector. The definition of financial instruments thus refers to Section C of Annex 1 of the Directive on Markets in Financial Instruments⁷. The scope of the FTT is thus not limited to the transfer of ownership and covers organised market trades and over-the-counter trades.

However, certain transactions are excluded from the scope of the FTT for different reasons. Transactions with the EU, ECB and national central banks for example are outside the scope of the FTT so as not to negatively impact refinancing possibilities or monetary actions in the event of a future crisis, and to avoid the EU being restricted in its capacity to establish an internal market. Other exclusions are aimed at preventing breaches of overriding principles established by the TFEU and avoiding potential conflicts with other EU directives. Thus, the proposal excludes the taxation of spot currency transactions in order to comply with Article 63 TFEU (principle of free movement of capital and payments between member states and between member states and third countries). It also excludes the taxation of primary market transactions (i.e. day-to-day

⁷ Directive 2004/39/EC (MiFID)

activities such as insurance contracts, mortgage and consumer lending, payment services, etc.), with the aim of protecting non-financial sectors (e.g. households, companies or governments with financing needs) from the burden of taxation and to avoid conflict with the Capital Duty Directive⁸ that prohibits the levying of indirect taxes on the raising of capital.

Implementation of harmonised rules is therefore crucial to the effectiveness of a financial transaction tax within the European Union.

An important exception to the non-taxation of primary market transactions that is particularly relevant to the asset management sector relates to the issue and redemption of shares and units in Undertakings for Collective Investment in Transferable Securities (UCITS⁹) and alternative investment funds (AIFs¹⁰). This exception appears to be at odds with the prohibition on levying indirect taxes on the raising of capital but the EU Commission seems to indicate that the proposal should have precedence over the provisions of the Capital Duty Directive, and is proposing to amend the latter accordingly (proposed Article 15: *"This Directive shall be without prejudice to Council Directive .../.../EU [i.e. the proposal]"*). The rationale behind the exception makes little sense as it may negatively impact the cost of capital, putting EU investment funds at a competitive disadvantage compared to non-EU investment funds.

It also gives rise to double taxation of the asset management industry as investment funds will be subject to the FTT on the issue and redemption of shares and units, as well as on financial transactions in relation to their portfolios, thereby increasing the transaction costs of EU investment funds, putting pressure on fund raising, investment volumes and rates of return, and thus on management and performance fees. Aside from the detrimental consequences for the business model of the EU asset management industry, this exception appears particularly contradictory at a time where the EU Commission is trying to both maintain the advantage of the cross-border distribution of EU UCITS and increase cross-border investment appetite for EU AIFs through the possibility of marketing AIFs via an EU passport¹¹.

Finally, it should be noted that certain intermediary entities are exempted in as much as these are not exercising trading transactions per se, but only trading facilitation functions or financial assistance functions¹².

Territorial scope

The FTT will apply to all financial transactions with a link between the economic substance of the transaction and the territory of any member state. The territorial application of the FTT requires that *"at least one party to the transaction is established in a member state and that a financial institution established in the territory of a member state is party to the transaction, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction"*. The concepts of financial institution and establishment here are particularly important to understanding the potential impact of the FTT on the asset management industry.

⁸ Directive 2008/7/EC of 12 February 2008

⁹ Article 1 (2) of Directive 2009/65/EC as amended

¹⁰ Article 4 (1) (a) of Directive 2011/61/EU (AIFMD)

¹¹ AIFM Directive 2011/61/EU

¹² These entities are: European Financial Stability Facility, Central Counterparties only where exercising CCP functions, Central Securities Depositories and International CSD only where exercising CSD or ICSD functions and any international financial institution established by at least two member states for the purpose of raising funds and providing financial assistance to members

Following the approach explained above regarding definitions, the proposal includes in the definition of 'financial institution' the regulated world (i.e. investment firm, regulated market¹³, credit institution, securitisation special purpose entity¹⁴, insurance, reinsurance and relevant special purpose vehicle¹⁵, investment funds and management companies¹⁶ and pension funds¹⁷) and the non-regulated world. For the latter, the Commission's idea is to include intra-group financial transactions and shadow-banking activities by applying the FTT to

undertakings engaged mainly in the trading of financial instruments or acquisition of holdings in undertakings, where these activities constitute a significant part of their overall activity. The EU Commission does not provide indications as to the criteria by which the term 'significant' should be measured and we can easily imagine that it would create a source of distortion between member states willing to promote one sector or another.

With respect to the concept of establishment it is proposed that the member states' taxing rights will be defined on the basis of the following rules:

Non-financial institutions	Financial institutions
<ul style="list-style-type: none"> Natural person: permanent address or usual residence Other: registered office 	<ul style="list-style-type: none"> Establishment in the member state where any of the following conditions is fulfilled (first condition in descending order having precedence if more than one condition is met): <ul style="list-style-type: none"> Authorisation by the authorities of that member state Registered office seat within that member state Permanent address or usual residence located in that member state Branch within that member state that carries out transactions It is party to a financial transaction as a principal or agent with a financial institution or a non-financial institution established in that member state

Because it suffices that only one party of the transaction is established in EU, then not only financial transactions involving EU financial institutions are concerned, but also transactions with third country financial institutions. With respect to an EU financial institution, taxation will take place in the member state in the territory in which it is established on condition that the financial institution is party to the transaction. With respect to the third country financial institution, taxation will take place in the member state in the territory in which a party to the

transaction is established on condition that the financial institution is party to the transaction. The above rules suggest the following comments. First of all, it is to be hoped that the EU Commission will provide guidance to member states on the harmonised interpretation to be given to e.g. 'permanent address'¹⁸ (e.g. the EU Commission could use the tax concepts from the OECD Model for the avoidance of double taxation), as well on the methods acceptable for proving and updating permanent address information.

¹³ As defined under Article 4 of Directive 2004/39/EC (MiFiD)

¹⁴ As defined under Article 4 of Directive 2006/48/EC (taking up and pursuit of the business credit institutions)

¹⁵ As defined under Article 13 of Directive 2009/138/EC (taking up and pursuit of the business of Insurance and Reinsurance)

¹⁶ As defined under Article 4 of Directive 2011/61/EU (AIFMD) and Articles 1 and 2 of Directive 2009/65/EC as amended (UCITS)

¹⁷ As defined under Article 6(a) of Directive 2003/41/EC

¹⁸ Same comment for 'usual residence', 'branch' or 'registered seat'



The failure to do so would create deficiencies in rules for identifying EU parties along the lines of those encountered when implementing the EU Savings Directive¹⁹, and would be a source of tax uncertainties and possible distortions within the EU. Second, with some similarities to what is currently being done for the purpose of complying with the U.S. Foreign Account Tax Compliance Act, asset managers will have to undertake an internal review of their client base, distribution chain, operations and technology so as to identify EU clients and intermediaries, consider the type of information they will have to collect to establish or reject a link between the financial transaction and the EU, assess the opportunity of changing the distribution chain, and determine internal procedures and costs for complying with the FTT (e.g. technology infrastructure, compliance management). Results of the internal review are likely to raise the question of the opportunity of selling EU investment funds products or of marketing to EU investors.

Taxable events

The FTT will become chargeable for each financial transaction at the moment it occurs (cancellation or rectification have no effect, except for cases of error). The time of occurrence will need to be defined, especially for asset managers active in financial markets, as it could refer either to the trade date (transfer of ownership) or settlement date (payment and delivery). An impact assessment analysis shows that adopting a settlement date approach only may provide for tax deferral incentives and substantial cash flow advantages, and thus suggests that the transfer of ownership should be the taxable event for the sale and purchase of financial instruments, and that the moment when the contract is agreed should be the taxable event for derivatives. Given the diversity of financial instruments, derivatives and markets, for a given transaction asset managers may have to refer to the market practice of the principal market for the relevant financial instrument or derivative in order to determine the taxable event. It will thus be necessary for business, technology and compliance functions to work closely together in order to ensure proper tracking of taxable events, as these will represent the starting point of the due date for payments and reporting of the FTT.

Taxable base

In the case of financial transactions other than derivatives, the tax base is the higher of the consideration due or the market price (i.e. arm's length price). The FTT will thus apply to gross transaction values for spot transactions. Taxation of gross values is expected to have detrimental effects for asset managers engaged in high frequency trading which may result in a significant reduction of the volume of narrow-margin short-term transactions. If the FTT is not widely adopted by the world's major financial centres, it would likely result in a wave of relocation²⁰.

¹⁹ Directive 2003/48/EC dated 3 June 2003 on taxation of savings income in the form of interest payments

²⁰ The impact assessment estimates that trading based on algorithmic-generated orders may count for up to 40% of total transactions

As the FTT is not based on the domestic issuance principle (contrary to UK stamp duty for example), it would be relatively easy (cost considerations aside) for an industry relying on automated-orders and electronic communication systems to relocate trading platforms and trade, say French bonds, without suffering FTT.

Concerning derivatives, the approach was taken to tax the value of the underlying instrument or asset of the derivatives agreement (i.e. notional amount). A hedge fund established in Ireland acquiring a loan receivable with a face value of €50,000,000 at a discount from a financial institution and entering into an interest rate swap with a UK bank with a fixed rate of 4.5% swapped for 6-month Euribor would thus trigger a €100,000 FTT liability (on the transfer of ownership of the financial instrument i.e. 0.1% due from the vendor and 0.1% due from the hedge fund) and a €5,000 FTT liability (on the swap element). This example illustrates the cascading effect of the FTT, as in the trading chain every purchase and sale will be subject to the FTT, thereby leading to a higher effective tax rate than expected (0.21% in our example).

The determination of the tax base will probably require asset managers to maintain data and establish methodologies in close consultation with internal or external valuation, transfer pricing and tax teams. A best practice would be the establishment and maintenance of documentation to support the taxable amount in the event of an audit by a relevant tax authority.

Tax rates

It is currently proposed to levy FTT at a rate of 0.1% for financial instruments other than derivatives and a rate of 0.01% for derivatives. The expectation of the EU Commission is to raise approximately €57 billion per year, part of which could go to the EU budget, with another portion contributing to the public finances of member states²¹. The differentiation in rates can be explained by the intention to compensate, to some degree, for the fact that the tax base for a derivative product (notional amount) does not reflect economic value. A lower rate is therefore applied to derivatives. The justification can also be found in the willingness to adapt the rates to suit the objectives of ensuring substantial revenue collections, minimising the risk of relocation and avoiding negative impacts on non-financial sectors.

Member states will be free to adopt higher rates when transposing the provisions of the FTT Directive. The benefit of applying higher rates will have to be balanced with an increasing risk of relocation.

²¹ The use of the proceeds of the FTT is also a subject of debate among member states

Taxpayers

Since the political message of the FTT is that the financial sector should make a fair contribution to public finances for the benefit of citizens, non-financial businesses and member states, it is natural to see that the legal impact of the FTT is on the financial sector only. Thus, on the condition that it is a party to a transaction either as principal or agent, the financial institution will be responsible for paying the tax.

Beside the tax cost in itself (assuming the cost is not transferred to final consumers) the FTT will represent an additional administrative cost for asset managers that will need to be included in the cost/benefit analysis of complying with AIFMD, UCITS IV, Solvency II, etc. The additional pressure created by the proposal on operating models together with the accompanying regulatory package may to some extent exacerbate consolidation trends in the industry, strategic repositioning of niche or medium players or even disappearance of certain market players.

The proposal introduces an exemption for certain intermediary taxpayers whereby if a financial institution acts as an agent of another financial institution, only the other financial institution shall be liable to pay the FTT. This exemption is particularly relevant for brokers in the asset management industry. For instance, a broker responsible for executing a buy order submitted by an EU feeder investment fund to invest in shares or units issued by an EU master investment fund would not be responsible for paying FTT. However the answer would be different for a broker responsible for executing buy/sell orders submitted by a high net worth individual. In that case, the broker would be responsible for paying FTT on the purchase and sale of shares or units issued by the investment fund. Brokers will thus need to familiarise themselves with the proposal and review their client base and contracts in order to measure the impact of the FTT on their organisation's profitability (i.e. impact on fees and pricing), operations (e.g. compliance management, client communication) and technology (e.g. update of trade and payments software to include the effects of the tax).

Where the message is devalued is when the proposal imposes joint and several liability on each party to a transaction, including persons other than financial institutions, where the financial institution has not paid the tax within the prescribed deadline. This measure raises serious doubts as regards its practical application and enforceability. Indeed how can collection of the FTT due on the sale and purchase of shares between a U.S. private equity fund and a UK private equity fund be enforced when the UK private equity fund has failed to pay the 0.1% FTT due on the purchase of shares, especially when no sanction or restriction to the legal transfer of ownership is foreseen by the proposed directive? Contrary to the UK stamp duty mechanism, evidence of legal ownership will not be linked to the proper payment of the FTT under the current proposal, meaning that in our example, the U.S. private equity fund will have no incentive to pay the FTT due from the UK private equity fund. Regulatory sanctions (e.g. through a licence suspension) could be envisaged, but it would require the exchange of information, cooperation and coordination between the authorities of member states and third countries.

Due date for payments and tax reporting

The EU Commission leaves the responsibility to member states for defining rules that will ensure effective collection of the tax, which for the reasons mentioned above might be one of the most challenging tasks under the current proposal.

In doing so, member states will have to comply with the following minimum obligations:

- (i) Member states shall adopt measures to ensure that every person liable for payment of FTT submits a monthly return by the tenth day of the month following the month of the taxable event.

Chief compliance officers of asset management firms will have to reconsider their technology infrastructure and internal organisation in order to meet the additional reporting obligations imposed by the proposal. A question arises when reading the terms of this provision — more particularly the reference to 'every person liable'

— as to whether persons other than financial institutions will have to comply with the reporting obligations if their joint and several liability is engaged by reason of failure of the financial institution to pay the tax. We expect the answer to this question to be a straight and clear 'no', as otherwise it would transfer the legal impact of the tax to the non-financial sector, making administration of the tax unmanageable and unacceptable for non-financial businesses and households.

(ii) Member states shall ensure that any FTT due is paid at the moment of the taxable event when the transaction is carried out electronically and within three working days from the taxable event in all other cases.

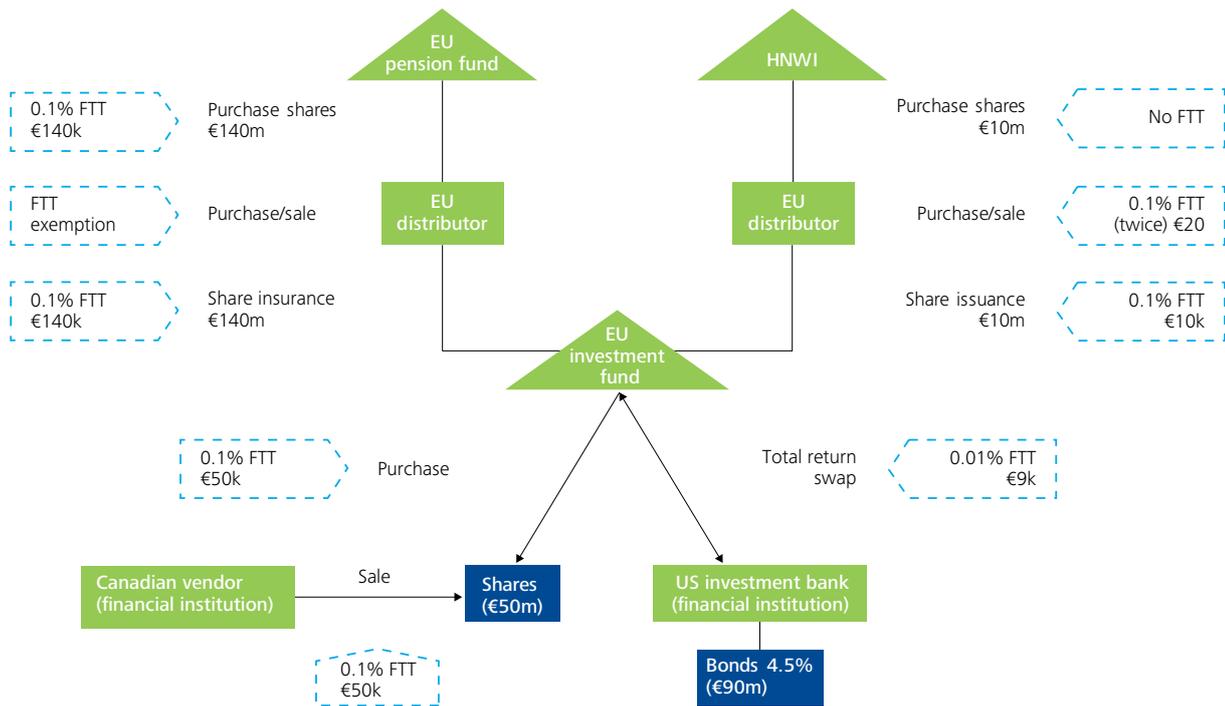
For transactions concluded electronically, the trade and settlement generally occur at the same time, so payment processing for the tax should not be a major issue beside the requirement to define the technology infrastructure parameters. For transactions that are not carried out electronically (a small proportion, in principle), the deadline for payments might be viewed as particularly short and may cause a pre-financing issue if taxable amounts are significant and settlement of the financial transactions occurs more than three days from the taxable event.

Other taxes on financial transactions

In order to ensure the effectiveness of a financial transaction tax within the European Union, the proposal prohibits the maintenance or introduction of taxes on financial transactions other than the FTT or VAT. If the proposal becomes a reality, the financial sector may thus expect the abolition of national tax measures that currently exist (e.g. UK, Belgium, Finland). However, the financial sector should expect developments with respect to the current VAT exemption of certain financial services.



Illustration of the effect of the FTT on the fund management industry



Total FTT: €419k
 ETR = 0.3%



Conclusion

Over the past four years, the European Union has seen a dramatic deterioration of its member states' public finances and overall debt levels that can partly be explained by member states' intervention to rescue the financial sector post-2008 and avoid a systemic crisis. With the threat that the current eurozone debt crisis represents to the global economy, there is an urgent need to find resources to enhance public finances. Governments of EU member states are also facing a growing sentiment of economic inequality among their citizens and are eager to demonstrate to their electorates that measures are being taken to reform the financial sector and ensure that taxpayers do not bear the costs of resolution.

The idea of a tax on the financial sector has therefore (re)emerged as an indispensable means of raising new resources, and the European Union is keen to press ahead with it. However, the reality of such a tax should be placed in the context of the challenge for the European Union over the next decade, i.e. fiscal integration. As it stands, entry into force of the FTT on 1 January 2014²² depends on unanimous approval of the EU Commission's proposal by the 27 member states, which currently looks unlikely due to strong opposition from the UK and Ireland. The FTT's opponents are concerned by the negative effects that relocation could have on their real economies without the introduction of a global tax on the financial sector. A global consensus is, however, far from being reached, and the countries of the G20 have barely acknowledged the initiative without providing any support²³.

Aware of this deadlock situation, the supporters of the FTT (Germany and France at the top of the list) are considering different options to enable the FTT to operate in a similar way to the 'enhanced cooperation procedure', which requires only nine members to participate, or even plans for a fundamental reform of the TFEU that would involve establishing a more integrated and smaller eurozone. There is a hope that the introduction of a tax on the financial sector within a core EU group would pave the way towards global adoption. Given the proposed terms of the FTT, we think that the use of such options would underestimate the relocation risks and detrimental consequences for real economies.

Alternatively the European Union could propose other forms of taxes on the financial sector, such as a 'financial activities tax'²⁴ (or FAT, a tax levied on the profit and remuneration of financial institutions) combined with a reform of VAT on financial services, though it would still have to obtain the unanimous agreement of the 27 member states.

While there is no political consensus, strategy or reform in the area of fiscal integration within the EU, the proposed FTT will remain 'something in the air'. However, because of the unprecedented global economic and political pressures, the asset management industry should keep a close eye on the EU Commission's proposal, and more generally on the global debate around taxation of the financial sector, as changes are likely to be on the cards in the coming years.

In order to ensure the effectiveness of a financial transaction tax within the European Union, the proposal prohibits the maintenance or introduction of taxes on financial transactions other than the FTT or VAT.

²² Under the proposal, member states are expected to issue transposition provisions at the latest by 31 December 2013 for effective introduction from 1 January 2014

²³ G20, Cannes Summit Final Declaration, 4 November 2011, paragraph 82, page 17

²⁴ Current examples include: Denmark (tax on wage and salary costs for businesses engaged in certain activities that are exempted from VAT), France (payroll tax levied on employers not liable for VAT) and China (5% business tax on interest income and capital gains on the trading of financial instruments)

Managing risks under UCITS IV

New release or fountain of youth?

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Over the last three years, an unprecedented combination of factors has paved a new way for UCITS risk management. As a result, and as a natural consequence of the relative stringency of the new regulatory requirements compared to the previous guidelines in force, risk management has climbed higher on the list of priorities of executives and boards of directors.

A major motivation of the UCITS IV framework is undoubtedly to be found in the aftermath of the recent credit crisis. This worldwide turmoil evidenced the need for regulators to embrace a systemic, global perspective on risk management. It also demonstrated the intrinsic dependence of the financial services industry, including investment fund management, on the perception of investors in terms of risk appetite. When confronted with investors' rising doubts, uncertainties, lack of confidence and herding effects, funds have been subject to waves of redemptions which could not have been predicted beforehand. The abolishment of certitudes (embodied in the 'too big to fail' saying), together with the ever-increasing sophistication of financial products, also contributed significantly to reinforcing the need for risk management.

In the same vein, investor protection is considered a key proposal of the UCITS framework — and undoubtedly underpins the success of the label, as the global standard for retail funds is accompanied by a robust risk management framework, which has evolved over the years to reflect market and product developments. Historically, UCITS III introduced an enhanced risk management process to take into account the newly permitted use of financial derivatives and more sophisticated investment techniques.

These requirements, including the deployment of the Value at Risk (VaR) methodology to calculate global exposure were pioneering within the asset management sector at the time. UCITS IV has provided further enhancements to the risk management regime in order to develop a more integrated approach to risk with a greater emphasis on risk testing, governance frameworks and disclosure.



Along the way from UCITS III to UCITS IV, risk management has been recognised as a key promoter and selling point of the label. Would this regulatory reform then be seen as a 'necessary release' of a product which would otherwise be fairly difficult to sell? At the very least, the need to align risk management requirements to the new reality described above has to be acknowledged. In that respect, the UCITS IV framework fills the gaps left by UCITS III, by tackling certain issues in a more substantial manner.

UCITS IV began life as a package of measures to increase efficiencies in the European fund market by providing for a management company passport, simplified regulatory notification, an EU-wide fund merger regime, master-feeder structures and enhanced supervisory cooperation. However, the draft directive evolved during the financial crisis, with an increased focus on investor protection, governance and risk management. Below we review the main foundations and significant amendments of the UCITS IV framework.

The increased focus on investor protection is made clear through the Key Investor Information Document (KIID), which includes the controversial Synthetic Risk Reward Indicator (SRRRI) — a risk reward scale from 1 to 7, based on a fund's volatility over the past five years³. While simplistic in concept, the SRRRI has proved very difficult to implement in reality and many asset managers question the accuracy of expressing a fund's risks through a single synthetic rating. Notwithstanding the challenges and costs involved, the KIID is likely to prove popular with retail investors and may become a European template for other products under the European Commission's Packaged Retail Investment Products (PRIIPs) initiative.

The ability to manage, distribute and administer a UCITS in one EU member state though a management company located in another member state came with additional harmonising measures. These included the appointment of a hierarchically and functionally independent 'permanent risk management function' by management companies to review and report regularly on compliance with the risk limits. Management companies, including self-managed investment companies, must retain the necessary resources and expertise to monitor the activities carried out by third parties effectively, while there is also a greater emphasis on the documentation of risk policies and procedures as well as on monitoring, reporting, analysing and forecasting risk.

Commission Implementing Directive 2010/43/EU provided a new chapter on risk management with the detailed requirements set out in CESR's 'Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS'. Under these guidelines, each UCITS must document internal risk management measures and limits encompassing market risks, liquidity risks, counterparty risks and operational risks.

UCITS IV has provided further enhancements to the risk management regime in order to develop a more integrated approach to risk with a greater emphasis on risk testing, governance frameworks and disclosure.

¹ Committee of European Securities Regulators, *CESR's Guidelines on the Methodology for the Calculation of the Synthetic Risk and Reward Indicator in the Key Investor Information Document*

For example, global exposure estimates obtained through the use of the commitment approach have become more restricted in application due to new methodologies and the use of duration netting and hedging. Furthermore, the old distinction between 'sophisticated' and 'non-sophisticated' has been removed and replaced with a requirement for a UCITS to self-assess whether to use the commitment approach, relative VaR or absolute VaR. While this does not represent a major departure from the previous approach, management companies need to note various clarifications in relation to the use of the three approaches, including a revised definition of the benchmark in the context of relative VaR.

UCITS IV also introduced additional disclosure requirements in relation to risk management. The method used to calculate global exposure must be disclosed both in the prospectus and the annual report, while the annual report must also set out the method for calculating global exposure and provide further details if VaR is used. Also, if the funds are using VaR, the prospectus must disclose the expected level of leverage and the risk of higher leverage levels. The guidelines specify that leverage should be calculated as the sum of the notionals of the derivatives used, which is not consistent with current market practice. As a result, concerns have been expressed that this figure could be misleading because it actually refers to total derivative use rather than leverage, and managers have had to deal with the resulting investor queries. To a large extent, UCITS IV features new, innovative requirements, filling in some gaps that received particular attention in the aftermath of the credit turmoil of 2007-2009. For instance, a distinct advance of UCITS IV is to explicitly require the implementation of a liquidity risk management framework. Somewhat surprisingly, despite its intrinsic importance to the investment fund



industry, this matter had previously been somewhat neglected by regulators. The regulatory requirements of CESR 10-788 advocate the implementation of stress-testing scenarios simulating liquidity crises in the market and their impact on complex structures. Liquidity is also explicitly mentioned as a material risk that management companies have to properly assess, while another mention of liquidity is made through the collateral management process attached to counterparty risk mitigation. National translations of European guidelines can take an even more stringent form; for example, Luxembourg has decided to require management companies to adopt a systematic description of their liquidity risk framework through the Risk Management Procedure (RMP) document. Interestingly enough, the latter was modified significantly under UCITS IV, and its framework is now meant to have a formal and rigid structure in which processes are comprehensively described.



Another innovation addresses risk models, or more specifically the *risk of risk models*. A validation of risk models is required to be undertaken in a way that the conceptual soundness and integrity of the model is assessed by *a party independent of the building process*. This stands as a major hurdle in the estimation of the model's risk, i.e. the risks arising from flaws in the structure of the model itself or the propensity of the model to be used inappropriately (in the mapping, calibration or parameterisation of fields), and ultimately give rise to inaccurate estimates. From the standpoint of business value, risk model validation obviously bears much more significance than mere regulatory compliance. Indeed, gauging the *risk of risk* adds tremendous business value in paving the way for embedding risk management into front office decision triggering systems (e.g. providing support to investment decisions, risk budgeting, risk allocation, etc.). Only when the limitations of the model are known, and the necessary critical analysis of the measurements obtained has been conducted, can we effectively devise an appropriate risk management system.

While most of the validation exercise is essentially achieved through a one-off analysis of the specific assumptions and features offered by the model, it is nonetheless meant to be a continuous process. In particular, the frequency of a recurrent validation exercise is, to a large extent, dictated by the quality of the results produced by the risk model. The process of quantifying the performance of a risk model on the basis of its historical predictions is known as *backtesting*.

All in all, backtesting is the process of assessing the accuracy and quality of a risk model by comparing model-generated measurements over time against actual observed gains and losses. Any risk model produces a range of risk metrics, which are loosely speaking statistical measures of the magnitude of potential losses assuming some confidence interval. Because a confidence interval is to be stipulated, say 99%, we expect the system to lead to erroneous results (i.e. actual losses exceeding the forecast, known as *overshootings*), on average, in 1% of the cases. As an example, for a 250 model point yearly backtesting, the theoretical critical number of overshootings is 2.5, which is increased up to 4 by regulators as an implicit acceptable upper threshold for exceptions. Above this limit, *“UCITS senior management should be informed on a quarterly basis”*², with information containing *“an analysis and explanation of the sources of ‘overshootings’ and a statement of what measures if any were taken to improve the accuracy of the model”*³. Backtesting therefore ensures a gradual convergence between the factual observation of the model’s performance and the main features of the model’s setup (and vice versa). Its importance also precipitates through the frequency adjustment, which is undertaken at least monthly (whereas this was yearly under UCITS III). Backtesting represents a likely trigger for the model’s revision, and in that respect qualifies as a fundamental piece of ongoing validation. This in particular fosters a culture of defining and critically analysing in which respect the backtesting results and retroactive study of the performance of the model are related to the core model assumptions and setup.

The range of UCITS IV regulatory changes extends beyond the issues discussed above to touch on noteworthy topics such as valuation risk and collateral management. While the fundamental basis of risk management post-UCITS IV remains unchanged, significant enhancements have been made in terms of identifying, monitoring, measuring, reporting and responding to risk management challenges. While UCITS IV has been fully implemented in several EU jurisdictions, and policies and procedures have been updated accordingly, management companies need to ensure they have the appropriate expertise and resources to implement a risk management policy and demonstrate this to regulatory authorities. From a value creation point of view, the risk management requirements under UCITS IV can be seen as highly beneficial, creating appropriate conditions for a more contemporaneous, investor-suitable, risk management framework. However, the adequacy of the required regulatory framework, and the effectiveness of the investor protection acquired through it, will undoubtedly be regularly and consistently tested. After all, financial markets are relentlessly adept at finding ways to make sure real scenarios supersede the most risk-averse simulations.

A validation of risk models is required to be undertaken in a way that the conceptual soundness and integrity of the model is assessed by a party independent of the building process.

² Committee of European Securities Regulators, *CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*

³ Commission de Surveillance du Secteur Financier, *CSSF Circular 11/512*

IASB and FASB issue Exposure Drafts (ED) on investment entities

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After much discussion and numerous focus group meetings, the IASB has issued an exposure draft on investment entities to bring IFRS into line with similar provisions in U.S. GAAP. The IASB and FASB worked on this joint project to provide guidance on accounting for investment entities. This resulted in the IASB and FASB each issuing an exposure draft (ED) in August 2011 and October 2011 respectively. Comments on the proposals in both cases were due on 5 January 2012. The guidance in both exposure drafts is similar but not identical.



Both EDs propose that an investment entity (as defined in the ED) be required to measure investments in entities it controls at fair value through profit and loss rather than consolidating those entities. Strict criteria would have to be met for an entity to qualify as an investment entity. This is a significant change in IFRS as currently entities are required to consolidate investments in entities that they control irrespective of whether the entity was an investment entity or not. U.S. GAAP currently permits an investment entity that meets the criteria under ASC 946 to account for its controlled investments at fair value through profit and loss.

The IASB and FASB jointly developed the criteria for determining whether an entity qualifies as an investment entity. **For an entity to be considered an investment entity, it would need to meet all of the following criteria:**

- **Nature of the investment activity:** the entity's only substantive activities are investing in multiple investments to earn capital appreciation, or investment income (such as dividends or interest), or both
- **Business purpose:** the entity makes an explicit commitment to a group of investors that the entity's purpose is investing to earn capital appreciation, or investment income (such as dividends or interest), or both
- **Unit ownership:** ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed
- **Pooling of funds:** the funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and which collectively hold a significant ownership interest in the entity
- **Fair value management:** substantially all of the investments of the entity are managed, and their performance is evaluated on a fair value basis
- **Reporting entity:** the entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity

Nature of the investment activity

An investment entity must have no other substantive activities, assets or liabilities other than those relating to investing activities. However, an investment entity may provide investment advisory services related to its own investment activities and may temporarily hold defaulted collateral from collateralised investments (e.g. real estate securing commercial mortgage loans) as long as the entity did not acquire the investments with the intention of controlling the secured collateral.

Although the business purpose of an investment entity would be the holding of multiple investments, either directly or indirectly, it is not required to hold multiple investments at all points in time. For example, an investment entity could hold cash rather than multiple investments during its initial offering period, during the process of liquidation or while identifying suitable investments (either initial investments or redeploying capital following investment disposals).

An investment entity may hold multiple investments indirectly through another investment entity by isolating an investment into a separate legal structure for regulatory, tax, legal or other business reasons. For example, an entity may hold an indirect investment through a master-feeder structure where investors invest in an on-shore or an off-shore feeder fund (dependent on their domicile) which in turn invests in a master fund that holds multiple investments. While the only investment of each feeder fund is its interest in the master fund, the feeder fund would be considered to hold multiple investments through its interest in the master fund.

Business purpose

An investment entity, as defined in the ED, makes an explicit commitment to investors that its sole purpose of investing is to earn capital appreciation or investment income (such as dividends or interest), or both. Offering memorandums, prospectuses, indenture agreements, marketing materials and partnership agreements may provide evidence of the investment objective of the entity, as may the manner in which it presents itself to prospective investors.

As part of the express business purpose, an investment entity should identify and document the potential exit strategies for realising capital appreciation or receiving distributions or interest from its investments. Exit strategies will vary based on the type of specific investments held by the entity. Hedge funds and mutual funds holding public equity securities would be likely to have an exit strategy of disposal through an exchange, while private equity funds would be more likely to have exit strategies such as initial public offerings or private placement of equity securities. Exit strategies for debt securities could include broker- assisted private placements or conversion of convertible debt to equity securities and disposing of those equity securities through public markets.

U.S. GAAP currently permits an investment entity that meets the criteria under ASC 946 to account for its controlled investments at fair value through profit and loss.



Unit ownership

An investment entity is owned by investors through ownership units (e.g. ordinary shares or partnership interests) which represent a specifically identifiable portion of the net assets of the entity. However, the ownership unit does not have to represent a proportionate interest in all of the investments of the investment entity. An investment entity can have multiple classes of equity investments.

Pooling of funds

An investment entity sells ownership interests to investors in order to pool the raised capital to achieve its investment objectives. Investors unrelated to the investment entity's parent (if any) must hold significant ownership interests in the entity, which the parent (or its related parties) does not have an implicit or explicit arrangement to acquire. However, the ED does permit

an entity whose single investor is an investment entity to still be considered an investment entity if it meets all of the other investment entity criteria.

Fair value management

An investment entity manages, evaluates and reports its investment performance internally and externally on a fair value basis. To meet this criterion, information provided to the management of the entity for decision-making purposes and information provided to investors must be prepared on a fair value basis.

Reporting entity

The last criterion requires the investment entity to be a reporting entity. This assessment should take into account the economic substance (rather than the legal form) of the entity. The entity does not have to be a legal entity.



Parents of investment entities

The IFRS ED does not propose that the exception to consolidation be extended to the parent of the investment entity (unless they themselves are investment entities). Parents of investment entities would continue to be required to consolidate all entities that they control, including those controlled through an investment entity.

The IASB considered whether the use of fair value rather than consolidation should be extended to a non-investment entity parent of an investment entity, but have proposed that **it should not be for the following reasons:**

- The IASB expects that in most cases investment entities will have investment entity parents, meaning that fair value accounting will be available when needed
- The Board had concerns over potential accounting inconsistencies and possibilities for abuse (for example, the issue of the parent's equity to an investee of its investment entity subsidiary could result in the group appearing to have a stronger capital base although the additional equity is held within the group)

Disclosures

The ED proposes specific disclosure requirements for investment entities in addition to those required by IFRS 7 'Financial Instruments: Disclosure and IFRS 12 Disclosures of Interests in Other Entities' including:

- If the status as an investment entity has changed, information on both the reason for the change and the impact on the financial statements
- If the investment entity has provided any financial or other support to controlled entities during the financial statement period when it was not contractually required to do so, information on the type and amount of support provided and the reasons for providing the support

- Any current intention to provide financial or other support to a controlled investee (including assisting in obtaining financing)
- The nature and extent of any significant restrictions on an investee's ability to transfer funds to the investment entity (whether cash dividends or repayments of loans or advances)

For controlled investments, the proposed disclosure requirements include the investee's name, country of incorporation or residence and the proportionate ownership interest in the investee held (and if different, also the proportion of voting interest held). For investment entities which control another investment entity, the disclosure requirements would also apply to that controlled investment entity.

The ED also proposes additional disclosures including:

- Detailed per-share information for each period presented
- Ratios of expenses and net investment income to average net assets (including the methodology for computing the ratios)
- Total return (including the methodology for computing total return)
- Total committed unfunded amounts from investors, the year of formation and the ratio of total contributed funds to total committed funds of the owners

Although the investment entity criteria would be the same under IFRS and U.S. GAAP, there will still be some differences. Under U.S. GAAP entities regulated by the 1940 Investment Companies Act would qualify as investment entities irrespective of whether they meet the criteria in the ED. There is no similar exemption under IFRS.

A second significant difference relates to the accounting by a non-investment entity parent of its investment in an investment entity subsidiary. Under IFRS, the parent of an investment entity would not be permitted to retain the fair value accounting applied by the investment entity subsidiary. Under current U.S. GAAP and the U.S. ED, the non-investment parent can retain the specialised accounting applied by the investment entity subsidiary.

A third difference relates to how an investment entity accounts for its controlling financial interests in other investment entities in a fund of fund structure. Based on the U.S. ED the investment entity would consolidate a controlling financial interest in another investment entity. Under the IASB ED an investment entity would account for a controlling financial interest in another investment entity at fair value.

The comment period for the exposure draft expired on 5 January 2012.

An investment entity is owned by investors through ownership units (e.g. ordinary shares or partnership interests) which represent a specifically identifiable portion of the net assets of the entity.

Reform of 'MiFID'

Spotlight on the 'inducements' section

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On 20 October 2011, the European Commission presented its proposals to revise the Markets in Financial Instruments Directive (MiFID) for likely implementation throughout member states at the beginning of 2015.



Among the many subjects covered, the issue of investor protection, in particular with regard to investment services and activities, is being widely discussed in the fund management industry.

In its previous versions, the MiFID already provided for the obligation, in relation to the provision of an investment service, to inform clients of any remuneration paid to the service provider by a third party and to ensure that this remuneration helps enhance the quality of the service provided to clients (Article 26 of regulation 2006/73/EC) and is not detrimental to clients' interests.

The new proposal goes much further in regulating these services, to the extent of prohibiting any remuneration/monetary benefit or 'inducement' from a third party, or from a person acting on behalf of a third party, in the context of the provision of independent advice and in relation to portfolio management.

As regards to the provision of investment advisory services, the supplier must inform its client at the start of their relationship that it is providing its services on an independent basis, where applicable.

If this is the case, the service provider may not receive any remuneration from a third party (management company) for its advice, and only non-monetary benefits — such as product training — are permitted, provided their receipt does not impair compliance with the duty to act in the best interest of clients.

In the context of portfolio management, the ban would mean that a management company is forbidden from accepting trailer fees from issuers if the portfolio under its management mandate includes UCITS shares or units.

This would likely lead to these trailer fees being earned by the fund, as is the case for the management of funds of funds.

Returning to the removal of inducements in the context of independent investment advice, the first difficulty will be for industry professionals — particularly distributors — to decide in which cases they will, or will not, be considered 'independent' within the meaning of the Directive.

It should not be forgotten that, in the eyes of the regulator, investment advice is deemed to be given independently when the following two conditions are met (Art.24 5.i.):

- The service provider has assessed **“a sufficiently large number of financial instruments available on the market”**
- The financial instruments analysed are **“diversified with regard to type and issuers or product providers”**, and it is indicated in particular that the service provider should not limit itself to analysis of the instruments offered by entities having *“close links with the investment firm”*

This definition then raises the question of evaluating the acceptable number and diversity of products and suppliers analysed.

In France, the report by Louis Giscard d’Estaing published in July 2011 on financial advisors suggests defining an advisor’s independence as the fact of *“not being commercially linked, for each product category [etc.] with a single issuer and not having a capital link with an issuer of financial instruments, a credit institution or an insurance company”*.

This definition would exclude the majority of distributors from the scope of application of the removal of inducements, focusing on the profession of independent financial advisors and, to a lesser extent, some private banks.

If this definition is adopted by the legislator, independent financial advisors in France could find themselves in a difficult situation, as commission sharing currently represents between 60% and 80% of their revenue.

Moreover, this profession is generally exercised in a fragmented way, with small-scale entities having one or two employees. The profession also believes that it will be difficult to invoice consultancy fees to clients who have not previously had to pay such fees. It is also believed that such fees would only partially cover the amounts received from commission sharing.

For comparison purposes, in France, the distribution market is around 70% owned by retail banks (45%) and insurance companies (25%), while the proportion of UCITS distributed via 'independent' networks represents quite a small amount, at around 17% of the total assets distributed (5% by independent financial advisors and around 12% by private banks).

In the United Kingdom, the opposite situation prevails, with net domination by 'Independent Financial Advisers' who hold over 60% of the market — around 5% for private banks — against only 5% for retail banks. (Source Strategic Insight estimates, European Industry Association, at the end of 2009).

In addition, concerns are being raised by 'entrepreneurial' small and medium-sized management companies, not affiliated to banking or insurance groups, which depend on this distribution network to promote their products.



However, the scope of the impact of this ban is relative given that the provision of investment advice does not *de facto* cover intermediation activities in relation to insurance products, especially life insurance policies, which are the main products marketed in France by independent financial advisors and private banks, although unit-linked policies have UCITS among their underlying assets.

Conversely, it is possible that the ban — which currently relates to advice concerning the acquisition/sale of financial instruments within the meaning of MiFID, including UCITS — paves the way for a departure from the business model by which the producer remunerates the distributor.

Accordingly, one might expect this to be extended to insurance products at some point, especially in conjunction with the Packaged Retail Investment Products Directive (PRIIPs) or the reform of the Insurance Intermediation Directive (IMD2).

This is rendered all the more likely by the fact that in the United Kingdom the Retail Distribution Review (RDR), which has been the subject of a number of proposals by the European Commission and is due to come into force on 1 January 2013, already provides for a broader remit in terms of the scope of impacted actors and products, since it targets any advisory service on any investment product aimed at a general 'retail' public and will, in particular, concern insurance products distributed to British private individual investors.

Financial transaction tax

On 30 November 2011, the European Fund and Asset Management Association (EFAMA) submitted its comments on the draft Directive to the European Commission.

EFAMA made it clear that:

- The additional cost related to tax will impact investors, including fund or pension plan investors
- The cost can be significant due to the multiple layers in which the tax can be withheld (portfolio of funds/subscriptions and redemptions of fund units/use of nominee shareholders, etc.)
- The financial transaction tax would create a competitive advantage for funds established outside the EU
- The financial transaction tax would also open the door to tax avoidance for sophisticated investors using investment vehicles located outside the EU

The industry is also concerned by the uncertainty regarding the revenues of such a tax. The EU Commission estimates yearly revenues between €37 and 55 billion. This estimate, however, was computed without reference to the OTC market, which may lead to a much higher return than anticipated.

U.S. FATCA rules: regulation delayed?

Many professionals are waiting for the publication of the FATCA draft regulation before year end, hoping that this publication would allow them to better estimate the impact of those new U.S. tax rules on their business. Furthermore, all non U.S. financial services companies may be impacted (banks, funds, pension funds, insurance companies, etc.) by the new rules aiming to fight against U.S. tax evaders. The new law requires non U.S. financial intermediaries to sign an agreement with the U.S. tax authorities to assist them in their fight, unless intermediaries are ready to suffer additional withholding taxes on direct, but also indirect (passthru) U.S. source income they receive. It seems that professionals will need to wait at least until mid-January before accessing the draft regulations. U.S. authorities also confirmed, in a recent conference, that final regulations should be available during 'the summer' of 2012. Will those regulations bring good news? U.S. officials announced they have listened to the major concerns of the industry, i.e. the potential conflicts between FATCA and local laws and the anticipated difficulties in implementing the withholding requirements for passthru payments. However, the significant anticipated costs for implementing those rules will fully remain at the charge of non U.S. financial institutions.

Link'n Learn 2012

As previously announced, Deloitte has, since 2009, decided to open its knowledge resources to the professionals of the Investment Management community. We are happy to present to you the calendar of our new Link'n Learn season which, as usual, will be moderated by Deloitte's leading industry experts. These sessions are specifically designed to provide you with valuable insight on today's critical trends and the latest regulations impacting your business. An hour of your time is all you need to log on and tune in to each informative webinar. For access to the sessions do not hesitate to contact deloittelearn@deloitte.lu

Agenda

- 12-Jan** Introduction to Undertakings for Collective Investments (UCITS) **NEW!**
- 19-Jan** Introduction to third party assurance reports (ISAE 3402, SSAE 16, AT 101, etc.)
- 02-Feb** Introduction to hedge funds
- 01-Mar** Risk management within UCITS IV, the CESR Guidelines 10-788 **NEW!**
- 08-Mar** Wealth management structuring using Luxembourg regulated vehicles **NEW!**
- 22-Mar** Tips to succeed in FATCA implementation
- 29-Mar** Key Investor Information Document (KIID) Content and implementation challenges
- 19-Apr** A new way of counterparty risk management: EMIR for OTC derivatives **NEW!**
- 26-Apr** Impacts of Basel II and Solvency II for the asset management
- 03-May** Transfer pricing **NEW!**
- 10-May** AIFMD: what does your business need to know
- 24-May** MiFID II **NEW!**

- 07-Jun** Risk & capital: from Basel II to Basel III
- 21-Jun** Custodian responsibilities Latest developments based on AIFMD and UCITS V **NEW!**
- 28-Jun** Introduction to tax and real estate funds
- 05-Jul** Transaction cycles and net asset value calculations
- 12-Jul** Treatment of errors and Anti-Dilution techniques
- 20-Sep** Introduction and latest updates to ETFs and index tracker funds
- 27-Sep** Solvency II – The challenges of pillar II and the ORSA **NEW!**
- 04-Oct** Introduction to private equity funds
- 18-Oct** Introduction to Islamic funds
- 25-Oct** Introduction to derivatives instruments (part 1)
- 08-Nov** Introduction to derivatives instruments (part 2)
- 15-Nov** Evolution of the custody framework: a focus on Target 2 Securities and UCITS V **NEW!**
- 22-Nov** Investment restrictions of investment funds
- 29-Nov** Introduction to IFRS for funds
- 13-Dec** Performance fee calculation and multi-class of shares principles

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