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FSI Investment Management Newsletter 1/2012
Current Regulatory Developments

Implementation of the AIFMD in the investment fund industry
Derivative trading post EMIR
Current tax issues

This issue of our Investment Management Newsletter provides a summary of the key issues faced the investment fund industry is facing on the implementation of the Directive on Alternative Investment Fund Managers (AIFMD or AIFM directive). The first draft of the legislation on implementing the AIFM directive in Germany is expected in the second quarter of this year. From ESMA's final report to the European Commission on 16.11.2011, which forms the basis on which the Commission will develop the so-called Level 2 implementing measures, some of the key issues facing the regulated management companies (KAG) which set up or manage alternative investment funds are already evident. These comprise the following:

- Authorisation and certain areas of the business organisation
- Risk management requirements and the valuation of assets
- Framework conditions for depositaries
- Disclosures to investors and transparency for AIFs
- Distribution and cross-border management

Another item addressed in this Newsletter is the possible impact of the European Markets and Infrastructure Regulation (EMIR).

With regard to tax issues in the asset management sector, the Newsletter addresses two topics: potential liability risks when licensing software from service providers abroad and the provision of non-assessment certificates to domestic brokers by management companies (circular from the Federal Ministry of Finance dated 11 December 2011).

Impact of the AIMFD on the investment fund industry

The AIFM directive defines requirements for the managers of alternative investment funds (AIFM). With the exception of regulations for securitisation instruments and private equity instruments, it contains only very few qualitative and quantitative requirements on investment policies or other product regulations for alternative investment funds (AIF). The AIFM directive is based on the concept that AIFs are marketed to professional customers within the meaning of the Markets in Financial Instruments Directive (MiFID).

We currently expect that the AIFMD will be transposed into one national Investment Act, including also the provisions for undertakings for collective investment in transferable securities (UCITS) authorised under Directive 2009/65/EC.

Requirements on authorisation and certain areas of the business organisation

Relevant questions on authorisation and new requirements on additional own funds

According to the AIFM directive, a management company may generally set up both funds authorised under Directive 2009/65/EC (UCITS IV Directive) and certain alternative investment funds (AIF), which are currently regulated in the Investment Act (InvG), i.e. institutional funds, hedge funds, other funds, real estate funds etc. An AIF may also be set up through a separate company.

Investment companies already in existence must, however, also apply for authorization as an AIFM in their EU member state. Where a management company is authorized under Directive 2009/65/EC (UCITS management company), it is not required to provide documents which were provided when applying for the authorization under Directive 2009/65/EC if they are still up-to-date within the meaning of that directive. Therefore, the requirement to provide information could be reduced largely to information on remuneration policies and practices of the AIFM, contractual terms of the AIF, disclosure to investors and delegation to third parties. Notification to the national supervisory authority of any significant changes in the information supplied under the initial authorization procedure must also be made subsequent to the initial authorization as an AIFM. If no objections are raised by the national regulatory authority within one month, the changes may be implemented by the AIFM. In general, this increases the amount of administrative work significantly, which will be of particular relevance when launching new AIFs; further details are provided below.

The core and non-core services of the AIFM are largely equivalent to those in the UCITS IV Directive. The same holds true for the internally managed AIF investment company with variable capital or SICAV. However, the AIFM must perform portfolio management and risk management itself. Nevertheless, this does not exclude the delegation of some of its functions in particular cases. The AIFMD also requires each AIF to have a single AIFM.

In addition to authorisation, the AIFMD defines the requirements for own funds. The initial capital must amount to at least EUR 125 000 (according to Section 11 of the Investment Act (InvG) EUR 300 000). Over and above this, the level of own funds is flexible, being 0.02% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million. The maximum required total of the initial capital and the additional amount is EUR 10 million according to the AIFMD, which concurs with the current cap defined in the Investment Act (InvG).

Furthermore, additional own funds are required to cover professional negligence. This includes risks which could give rise to (legal) claims against the management company, including, for example, system failures or failures in portfolio or process management or in determining the net asset value. According to ESMA, the calculation and provision of the additional own funds can be carried out in one of three ways. The management company takes out an insurance policy complying with the qualitative requirements set by ESMA with insurance coverage per claim of at least EUR 2 million or 0.75% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million. The Insurance coverage per claim may not exceed EUR 20 million however. The insurance cover for all claims can either amount to EUR 2.5 million or 1% of the amount by which the value of the portfolios of the AIFM exceeds EUR 250 million or 0.01% of the value of the portfolios. The insurance coverage for all claims is capped at EUR 25 million. No other liquid assets have to be maintained over and above these amounts. As an alternative to the insurance-based solution, the investment company can calculate the additional own funds using a formula (as a rule: 0.01% of the portfolios managed by the AIFM at the end of each financial year) and hold the corresponding amount in own funds;

BaFin (the Federal Financial Supervisory Authority) can require lower or higher levels of own funds, with 0.008% of the portfolios managed as a minimum. According to the ESMA Report, the two ways can be combined, whereby at least 10% must be in the form of own funds and 90% can be covered by insurance.

By contrast to the Investment Act (InvG), the AIFMD requires all own funds to be invested in liquid assets or assets readily convertible to cash and may not include speculative positions.

Management companies managing UCITS as well as AFIs will be required to use the regulation which leads to the higher amount of own funds. In addition, the conservative investment of own funds will have to be taken into account.

Organisational requirements for management companies which manage AIFs: comparison to the UCITS IV requirements

The AIFM Directive prescribes certain organizational arrangements and procedures relating, for example, to due diligence processes on selecting brokers, counterparties and taking investment decisions, placing orders and order allocation, handling of inducements, recording portfolio transactions, documentation requirements or handling conflicts of interests. There are also other requirements, such as the establishment of an independent compliance function or setting up rules on personal transactions by employees. ESMA's approach to the organizational requirements for the management of AIFs is largely consistent with the UCITS IV approach, with no exceptions for certain AIFs being provided.

Additional conditions have to be observed if prime brokers are used. In respect of third party mandates, the AIFM or management company must obtain the approval of the AIF investors if it invests in other AIFs which are managed by the same AIFM or the same management company. A general informal approval is however adequate in this case.

New and more extensive requirements in respect of the internal remuneration policy

The AIFM directive defines a list of requirements containing both organizational and content-related rules. As such, the AIFMD has extended the requirements over and above those required to date. The requirements are, however, in line with those to which banks are already required to adhere. They also include the establishment of a remuneration committee, taking into account the principle of proportionality. Special transitional rules are not foreseen. We anticipate corresponding rules for the management of UCITS to be introduced in UCITS V.

Criteria for delegation

Under the AIFMD any component of the process chain can be delegated, as is the case for UCITS. Explicitly, risk management may also be delegated. However, the qualitative requirements in respect of risk management are equivalent to those pertaining to the outsourcing of fund management. In addition, a specific delegation concept must also be prepared, as is the case to date. This includes selection procedures and risk analysis prior to delegation, the principle of materiality, ongoing monitoring of the delegate and material requirements in respect of the delegation agreement. The fact that ultimate responsibility rests with the AIFM must be laid down contractually and ensured under the monitoring procedures on the delegated activity. Purchasing insignificant services will not be qualified as outsourcing.

Consequently, we do not consider there to be a difference from the rules for management companies in force to date; the monitoring of the delegated activities may possibly have to be reviewed. We do not consider the business model of the master management company to be put into question. In contrast, there is a new requirement to notify the regulatory authority before delegation comes into effect. The directive also stipulates further requirements in respect of sub-delegation.

Transitional provisions of little use for management companies

Most of the transitional provisions relate to closed-end funds. The only transitional provision relevant to the regulated management companies concerns the one year period in which application for authorization as an AIFM can be made, i.e. up to 22 July 2014. To what extent the provisions of the AIFM directive are applicable to all new AIFs launched after 22 July 2013 depends on the transformation of the directive into national law. In the worst case, i.e.

the provisions are immediately applicable; an institutional fund may only be set up if authorization as an AIFM has been granted. This means that transitional provisions in the AIFMD would be of little use. It should also be noted that the advantages of the AIFMD, such as the opportunity to offer a greater range of new products and the improved marketing opportunities (EU passport) can only be utilized after authorization has been granted.

Requirements on risk management, liquidity management and valuation

No major new requirements on risk management and liquidity management for AIFs

The requirements of the AIFMD correspond largely to those for management companies in the Rules of Conduct and the Organisational Requirements in accordance with the Investment Act (InvVerOV) and the Minimum Requirements on Risk Management for Investment Companies (InvMaRisk). The AIFM directive also prescribes the establishment of a permanent risk management function which is functionally and hierarchically separated from the operating units. In addition to this, the AIFM is required to establish a risk management policy describing the internal risk management procedures. These procedures also include a due diligence process prior to taking any investment decisions and the management of risk associated with the portfolio positions. Notification to the regulatory authority of significant changes in the risk management policy or procedures is also required. In addition, the salary and bonus structures of the senior management of the risk management function are subject to monitoring by the remuneration committee of the AIFM.

The AIFMD also provides explicit requirements for the management of liquidity risk. These range from continuous monitoring and controlling of liquidity risks, through to special liquidity stress tests and ensuring consistency between the investment strategy, the liquidity profile and the redemption policy on units of the AIF.

As things stand now, we do not consider that the new requirements exceed those of the InvMaRisk.

Valuation

The management company is required to ensure that an independent and proper valuation of the assets of the AIF is carried out. Assets which cannot be valued may not be purchased for the fund. The internal valuation policies and procedures (which must be prepared) define how the valuation is to comply with national law and the articles of incorporation or the contractual provisions. The policies and procedures must also include the controls to be carried out if individual assets are valued. This also implies ensuring independence if the AIFM itself performs the valuation. If the assets of the AIF are valued using a model, the model must be validated by an independent person and documented accordingly. We are of the opinion that this could also be carried out by the auditor. There are also requirements to update the valuation policies and procedures annually and to ensure they are applied consistently. Consequently, this could mean that management companies may have to review and adjust certain matters.

The delegation of fund accounting and fund valuation is also possible under the AIFMD. The directive prescribes specific professional requirements in respect of an external valuer, which the external valuer must guarantee to the AIFM. The AIFMD speaks of an external valuer when the responsibility for proper valuation lies with the service provider. As such, the use of external price and market data (e.g. Bloomberg) does not constitute the delegation of the valuation.

The European Commission published a proposal on changes in the UCITS IV Directive and the AIFMD in November 2011. It clarifies that external rating cannot be relied upon alone in assessing the credit quality of assets.

Leverage

The AIFM or the management company must define the maximum level of possible leverage for each AIF. Various criteria must be taken into account, such as the type of AIF and its investment strategy, the sources of leverage, the extent to which leverage is collateralized and the asset-liability ratio. Quantitative restrictions are not defined. Disclosures on leverage must be made in the disclosures to investors and in reporting to the regulatory authority.

According to details provided by ESMA, leverage must be calculated using both the gross method, i.e. the sum of all the absolute values with no netting arrangements, and the commitment method. The latter corresponds to the Committment Approach in the Derivatives Regulation (DerivativeV). For certain instruments ESMA defines the same com-

ponents of the calculation as defined in UCITS IV funds. The two methods give rise to differing results as the following example demonstrates.

The following example is based upon a portfolio with total assets of EUR 4,700,000. It consists of EUR 500,000 liquid assets, securities of EUR 4,000,000, and an option (underlying XY) with a market value of EUR 150,000 and a notional amount of EUR 250,000. The portfolio includes also a forward position for hedging against currency risks, having a market value of EUR 50,000 and a notional amount of EUR 200,000. The relevant exposure amounts calculated through the Commitment Method according to the Derivatives Decree are assumed to be EUR 120,000 for the option and EUR 0 for the forward position, considering netting with non derivatives assets according Art. 17a) Derivative Decree.

The calculation of the total leverage effect of the entire portfolio shows the following results:

Sum of notionals	Commitment Method
$= \frac{\text{fund assets + notionals of derivatives}}{\text{fund assets}}$	$= \frac{\text{fund assets + derivative exposure}}{\text{fund assets}}$
$= \frac{500{,}000 + 4{,}000{,}000 + 250{,}000 + 200{,}000}{4{,}700{,}000}$	$= \frac{500{,}000 + 4{,}000{,}000 + 250{,}000 + 0}{4{,}700{,}000}$
= 1.05	**= 0.98**

The following results represent in contrast only the leverage effect of derivatives:

Sum of notionals	Commitment Method
$= \frac{\text{notionals of the derivatives}}{\text{fund assets}}$	$= \frac{\text{derivative exposure}}{\text{fund assets}}$
$= \frac{250{,}000 + 200{,}000}{4{,}700{,}000}$	$= \frac{120{,}000 + 0}{4{,}700{,}000}$
= 0.095	**= 0.03**

To avoid potential misunderstandings in the interpretation, it is recommended to clarify if the leverage effect which is shown in the disclosure to investors is referring to the total leverage of the portfolio or to the leverage effect of derivates only. For both cases, the calculation methods imply different results.

Following notification to the regulatory authority, in addition to the other two methods, an AIFM can also use the advanced method. ESMA has announced that further details will be provided on this during the course of other EU legislative procedures. No other methods are permitted.

New requirements on the investment policies of AIFs

The AIFM directive contains very few qualitative and quantitative requirements in respect of investment policy. The most significant one relates to the investment of AIFs in securitized positions and is aligned to the provisions currently in force for banks. Consequently, an AIF may only invest in securitisation instruments issued after 1 January 2011 if, as a general rule, the originator, sponsor or original lender retains a net economic interest of not less than 5% in the respective position. 'Investment' is to be understood in very wide terms and comprises any kind of possible exposure for the AIF. To comply with the threshold, the management company must verify the threshold under the due diligence procedures carried out before investment is made, in addition to other aspects on a best efforts basis. The management company is also required to have available or have access to all the relevant data on the respective securitization instruments. This includes regular information on the 5% net economic interest mentioned above. If the

net economic interest of the issuer falls below the 5% threshold, the AIF is required to hedge or sell the position, taking the best interests of the investors into account. In the case of special purpose entities investing in other special purpose entities, verification must be made down to the underlying pool or positions.

Although there is a transitional period up to 31 December 2014 with regard to positions of an AIF issued prior to 1 January 2011, overall the requirements go far beyond the current status of UCITS IV, InvMaRisk and InvVerOV and therefore management companies will be required to make changes. In particular, under these conditions it will be necessary to review the return on these kinds of transactions.

It should be mentioned here that this regulation will also apply to undertakings for collective investment in transferable securities (UCITS) authorised under Directive 2009/65/EC as a result of a change made to the Investment Directive by the AIFMD.

Furthermore, a new regulatory framework has been set up with regard to investments of an AIF in non-listed companies (hereafter 'target companies'). However, these rules do not apply to small and medium-sized enterprises and special purpose vehicles with the purpose of purchasing, holding or administrating real estate. Within this context, small and medium-sized companies comprise all non-listed companies not exceeding 250 employees and not exceeding either sales revenue of EUR 50 million or total assets/liabilities of EUR 43 million.

If one or more AIFs of an AIFM or several AIFs of various AIFMs acquire, hold or dispose of more than 10, 20, 30, 50 or 75% of the shares in target companies on the basis of a joint agreement, this initially triggers notification to the national regulatory authority. The deadline for submitting the notification is 10 working days after reaching, exceeding or falling below the respective threshold.

If control over the target company is acquired, additional disclosure requirements, cooperation duties and reporting duties become relevant. Control is deemed on the acquisition of more than 50% of the shares. In this case, in terms of content, the notification to the regulatory authority becomes more extensive, amongst other things.

The AIFMD also contains rules to protect the target companies after the acquisition of control from asset stripping by the new owners within the first 24 months.

Depositaries

Regulatory requirements on appointing a depositary, duties of the depositary and depositary liability

The AIFM directive sets out a catalogue of requirements on the depositaries of AIFs. For example, in general the depositary must be a credit institute or an investment firm having its registered office in the EU. Exceptions to this will be of insignificance for the regulated investment fund sector to date.

The registered office of the depositary is, generally speaking, the home member state of the AIF. Selection of or transfer to depositaries in non-EU countries is only possible under certain limited conditions. ESMA also defines numerous criteria in its final report which the contract with the depositary must fulfil in the future. A model agreement was not provided by ESMA. As things stand now, the new criteria are also applicable to existing contracts.

The regulatory duties for AIF depositaries include four areas: cash flow management and monitoring, safekeeping, oversight functions and due diligence. The safekeeping function relates to all assets and therefore includes other assets which would not necessarily be held at the depositary itself. In this case, the duties of the depositary lie in the verification of ownership by the AIF and maintaining sequential records of those assets in the portfolio. In order for the depositary to carry out its oversight duties, the management company must supply the depositary with all the necessary information, including data access and physical access rights. The other duties of the depositary are largely identical to those of a depositary banks for undertakings for collective investment in transferable securities (UCITS) authorised under Directive 2009/65/EC. They relate primarily to the issue and redemption of fund units, the valuation of units, verifying the legitimacy when carrying out the instructions of the management company, the timely recording of fund transactions and income distribution.

Delegating the duties of the depositary to third parties is only possible under certain conditions. This is evident in the duty of the depositary to carry out a due diligence process on technical and organizational matters prior to delegation. In addition, it must demonstrate an objective reason for the delegation.

In addition to its function as a depositary, the company can also insource activities from AIFM. This includes middle and back office functions as it is already quite common in the regulated field. As such, these activities also include the valuation function. In all these cases, an effective conflict of interest management must be in place, which must also be disclosed to the AIF investor.

The AIFMD defines regulatory rules concerning the liability of the depositary, including that of any sub-depositaries. Exclusion of liability for the sub-depositary is only possible under certain restricted conditions. In addition, the depositary is not liable if the loss is caused by an external event beyond its control, which could not have been avoided despite all reasonable efforts. Under certain circumstances the insolvency of a sub-depositary could constitute one such external event.

The rules on depository liability are expected to be transposed into national law in alignment with UCITS V.

Disclosure to investors, reporting and transparency requirements for AIFs

New set of requirements on disclosure of information to AIF investors prior to investment, on an ongoing basis and contractual terms

The AIFMD requires the AIFM to make information on the AIF available to all investors prior to investment by the investor. The AIFM directive defines the content of the minimum level of information for the AIF investor, does not, however, stipulate any further formal requirements (layout, length etc.).

In addition, the investor must be provided with information periodically on the risk profile of the AIF, the risk management system, managing liquidity, the percentage of assets subject to special arrangements arising from their illiquid nature and on the leverage of the AIF. This information can be disclosed, for example, in the annual reporting to investors. In addition to this, if certain material changes occur, the investor must be informed on a timely basis. A material change is deemed to be information which would influence the investment decision of the investor. We are of the opinion that such information could be published on the homepage of the AIFM.

These requirements means that management companies will have to make considerable changes, notably in respect of investor information to be provided prior to investment and in implementing processes to ensure timely information on an ongoing basis, particularly since up to now, investor information prior to investment has not been required for institutional funds.

Requirements on the annual reporting of the AIF

The annual report constitutes part of the disclosure to investors mentioned above. The AIFM directive prescribes the preparation of an annual report for the AIF no later than six months after the end of the financial year. This should be prepared under the accounting standards of the AIF's home member state. The requirements in respect of the minimum content of the annual report correspond largely to the requirements of the Investment Act (InvG) and the Investment Fund Accounting and Valuation Directive (Investment-Rechnungslegungs- und Bewertungsverordnung (InvRBV)).

Going beyond the current requirements is the obligation to disclose materially relevant current information or information on events during the year in the annual report and to describe their actual and potential impact on investors. Where the information has already been provided, a reference in the annual report to where this information is available is sufficient.

The AIFMD requires AIFM to disclose in the AIF annual reports the total fixed and variable remuneration paid to its staff and any carried interest paid by the AIF. Separate disclosure is required for those employees whose actions have a material impact on the risk profile of the AIF. The AIFM is responsible for identifying these employees; the selection

procedure must be documented in a transparent manner for the regulatory authority. ESMA considers that the criteria correspond largely to those developed by the Commission of European Banking Supervisors CEBS. According to these criteria certain functions (e.g. executive management) are automatically included. There is room for interpretation in respect of other functions (e.g. head of middle office). To what extent staff from service organizations are to be included, e.g. for risk management, is not yet clear.

It is not necessary to allocate the remuneration data down to each AIF managed by the AIFM. However, the management company must provide further references in the annual report in relation to the remuneration data provided, e.g. the number of AIFs managed. All annual reports must be audited, irrespective of the size of the respective fund.

Regulatory reporting
The AIFM must submit regular reports to BaFin (Federal Financial Supervisory Authority) at the following intervals:

Assets under management by the AIFM	Assets under management by individual funds	Frequency of reporting to the regulatory authority
> EUR 1.5bn	Not applicable	Quarterly
≤ EUR 1.5bn	1 fund > EUR 500 million	Quarterly
≤ EUR 1.5bn	No funds > EUR 500 million	Semi-annually
≤ EUR 100 million	Not applicable	Annually

The reports must be submitted no later than the end of the month following the end of the respective reporting period. Funds-of-funds may extend this period by 15 days.

The content of the reporting comprises the key financial data of each AIF. This includes information on liquidity management, risk management and the result of the regular stress tests. ESMA has developed a 1-page reporting template for this purpose. However, the national regulatory authority may request a different format. This would be in particular the case should the respective regulatory authority require a different reporting frequency in certain cases. At the moment, ESMA assumes that a uniform format will be used.

Distribution and cross-border management of AIFs

Obligation to apply for authorization but also significant improvement in cross-border marketing opportunities
The AIFM directive requires each AIF to be authorized for marketing in accordance with a uniform notification. This implies that distribution may commence 20 days after receipt of a complete notification file by the regulatory authority. There are no longer any exceptions to the obligation to be authorized, e.g. in the case of private placements of the AIF. This is also true for solely home member state constellations. This will lead to an increase in administrative work, particularly in the institutional business. Notification to the regulatory authority also extends to material changes in contractual conditions or in information available to investors. Exactly what constitutes 'material' has yet to be defined by ESMA. This is not likely to occur until Q4 2012. As such, there is an overlap with the duty to report changes in matters relevant to authorization. As things stand, we do not expect there will be the requirement to submit duplicate notifications.

At the same time, the opportunities to market AIFs to professional investors (within the meaning of the MiFID) have clearly improved. An AIFM can obtain authorization to market both EU AIFs and non-EU AIFs throughout Europe. The marketing authorization is facilitated by means of a uniform notification procedure, providing for fixed and shorter periods than those to date after which marketing can commence.

AIFMs with registered offices in non-EU countries, e.g. Switzerland, will be able to register both EU AIFs and non-EU AIFs for marketing in Europe probably from 2015 onwards.

Non-EU AIFs can be authorized in only one EU member state without an EU passport probably from 2018 onwards. Since, in this case, the EU member state might provide stricter national regulations, the added value for management companies is not evident at the moment.

In respect of marketing AIFs to private customers, the member states have the option of defining stricter, but non-discriminatory requirements. The implications for the industry are not evident at the moment. However, this could affect, for example, real estate funds and other alternative mutual funds, which are also currently subject to stricter requirements (e.g. prospect and KID obligations). It can be assumed that the requirements for this kind of fund will not be more lenient than those to date.

New potential for setting up funds: the EU Passport

In the future a management company with registered office in the EU will not only be able to set up and manage German AIFs but also other EU AIFs and non-EU AIFs. This can be carried out via a branch in an EU member state or directly cross-border; consequently, it is not necessary for the management company to maintain its own subsidiaries in several EU member states. A notification procedure must be undertaken which is aligned for the most part to the UCITS IV regulations. This offers interesting strategic positioning opportunities in respect of production.

Requirements for non-EU management companies

Non-EU management companies who want to market either EU AIFs or non-EU AIFs in the EU will have to apply for authorization as an AIFM in a member state of reference, probably from 2015, prior to the commencement of marketing. Although the authorization procedure is largely identical to that for management companies with registered office within the EU, the determination of the member state of reference by the non-EU management company is multistage and very complex, which may well prove to be a deterrent. However, after obtaining authorization the non-EU management company can then use the EU passport and can avail itself of the marketing opportunities previously mentioned.

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The AIFM directive presents both challenges and opportunities. Deloitte can support you from your first considerations as to how you are affected right through to the implementation of the AIFMD in your company.

Trading in OTC derivatives post EMIR

A regulatory topic currently preoccupying the financial industry is the planned regulation of the European Council and the European Parliament on OTC derivatives, Central Counterparties and Trade Repositories (the so-called European Markets and Infrastructure Regulation or EMIR).

The main features of EMIR in respect of OTC derivatives are:

- Compulsory use of central counterparties (CCP) to clear standardized OTC derivatives
- Measures to reduce the counterparty risk and operational risks in connection with derivative clearing in respect of derivatives not eligible for CCP clearing
- Rules for central counterparties (authorization, monitoring, equity, conduct of business, risk management, record keeping, interoperability arrangements between CCPs)
- Reporting obligations on OTC derivatives
- Creation of trade repositories which are obliged to grant access to information under fair conditions, with the European Securities and Markets Authority (ESMA) being empowered with the surveillance of the trade repository

The regulation will have a considerable impact on trading in OTC derivatives by market participants, both on the sell side and the buy side. Particularly affected are the existing operative settlement procedures of the market participants involved. This includes the identification of derivatives eligible for CCP clearing and those which will continue to be cleared bilaterally. In addition, processes will have to be set up to ensure there is direct or indirect link (via clearing brokers) with the CCPs; the processes must also fulfil the higher requirements in respect of collateral management to service the margin obligations and in respect of the notification to trade repositories. This implies that a decision must be taken on which derivatives, to what extent, will be used in the future.

EMIR implements, as a Level 1 directive, the political and regulatory course set by the Pittsburgh Declaration of the G20 leaders on 25.09.2009 and by the Financial Stability Boards in October 2010. The first draft of the regulation is dated 15.09.2010. The ECOFIN Council approved the compromise proposal of the Polish Council presidency on the text of the regulation on 04.10.2011. It is currently the subject of further European legislative procedures. The Level 2 proposals of ESMA are expected to be submitted to the EU Commission by 30.06.2012. As things stand, the regulation, including all the implementation requirements, is still expected to enter into force on 01.01.2013.

Deloitte Services

EMIR also presents both challenges and opportunities. Deloitte can support you from your first considerations as to how you are affected right through to the implementation of the EMIR in your company.

Potential tax liability risks related to German withholding tax on cross-border royalties

Under certain circumstances, license payments to software providers domiciled abroad may be subject to withholding tax which is payable by the domestic licensee.

Non-German resident licensors without a domestic effective place of management or permanent establishment are subject to non-resident tax liability with their income from German sources according to sec. 49 Income Tax Act (ITA). The domestic income includes inter alia any royalties paid for the use, or the right to use, the owner's rights and know-how. Such royalties are subject to a withholding tax in Germany at a rate of 15% (until 2008: 20%) at the level of the domestic licensee, sec. 50a ITA.

The WHT rate may be reduced or Germany may have waived its right to tax such royalties under an applicable Double Tax Agreement (DTA). Intercompany royalty payments might be not subject to WHT if the conditions of the EU Interest and Royalties Directive are met.

Basically, the WHT becomes final, i.e. the foreign licensor is not required to file any tax return in Germany. Thus, the foreign licensor is not entitled to claim a reduction for any business expenses incurred with respect to the royalties received.

Notwithstanding the fact that the conditions for a reduced or zero withholding tax under an applicable DTA, the domestic licensee is required to apply withholding tax and pay the withheld tax to the German tax authority unless the foreign licensor presents a tax exemption certificate at the time the royalty payment is made.

A retroactive exemption or retroactive refund of the withholding tax cannot be achieved. An application for refund of the withholding tax can basically be made with the German authorities within four years beginning at the end of the calendar year in which the royalty payment has been made.

Domestic licensees can be held liable by the German tax authority in case the domestic licensee fails to fulfill its obligations to apply withholding tax. However, notwithstanding such secondary tax liability of the domestic licensee the foreign licensor is still taxpayer and may be held jointly and severally liable ("gesamtschuldnerisch") with the domestic licensee.

In order to avoid any liability risks the domestic licensee should analyze whether any payments to foreign resident licensors are subject to German withholding tax according to sec. 50a ITA. Unless the licensor cannot provide an exemption certificate, the German licensee should apply withholding tax as a precaution. This is true particularly in view of the fact that after payments abroad a subsequent application of the withholding tax will in most case no longer be possible.

BMF Circular dated 19 November 2011 – Providing non-assessment certificates to domestic brokers

In a circular dated 19 November 2011, the Federal Ministry of Finance (BMF) has set out its position on legal procedural questions in relation to the provision of non-assessment certificates to domestic brokers by domestic management companies.

In a BMF circular dated 11 December 2009 an electronic procedure was established which was designed to support in particular domestic brokers by making it easier for them not to withhold investment income tax on transactions for domestic investment funds under the system for deducting investment income tax at source in force to date.

- The management company applies for non-assessment certificates for the investment funds it manages (Section 11 para. 2 sentence 4 Investment Tax Act (InvStG)), which are available to the respective custodian bank.
- In addition, the reference numbers with details on the period of validity of the non-assessment certificate are transmitted electronically by the management company to two central databases; this information can then be accesses by domestic brokers. One database is run by WM and the other by OMGEO; post-trade processing of many transactions of domestic brokers takes place via OMGEO.
- The data on the investment fund is transmitted only after the investment fund has been launched.
- Domestic brokers are permitted not to withhold the investment income tax if a reference number of a valid non-assessment certificate for the investment fund which they trade is in the database.

The Federal Ministry of Finance has now authorized this procedure for all withholding tax cases which will be realized up to 1 January 2014 if the following requirements are fulfilled:

- This procedure may only be used in relation to investment companies within the meaning of Section 2 para. 1 Investment Act (InvG) as amended by the UCITS IV Implementation Act (OGAW IV UmsG), with the exception of investment corporations with variable capital within the meaning of Section 2 para. 5 InvG as amended by the OGAW IV UmsG and their funds.
- The management companies are required to notify the respective tax office of the entries and (possible) early deletions to both databases (WM and OMGEO) at the same time.
- In addition, on request the management company must provide the tax office with an extract from the database containing the reference numbers and the validity of the non-assessment certificate.

The brokers must provide, on request, suitable evidence of compliance with the requirements for the non-deduction of investment income withholding tax at the time the tax was not deducted.

This means that management companies can continue with the current procedure to obtain and transmit the reference numbers and non-assessment certificates subject to the requirements mentioned above. The processes implemented should be reviewed to ensure that the requirements of the Federal Ministry of Finance are adhered to, in particular in respect of notification and data transmission to the tax authorities.

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Note

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