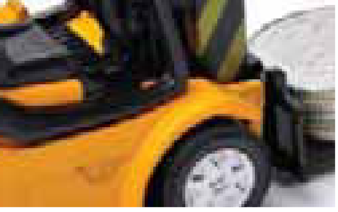
Performance

A quarterly topical digest for asset management professionals, issue 1, December 2009

Deloitte.



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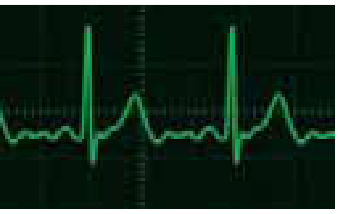

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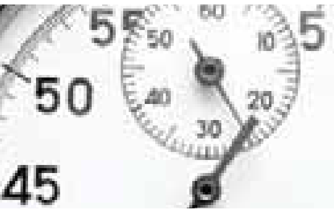

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In this issue

Performing together

It is with great pleasure that I introduce Deloitte's new publication Performance, a quarterly digest, dedicated to Investment Management professionals, which brings you the latest articles, news and market developments from Deloitte's professionals and clients. With 28 partners and more than 500 dedicated staff, our Luxembourg's Investment Management practice is the European center of competence for Deloitte for this industry sector and is at the forefront of market developments and initiatives both internally and for our clients. To help share and deliver some of our recent publications and research, Deloitte has decided to launch a quarterly electronic magazine that gathers together 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. They will also provide our perspective on the different challenges and opportunities being faced by the investment management community. As such, the distribution of Performance will be as large as possible and we hope to provide insightful and interesting information to all actors and players in the asset servicing and investment management value chains.

Performance is designed around 4 sections:

- **Market buzz:** presents the latest hot topics in the market in terms of products, services and actors;
- **Tax perspective:** discusses tax related developments and opportunities in detail;
- **External perspective:** provides a forum for prominent market actors to share their thoughts on key market issues, challenges or developments;
- **Regulatory angle:** provides regulatory development updates and perspectives its evolution.

Our ambition is to make this publication as exciting as possible and we look forward to receiving your contributions and suggestions for future articles.

We hope you will find this publication useful and look forward to engaging in discussions centered on the various topics covered.

My Partners and I would also like to take this opportunity to wish you and your family a very merry Christmas time and all the best for 2010.

Sincerely,

Vincent Gouverneur
Partner - EMEA Investment Management Leader

Hedge funds lite: the move to a UCITS brand?

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One year on from the crisis of September 2008, mutual funds remain the preferred vehicle for collective investment. The funds regulated under the European Directive 85/611 as amended (commonly referred to as the "UCITS" Directive) dominate the industry in Europe and cross-border distribution on an international scale. This directive was last amended in January 2009 (also known as UCITS IV) to rethink the existing rules.

It is in the sphere of the other types of investment funds, however, that the European Union is currently directing its focus by grouping all such 'non-UCITS' funds into the scope of a draft Directive on Alternative Investment Fund Managers ('AIFM Directive') launched in April 2009. In the face of such developments, an awareness of the possibilities and constraints of the UCITS and the future 'non-UCITS' framework will dictate choices in the development or restructuring of products.

UCITS III made financial derivative instruments into 'eligible assets'. Prior to this change, derivatives could only be used by UCITS for the purposes of efficient portfolio management, with the objective of hedging exposure or to access additional exposure to a market whilst avoiding any further risks. This change thus allowed UCITS to develop more complex investment strategies. The introduction of UCITS III enabled the gap to be bridged between traditional long only investment management and alternative management techniques operated by hedge funds. The growing popularity of UCITS III Absolute Return or Long/Short strategies such as the 130/30, which first appeared in the market in 2003, is evidence of the increased proximity between these broad categories of investment management. Despite the existing ban on uncovered short sales for UCITS, these funds have been able to replicate such strategies via the use of financial derivative instruments like Contracts for Difference or Total Return Swaps.

Nevertheless, the extensive use of financial derivative instruments or the application of complex investment strategies by a UCITS requires the establishment of a sound risk management process, as defined in Luxembourg by CSSF Circular 07/308 which addresses risk management techniques for sophisticated UCITS. A key requirement set out in this circular is the efficient management of the risks inherent in such positions by way of the value-at-risk calculation coupled with stress testing and back testing.

The non-UCITS universe encompasses funds such as hedge funds, private equity funds and real estate funds. Hedge funds in Luxembourg are subject to either the Law of 13 February 2007 on specialised investment funds, commonly referred to as the 'SIF Law', or to part 2 of the Law of 20 December 2002 on undertakings for collective investment, as amended. Part 2 funds are also subject to the guidance set out in CSSF Circular 02/80 for funds choosing to follow a so-called 'alternative strategy'.

Following the economic crisis, various EU member states have called for the regulation of 'alternative investment funds' resulting in the AIFM Directive published in

April 2009. This draft legislation will considerably intensify the regulation of alternative investment funds in three ways, by:

1. limiting the use of leverage;
2. imposing greater transparency via regular reporting;
3. setting up a process of independent valuation of the investments held including OTC derivative positions.

The draft AIFM Directive received considerable criticism from several professional bodies, most notably the AIMA for hedge funds and the EVCA for private equity funds. A revised draft of the AIFM Directive is expected to be published soon, the implications of which remain uncertain.

The choice between UCITS and non-UCITS will depend mainly on the following factors:

The client base

By virtue of the European passport, the UCITS product may be distributed easily, even beyond European shores, for example in Asia. As a result of the recent events impacting the world of hedge funds, many investors are favouring the UCITS brand as it gives greater transparency and security through the regulations currently in force. Examples of such regulations including the requirement to publish the Net Asset Value per share ("NAV") at least twice a month as well as via the possibility to sell shares at each NAV calculation date. For non-UCITS, regulations vary, for example for SIFs. On the one hand, they are reserved for well-informed investors with a minimum investment requirement of EUR125,000 and yet, on the other hand, the NAV calculation may even be set to an annual frequency.

The choice of strategy of the investment manager

Even though the investment restrictions of UCITS allow the application of almost 80% of hedge fund strategies, certain investment strategies are excluded for UCITS funds. The rules governing investment concentrations are rather stringent and the permitted extent for leverage is more limited than for a SIF. However, most financial derivative instruments are eligible under UCITS as long as the underlying instrument complies with the eligibility criteria set out by CESR, which have been enacted within Luxembourg regulations through CSSF Circular 08/380. For example, this Circular permits the use of hedge fund indices or commodity indices subject to certain conditions. The use of borrowing for investment purposes is prohibited for UCITS, but the leverage may be replicated through the use of financial derivative instruments or other techniques.

The impact of new legislation in the pipeline

The regulation of UCITS via EU Directive was first introduced in 1985 and supplemented by a number of recommendations issued by CESR with regards to eligible assets, risk management and the content of the prospectus. The changes brought about by the introduction of UCITS IV have been welcomed by all the industry players with only two areas requiring additional discussion and clarification; these being the management company passport and the new Key Information Document which is aimed at replacing the current simplified prospectus. For non-UCITS, the draft AIFM Directive contains too many grey areas as regards investment restrictions or reporting requirements.

In recent weeks, there have been several reports of hedge fund managers such as Man Investments or Cheyne Capital having launched UCITS III funds with the aim of replicating their alternative strategies in a regulated vehicle as a result of the uncertainty surrounding the outcome of the discussions of the AIFM Directive. Another recent trend concerns conventional managers crossing over into the world of hedge fund management by launching UCITS III funds investing in managed accounts with alternative investment managers thereby introducing an alternative type of fund of hedge funds whilst increasing transparency and liquidity.

A webcast on sophisticated funds will be organised shortly by Deloitte to provide in-depth perspective and market development information

Islamic Finance in a nutshell

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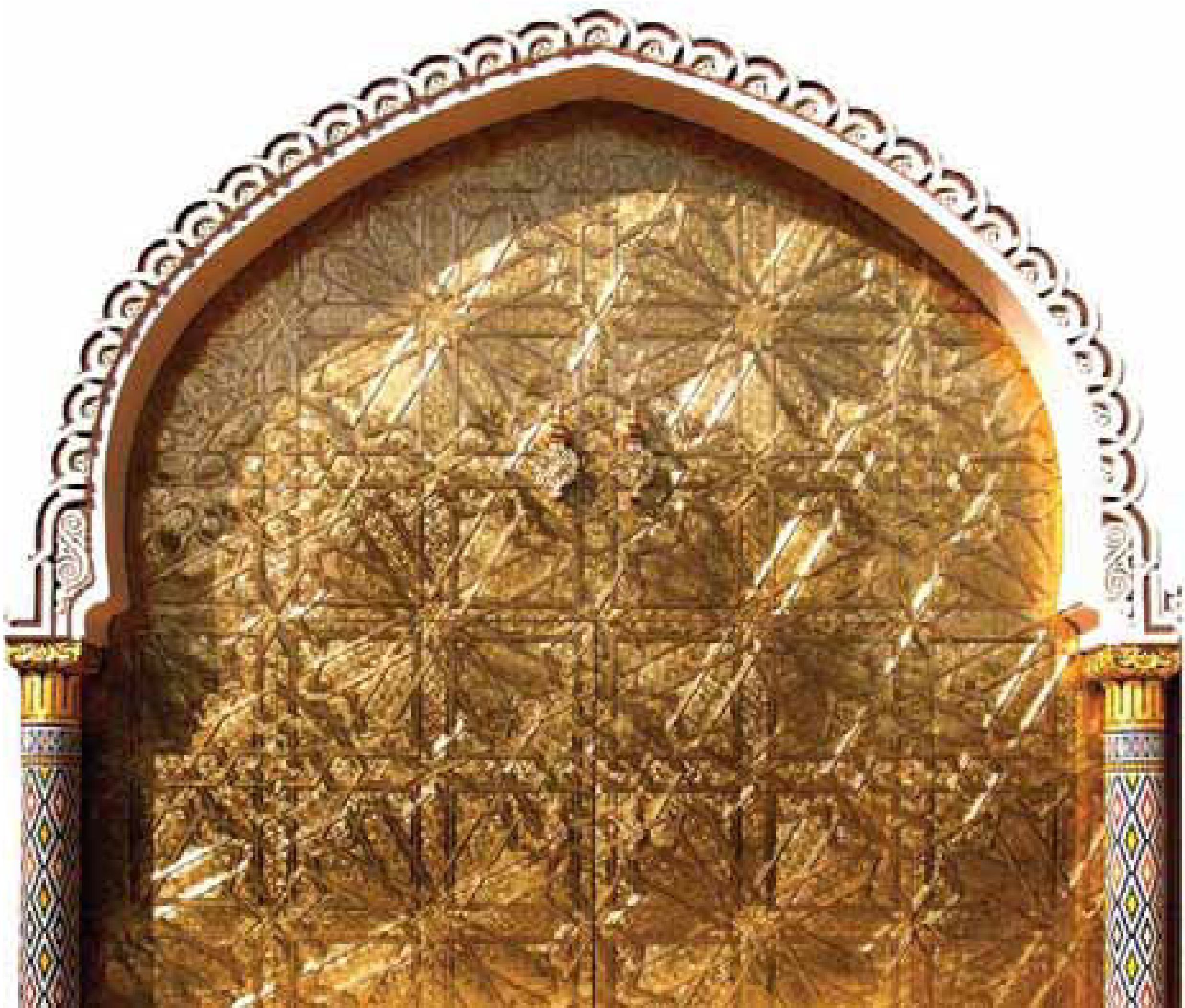
Despite the financial crisis, the fundamentals of the Islamic Finance sector have remained strong. Today, it is estimated that Islamic Finance represents a rather small but growing segment of the global finance industry of between 1% and 2% of worldwide financial assets. However, the appetite for Shariah-compliant investments is increasing.

What is this sector about? What are these products? And is there a role for Luxembourg in this sector?



Introduction

Islamic Finance is a subtle mix of Islamic law - Shariah - and Islamic finance, whose aim is to address the desire of Muslims to invest their funds in line with the principles of their faith. The main differences between Islamic finance and conventional finance relate to the restrictions that investors should observe to reconcile their beliefs with their utility, and the use of Shariah-compliant agreements to achieve this goal.

What actually is Shariah?

Shariah refers to Islamic Law, based on the *Qur'an*, the *Sunnah* (the sayings and actions of the Prophet Mohammed), and *Ijtihad* (the result of individual or collective effort or collective juridical analysis). It is very important to understand that Shariah has neither a static nor a uniform set of interpretations, as different Islamic schools of thought exist; Islamic scholars have differing opinions on a number of subjects, and the interpretations can be subject to change. Though there are initiatives to harmonise certain interpretations, Shariah compliance still largely depends on the position of the Shariah Board. An Islamic bank or institution must appoint such a board consisting of Shariah scholars, who will not only approve the investment products as Shariah-compliant, but also monitor the institution's ongoing Shariah compliance.

What are the main restrictions derived from Shariah?

There are three main restrictions – ***Riba, Gharar*** and ***Haram*** – which need to be considered:

Riba: this concept refers to the general prohibition of interest in return for the lenders' waiting for their money, and the prohibition of excess compensation without consideration. Capital in Islamic finance does have a cost, but this cost is based on profit and loss-sharing arrangements or negotiated prices for sale and lease transactions. As an example, the restriction of *Riba* implies that investments in shares of conventional banks are prohibited, as well as investments in highly-geared companies in general.

Gharar: the prohibition of ambiguity or uncertainty. For example, buying a car where the price is determined in the future is not allowed under *Gharar*. Based on ***Gharar,*** investments in derivatives are also generally prohibited.

Haram: the prohibition on investment in certain products and industries such as gambling, alcohol, pork, pornography and weapons.

Products and investments

To provide a idea of the main products and investments, below are a few common examples:

Islamic bank accounts

Islamic banks cannot offer conventional interest bearing accounts or products. What can be offered are, for example:

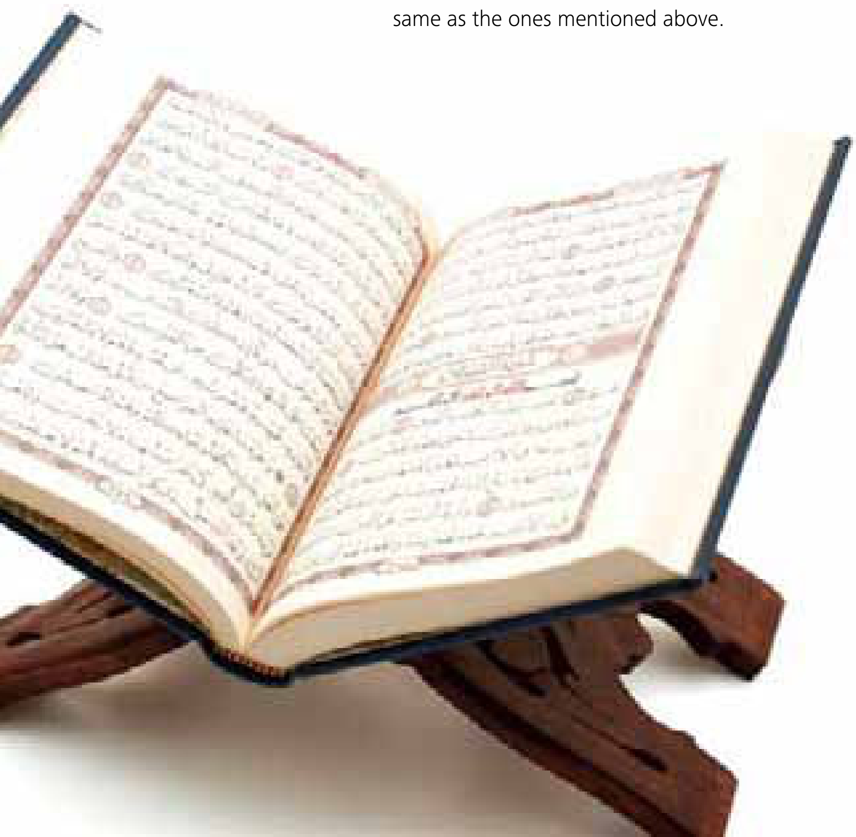
- *Amanah* accounts - similar to current accounts, whereby the bank is safekeeping the money without remuneration for the client. According to certain scholars, the bank may offer a non-contractual gift if the client agrees that the bank may invest the deposit;
- Investment accounts which can either be restricted, i.e. asset allocation is contractually determined, or unrestricted i.e. where the bank may place the money in any Shariah compliant product.
  The underlying agreement between the bank and the client is a *Mudaraba* agreement; a partnership agreement whereby one or more parties provide capital (the *Rab al Mal*; in this case, the client) and another party who does not provide capital but has the role of investment manager (the *Mudarib*; in this case, the bank) in exchange for a share of the profits. Under a *Mudaraba*, the *Rab al Mal* share in the profits and are therefore exposed to the losses; the *Muradib* shares in the profits and is only exposed to losses up to their time and efforts, except in cases of negligence. The funds deposited on investment accounts are not guaranteed as to their capital and there is no fixed return. In practice, it is considered by the regulators in certain Muslim countries that banks are under 'some kind of obligation' to maintain the capital and pay out a steady return (e.g. Qatar), or that failure to do so would be considered bad banking practices (e.g. Bahrain). In other countries, unrestricted investment accounts are not permitted by the regulator (e.g. Saudi Arabia).

Investments in qualifying shares – screening
In order to screen suitable equity investments, a double screening approach is applied:

- firstly an industry screen whereby certain sectors are, *per se*, excluded: for example conventional banking and insurance, alcohol and pork producers, distributors and stores, defense and munitions, gambling (e.g. casinos, lottery, bookmakers), and adult entertainment. Particular attention is paid to companies which may derive a substantial part of their turnover from selling alcohol or pork meat (e.g. hotels, restaurants, airlines, supermarkets);

- secondly a financial screen; the majority of Islamic scholars currently accept that investments in equities which have passed the first test can be made providing the following ratios are respected:
    - total debt/capitalisation less than 33%;
    - interest income/total revenues less than 5%;
    - accounts receivable/total assets less than 45%.

A number of Islamic indexes have already been created, such as the Dow Jones Islamic Market Index and FTSE Global Islamic Index. These are extremely useful reference sources but one should bear in mind that they may apply financial screens which are not necessarily the same as the ones mentioned above.



Islamic financing agreements
Financing can obviously not be provided through conventional interest-bearing products, and is therefore provided based on a range of specific Shariah-compliant agreements including *Murabaha* (a kind of installment credit sale, with mark-up), diminishing *Musharaka* (a declining balance partnership), *Ijara* (a lease), *Istisn'a* (a forward sale of manufactured goods or constructed property) and *Salam* (a forward sale of commodities).

Without entering into technicalities, the below example illustrates these principles:

- *Murabaha* to the purchase order - applied to the banking sector. A client wishing to finance the purchase of say 50 tons of coffee beans will communicate their specification of the goods to the Islamic bank, and make a binding promise to the bank to purchase these goods. The bank will then, in practice through an agent, buy the good at spot from a supplier, against immediate payment to the supplier. The bank then enters into a *Murabaha* agreement with the client against a price at spot plus a margin. The coffee beans can then be delivered directly to the client, who will pay back the bank in installments. The cost of the capital, based on all features of the transaction, is the margin of the bank.

(See schema 1 on the right page)

Islamic investment certificates - Sukuk
Often called Islamic bonds, *Sukuk* are in reality investment certificates. Contrary to bondholders, *Sukuk* holders indeed participate in the ownership of the issuer as *Sukuk* represents an ownership right of the underlying assets. *Sukuk* holders not only participate in the profits of the underlying asset, but are also exposed to the losses. The mechanics for setting up and issuing *Sukuk* are quite similar to securitisation. There are various types of *Sukuk* depending on the underlying contract: *Mudaraba Sukuk*, *Musharaka Sukuk, Salam Sukuk, Ijara Sukuk,* and *Istisn'a Sukuk*, all of which can be quoted except *Salam Sukuk*. Luxembourg was one of the pioneers in the quotation of *Sukuk* and new issues of *Sukuk* are regularly quoted on the Luxembourg stock exchange.

Islamic investment funds
The Shariah investment fund sector is developing rapidly with *Mudaraba* agreements being the most widespread when structuring Shariah compliant funds. Investors provide the capital, without being involved as an active partner in the operating business, and a *mudarib* has the role of fund manager. Profits or losses must be shared between the investors and the *mudarib* according to a predefined formula.

Shariah compliant investment funds can invest in a wide range of sectors such as transferable securities, real estate, private equity, infrastructure, but the investments must obviously be Shariah permissible.

It is not impossible to structure capital-protected investment funds, but these would typically:

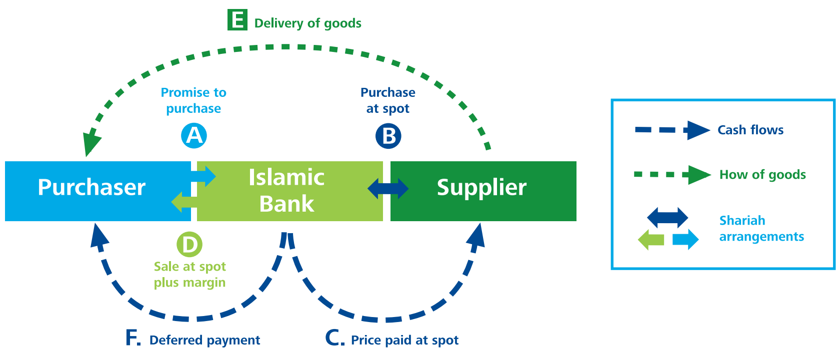
- invest most of the funds into fixed-term *Murabaha* (cost-plus sales) transactions. The invested amount plus realised margin on the *Murabaha* ensures that the fund is, in practice, able to return the capital, but with no formal guarantee;
- invest the remaining funds into *Arbun*, a down-payment on a basket of Shariah compliant shares, which are delivered on a forward date for a pre-determined consideration. *Arbun* is similar to options, but contrary to options, the down payment must be part of the total purchase price-it is not a premium. It is this component that may provide the extra return of the fund if *Arbun* is exercised and underlying shares are sold with a profit. If the purchase is not carried out, the down payment is lost for the investor.

(See schema 2 on the right)

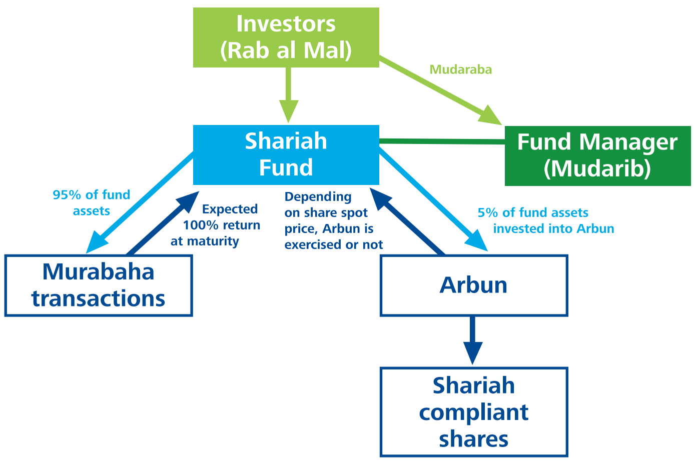
Luxembourg opportunities

It is clear that Luxembourg has a role to play in the Islamic finance sector, in particular, as an important gateway to Europe for inbound investments, and as one of the primary fund locations in the world. In addition to the technical expertise of Luxembourg local service providers and the adaptability of the legal and tax framework to compliment complex Shariah-compliant arrangements, Luxembourg has a number of investment vehicles to host these transactions. SIFs and SICARs are obvious vehicles to accommodate the acquisition and holding of Shariah-compliant assets. However certain unregulated entities such as *Soparfi* do offer tremendous flexibility. Hence, Middle Eastern based Shariah funds may also successfully use Luxembourg as an intermediate holding country for structuring their investments in a tax efficient way. Finally, we should praise the exceptional efforts of the Luxembourg regulator who has entered into an impressive number of double taxation agreements with Middle Eastern countries and those with an important Muslim population including Morocco, Tunisia, Indonesia and Malaysia. Pending treaties are with Bahrain, Kuwait, Lebanon, Pakistan, Qatar, Syria and UAE.

Schema 1
Example of Murabaha to the purchase order



Schema 2
Capital protected investment fund



Life settlement:
at the crossroads between the Investor and the Insured

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There are American concepts that have no exact translation into French, though they arouse the interest of the French-speaking community. This is the case of "life settlements", which are poised to become a highly valued instrument in a period that is hungry for decorrelation.

But what is a 'life settlement'? In a word, it's the transaction by which the subscriber of a life insurance policy sells the ownership of the policy to a third party. The transfer more accurately involves the obligation to pay the premiums and the right to receive the benefits of the policy. Life settlements could be likened to a lifetime transaction applied to life insurance. For the policyholder, it's an alternative to the conventional surrender. And for the investor, a new asset class that presents a certain interest is born. The aim of this article is to provide a more detailed explanation of this instrument.

The origins

In the early 20th century, American case law recognised the possibility of transferring ownership of a life insurance policy in the same way as more conventional financial assets like stocks and bonds. The transaction was made possible, but a fully-fledged market would not emerge until much later.

In the late 1980s, the American health care coverage system left numerous victims of the AIDS epidemic to face health care expenses on their own, compromising their financial situation. Those among them who in the past had taken out life insurance policies surrendered them in order to have an additional financial resource to fall back on. With the redemption values calculated by insurers being based on similar techniques to those used for pricing purposes, the surrender value was pretty low, in light of the reduced life expectancy of the affected population. This huge gap between low surrender value and generous benefits was quickly filled by investors through transactions known as 'viatical settlements'. The moniker bears a certain spiritual connotation, as one definition of 'viatical' is that of the Eucharist being given to a dying person. Clearly, the investor, given the imminent nature of the benefit, was prepared to pay quite a bit more than the insurer for the policy, as a good prospective yield was assured. Thus, 'viatical settlements' presented a market opportunity for investors seeking to maximise yields. The yield prospects were based on the aggravated mortality of AIDS patients, who did not survive the triple combination therapy available at the time. As AIDS patients who had sold their life insurance policies regained normal mortality levels, investors' yields plummeted. Moreover, the sector was rife with fraud, both from false illness claims and from unscrupulous brokers. In short, the window of opportunity slammed shut in the latter half of the 1990s. 'Viatical settlements' still exist, but now cover policyholders with impaired life expectancy suffering from all kinds of diseases, not only from AIDS. All in all, 'viatical settlements' are a special case within the field of 'life settlements', as they concern primary insured parties with a residual life expectancy of under two years.

The second phase

In spite of the compromising situation that resulted from it, this first experience in creating a secondary life insurance market paved the way for the appearance of a second, more successful attempt in the early 2000s, namely the 'life settlements' (also known as 'senior settlements'), which are evolving in a better informed and regulated environment than in the past (see also NAIC Life Settlements Model Act, NCOIL Life Settlements Model Act). A 'life settlement' is a 'viatical settlement' covering a primary insured party with a residual life expectancy of over two years. Here the market is really

expanding. Last year, the aggregate face values of life insurance policies settled in the United States of America is estimated at some $12 billion, with outstanding amounts approaching $30 billion by the end of 2008 (source: Conning Research).

The point of view of the actuary and the valuation

In the case of a single-premium insurance policy, the life settlement could take on the form of a zero-coupon bond with a known face value but unknown maturity. Thus, the actuarial rate is a random variable dependent upon the mortality – or more precisely, longevity – risk. When purchasing or performing the valuation of a policy, the actuary is called on to assess the expected benefit in light of the expected charge, or expected yield. This is done by means of a deterministic or stochastic calculation consisting of projecting future financial flows, weighting them according to their probability of occurrence, and discounting them for the time value of money. Thus, on the purchase date, each purchase price has a corresponding expected yield, and vice versa. The main assumption of this model takes into account the greatest hazard: the mortality of the insured party. This hypothesis takes the form of a mortality table: a vector of annual death probabilities or a matrix in the case of generational tables. In general, standard mortality tables are used as a starting point and then adjusted to account for the information generated by life expectancy reports resulting from medical examinations. Experience tables are sometimes used. These are 'made-to-measure' mortality tables that observe a sufficiently large cohort of individuals with similar characteristics to those of the population being studied. Finally, stochastic modelling makes it possible to factor in the liquidity and the asset-liability management considerations by having recourse to statistical risk measures and quantiles, such as the 'value at risk'.

The investor's point of view

Beyond being an 'alpha' opportunity, the 'life settlement' market provides investors with a powerful tool for independence in probabilistic terms. In effect, we have seen above that the yield economy of this asset class rests only on the mortality risk. As this does not correlate with the financial markets, our asset class presents a notable diversification opportunity. The markets certainly have a potential impact on the counterparty risk presented by the underlying insurers, but this does not suffice to give the lie to the non-correlation hypothesis. However, we note that as the currency of policies is the US dollar, and most of the investors in this market are non-American, this certainly poses an exchange risk. Finally, the longevity risk cannot be underestimated, as humankind is not unaffected by technical and hygienic advances that continue to push back life expectancy limits.

The policyholder's point of view

From an individual point of view, a policyholder looking for cash outcome will unquestionably find interest in a "life settlement" transaction that will generate returns that can be multiple of the cash surrender value his (her) life insurance policy. The need for cash (which can be due to unexpected health-related expenses or regular premiums becoming too costly) is not the only reason that can prompt an a policiholder to sell or surrender an insurance contract. The reason can also have grounds in asset management issues: coverage is no longer wanted, better performing policies or other investment products can be found on the market or life changes must be addressed. Yet, from a wealth management point of view, and considering that the beneficiary is a family member, an insured with a significantly impaired life expectancy would be more interested in keeping the policy to term rather than transferring it to the secondary market.

The insurer's point of view

'Life settlements' provide the insured, among other things, with the possibility of subscribing new policies that better suit to their changing needs, contributing to the vigour of the life insurance market. On the other hand, if we consider that 'life settlements' are the alternative to surrenders or lapses, it is then possible to imagine that life insurers' portfolios will be subject to less surrenders or lapses than expected, which would cause them to incur technical losses that will eventually have to be supported by the market. Nor would it be unreasonable to imagine that life insurers could, over the long term, adjust their surrender estimates, thus reducing the window of opportunity of the 'life settlement' market.

Regulatory aspects

Investment in 'life settlement' portfolios is possible in Luxembourg through regulated and unregulated investment vehicles.

The regulated investment vehicles available in Luxembourg allow a high degree of flexibility in terms of investment policy, particularly in combination with other advantages such as the ability to adopt several legal forms (namely the contractual form of mutual funds (Fonds Communs de Placement) represented by a management company, or open-ended funds (Société d'Investissement à Capital Variable) or any other legal form possible according to Luxembourg law in effect), a swift set-up process and tax flexibility for investors. In Luxembourg, the Law of 13 February 2007 governing specialised investment funds (SIFs) allows the creation of a regulated vehicle that is suited to include this asset class.

Unregulated structures include the range of private Luxembourg commercial companies and securitisation vehicles governed by the Law of 22 March 2004.

We note here that the SIFs, securitisation vehicles and commercial companies in Luxembourg which regularly issue securities to the public must be authorised by the Commission du Surveillance du Secteur Financier (CSSF) and are subject to a simplified supervision.

With its legal framework and tax opportunities, Luxembourg's financial centre is emerging as a domicile of choice for investors focusing on life settlements.

Operational aspects

Past experience has shown the importance of being well-versed in how life insurance works and in the ins and outs of its secondary market in order to limit operational risks.

In broad terms, a 'settlement' transaction in the secondary market could be summarised by the following key stages:

- intention to sell: the holder of a life insurance policy contacts a broker and fills out a sale application or 'settlement' form. The policyholder will provide useful information, particularly the life insurance policy and medical records;
- review of documentation: the broker will analyse the information in order to confirm the characteristics of the life insurance policy and the residual life expectancy, including a review for potential fraud. In addition, this broker can order supplementary health examinations. The medical status will confirm the residual life expectancy of the insured and serve to establish the transfer price of the life insurance policy;
- acceptance of the offer and signing of deeds: when an ultimate buyer has been found for the life insurance policy, a notice of change of ownership is drawn up and notified to the insurance company;
- transfer of funds: upon verification that the change of ownership is made, settlement funds are transferred to the seller.

The service providers

Vehicles established in Luxembourg investing in 'life settlements' have usually recourse to service providers specific to this asset class. Such service providers include:

- specialised intermediaries (brokers, independent financial advisors, life settlement providers), who provide supporting documentation for the life insurance policies that are being subject to a settlement application;
- medical underwriters that verify the documentation relating to the policies being purchased in order to confirm ultimate viability of the insured;
- actuaries who intervene in determining settlement purchase price and in regular appraisals of the 'life settlement' portfolio. Other actuaries might be involved in independent reviews of the calculations provided by the former;
- custodians located in the United States assure the purchase, safekeeping and servicing (paying premiums, keeping track of maturities, etc.) of the 'life settlement' portfolio;
- 'tracking firms' also located in the United States regularly check the occurrence of deaths among the insured parties related to the 'life settlement' portfolio.

Tax aspects

With regard to taxation, the key question for investors is the treatment of the income from their investment. Recent publications by the US Internal Revenue Service (IRS Rulings 2009-13 and 2009-14) issued in May of 2009 consider that henceforth the income from 'life settlements' (i.e. the payment of the death benefit) should be analysed for non-US investors as US-sourced income and not as a capital gain. Any gain from the sale of a life insurance policy is still considered a capital gain.

Treatment as US-sourced income involves the application of a withholding tax at the local rate of 30%. The tax could be reduced by applying any double taxation agreement that may exist between the United States and the investor’s country.

The treatment as income and the withholding rate applied are important tax features when selecting the appropriate investment vehicle.

It is where Luxembourg and the SIF excel as Luxembourg-based mutual funds are considered by most countries to be fiscally transparent.

The fiscal transparency of SIFs, if recognised at the same time in the investor’s country and the country where the investment is made, allows a reduction of or even the elimination of the US withholding tax based on the application of the tax treaty existing between their country of residence and the United States.

Thus, investors from a country which has signed a tax agreement with the United States can opt for a Luxembourg SIF organised as a mutual fund to host their 'life settlements' investments in a structure offering advantageous tax solutions.

New fiscal requirements for offshore funds in the UK: the new offshore fund regime

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The UK government is currently finalising the new rules that will supersede the existing Distributor Status (UKDS) regime for offshore funds via a new Reporting Fund regime, from 1 December 2009. The introduction of this new Reporting Fund regime will be accompanied by a change of definition of offshore funds from a regulatory to a characteristics based definition.

This article outlines the new regime and identifies the main differences between the old and the new rules.

UK fiscal environment

UK tax law differentiates between capital gains (or losses) realised on the disposal of capital investments as well as income such as dividends or interest. Whereas for individuals, income is subject to a personal tax rate (up to 40%, and 50% for income in excess of £150,000 after April 2010), net chargeable gains in excess of the annual exemption threshold (currently £10,100) are currently taxed at a rate of 18% (Capital Gains Tax).

The purpose of the current offshore fund legislation, which was introduced in 1984, is to counter the conversion by a UK resident investor of income into capital by means of investment in an offshore fund which rolls up, rather than distributes, its income.

For this reason, capital gains realised on the disposal of interests in offshore funds (Offshore Income Gains) are qualified as 'income' and as such are subject to personal (income) tax rates.

To avoid this unfavourable fiscal treatment for UK investors, offshore funds can currently apply for certification as a 'Distributing Fund', provided they have distributed at least 85% of their net income, or their UK equivalent profits, whichever is higher ('income to be distributed'), and do not in turn hold interest in a non-distributing offshore fund in excess of 5% of their assets. If these requirements are met, for any accounting period for which a UK investor holds an interest in an offshore fund, the distributions received by that UK investor will qualify as 'income' for UK tax purposes and capital gains realised by disposal of interests in offshore funds will still be subject to Capital Gains Tax.

However, the European marketplace for investment funds has changed significantly since the introduction of the current 'Offshore Fund' regime. For example, in 1984 it was not possible to market funds on a cross-border basis from one European Union country to another; this changed with the introduction of UCITS funds via the UCITS Directive of 1985. Moreover, commercial and EU market developments have also produced a wealth of investment opportunities, including the increasing use of multi-tiered fund structures.

The current offshore fund regulations thereby proved to be a major source of uncertainty for UK investors as well as the European fund industry making use of the UKDS. One reason for this is, for example, the fact that an incorrect determination of 'income to be distributed' could lead to a retrospective denial of the UKDS for the respective accounting period of a fund. As a consequence, a capital gain realised by a UK investor upon disposal of fund units held during this respective accounting period could be re-qualified as 'Offshore Income Gains' with the corresponding adverse fiscal treatment as stated above. This could happen even where the incorrect determination of 'income to be distributed' is discovered years after the relevant accounting period has expired.

In recognition of this, the UK government announced in 2006 its intention to revise the current tax regime for investments in offshore fund arrangements in collaboration with the industry, to simplify the operational aspects of the offshore funds tax regime and to provide more certainty to UK investors as well as foreign funds. The UK government has already implemented a new tax definition of an offshore fund.

With this new Reporting Fund regime, the UK government also intends to:

- abolish the need to physically distribute income by implementing a deemed distributed income approach;
- allow an advance application to be classified as a 'Reporting Fund' to provide a level of certainty to UK investors and foreign fund managers; and
- introduce rules on breaches that distinguish between minor and serious breaches and set out the consequences for funds and their investors.

New definition of offshore funds

Currently, the tax definition of an offshore fund is based on the regulatory definition of collective investment schemes in the Financial Services and Market Act 2000. However, tax and regulatory definitions apply in very different contexts resulting in uncertainty for investors and the fund industry. Furthermore, the UK Government believes that the reliance on the regulatory definition undermined the effectiveness of the tax rules. For this reason, the UK Government proposed the move to a characteristics-based approach to redefine the boundaries of the offshore funds tax regime and to ensure it is more effective at delivering the intended fiscal policy objectives.

Based on this characteristics-based approach a foreign arrangement could qualify as offshore fund if it is regarded as a 'mutual fund'. A foreign arrangement with respect to property of any description will qualify as a 'mutual fund' if:

- its purpose is to enable the participants to participate in the acquisition, holding, management or disposal of the property, or to receive profits or income arising from this activity;
- the participants do not have day to day control of the management of the property; and

- a reasonable investor would expect to be able, under the terms of the arrangements, to realise an investment in the arrangements on the basis calculated entirely, or almost entirely, by reference to the net asset value of the property that is the subject of the arrangements, or an index of any description.

Any arrangement that qualifies as 'mutual fund' will be regarded as 'offshore fund' if it:

- has been constituted as incorporated body resident outside the UK (e.g. Luxembourg société d'investissement à capital variable (SICAV)); or
- has been constituted by any other arrangements that create rights in the nature of co-ownership, where the arrangements take effect under the law of a territory outside the UK.

In this regard it is worth mentioning that HM Revenue & Customs (HMRC) has already stated in its 'Definition of 'offshore fund': Draft guidance for consultation' that a contractual arrangement such as a Luxembourg Fonds Commun du Placement (FCP) should also qualify as a 'mutual fund' under the new definition and could therefore be entitled to benefit from the new offshore fund tax regime.

Finally, any mutual fund under which property is held on trust for the participants by trustees' resident outside the UK will also be regarded as an 'offshore fund.'

With respect to umbrella funds, it is worth mentioning that umbrella arrangements will not themselves be treated as an offshore fund; rather it will be necessary to determine whether or not a specific sub-fund qualifies as an 'offshore fund' under the new rules. The same applies, in principle, in respect of share-classes as each class of interests in a certain arrangement will be treated as a separate arrangement and looked at separately for the purpose of determining whether the arrangements constitute a 'mutual fund' and an 'offshore fund', with the overall structural arrangements being disregarded.

Under the clarifications provided by HMRC, Exchange Traded Funds (ETFs) should also fall within the scope of the new definition of 'offshore funds' as they are usually operated in such a way that the quoted prices are at Net Asset Value (NAV) or very close to NAV.

The new reporting fund status

Application of the new requirements

The new regime will apply for periods of account starting on or after 1 December 2009. For funds with 31 December as their year end, the first period of account under the new regime will be the year ending 31 December 2010. However, transitional provisions will allow funds to continue to use the old rules for the first year after the effective date of the new rules provided that distributor status is received for the period of account which straddles 1st December 2009.

Up-front approval

Currently, in order to secure approval as a 'distributing fund', offshore funds must make an annual application to HMRC within six months of the end of the accounting period. As mentioned above, approval is only given retrospectively and must be applied for and obtained separately for each and every accounting period for which it is required.

Under the new regime, offshore funds can apply to HMRC for approval as a 'reporting fund'. An application for 'Reporting Fund' status must be made within the first three months of the first period of account for which it is required. The application must be accompanied, amongst others, by:

- a valid prospectus of the fund or, in the case where the application is made before the fund has been launched, a proposed prospectus of the fund;
- a statement as to whether or not the fund intends to prepare its accounts in accordance with International Accounting Standards (IAS), and, if it does not, a statement of which Generally Accepted Accounting Principles (GAAP) it intends to use;
- an undertaking to meet the requirements relating to reports to participants in the fund and the provision of information to HMRC.

'Reporting Fund' status should continue throughout the life of the fund unless it no longer wishes to be included within the regime or no longer complies with the requirements.

The new regime will enable a fund to disclose to its investors that it has been approved as a reporting fund, whereas under the current distributing fund rules, a fund can only market to investors on the basis that it will apply for distributor fund status each year.

Reportable income
Currently to obtain 'distributor status', funds are obliged to distribute at least 85% of their net income, or their UK equivalent profits, whichever is the higher, to UK investors. This physical distribution is commercially unattractive in certain circumstances and unhelpful to UK investors who wish to reinvest the distribution. Therefore, a deemed distributed income approach will replace the current obligation to distribute income to UK investors.

The starting point for the calculation of the 'reportable income' of a reporting fund for a period of account will be the 'total recognised income and expenses for the period' provided that the fund prepares its accounts in accordance with IAS, or an equivalent amount if the accounts are prepared in accordance with a GAAP that has been specified within the fund's application for reporting status. The following adjustments will then need to be made to determine the reportable income:

- adjustments for capital items:
  - exclusion of items that are considered as capital under Investment Management Association Statement of Recommended Practice (IMA SORP) due to the distinction between income and capital in UK tax law;
  - exclusion of expenses related to the acquisition and disposal of investments;

The European marketplace for investment funds has changed significantly since the introduction of the current 'offshore fund' regime.

- exclusion of expenses related to the setting up, dissolution or merger of the fund;

- adjustments for special classes of income;
  - adjustment for effective interest income (if the applicable accounting practice does not include the effective interest method for computing interest income);
  - consolidation of wholly owned subsidiaries;
  - inclusion of reported income from any holdings in other reporting offshore funds to the extent it exceeds actual distributions;
  - inclusion of reported income from any holdings in non-reporting offshore funds that are to be treated as if they were reporting offshore funds[1];
- adjustments for equalisation arrangements.

As yet, it seems unclear which foreign GAAPs will be accepted by HMRC as 'generally accepted' within the meaning of the new rules. However, HMRC has stated that a list of accepted GAAPs, albeit not exhaustive, will be provided to avoid any uncertainties and which will be updated as specific GAAPs are accepted by HMRC.

One of the objectives of the new regime is to simplify the operation of the offshore fund tax regime and to reduce compliance risks. Due to the complexity in determining reportable income, it appears doubtful that the new regime will fully meet these objectives. This applies especially to funds whose accounts are prepared in accordance with a GAAP other than IAS.

Reporting requirements

Under the new regime, Reporting Funds will be obliged to report reportable income to investors within six months of the end of each period of account of the fund (provided the period of accounts does not exceed 12 months), accompanied by a declaration as to whether the fund remains a Reporting Fund at the date the fund makes the report available.

UK investors will be taxed on reported income (deemed distributed income). A physical distribution as is currently required under the existing Distributing Fund regime will no longer be necessary, though in practice, depending on the needs of investors, reporting funds may choose to distribute an amount equal to the reportable income to avoid any investor confusion.

For the purpose of the new regime, a fund is required to publish its reportable income to investors. This can be done by various means including on websites, in newspapers, in electronic information systems or even by sending copies of the relevant reports to investors by post.

In addition to providing reports to the investors, Reporting Funds will also need to make submissions to HMRC. This includes, amongst others, providing copies of the financial statements of the fund, a calculation of the reportable income and a copy of the report made available to investors, as well as information on the number of units in the fund in issue. In contrast to what was included in a previous version of the draft regulations; there will be no need to provide HMRC with detailed information about UK investors, such as names and addresses.

Breaches

If a fund is in breach of the requirements of the new regime, the fund can lose its status as a Reporting Fund.

The new regime makes separate provisions for 'minor' and 'serious' breaches.

One objective of the new regime is to simplify the operation of the offshore fund tax regime and to reduce compliance risks.

'Minor' breaches: a difference of more than 10% between the amount reported to investors and the amount which should have been reported will be

[1] *Where a fund holds an interest in a non-Reporting Fund it can either calculate "excess" reportable income if certain conditions are met (particularly with regard to having access to the information to perform the calculation), or account for the fund on a mark-to-market basis.*

Under the new Reporting Fund rules there will be no limits imposed on the level of investments into non-Reporting Funds, but instead those investments must be marked to market.

considered a minor breach. Other minor breaches include failure to make a report available to each investor within the six-month period following the end of the period of account, and failure to provide HMRC with the required information. Furthermore, any report that has been provided to investors in error or if the report is considered incomplete, will also be treated as a 'minor' breach.

The 10% differential outlined is intended to act as a buffer to allow funds a small margin of error in calculating reportable income. It is however not designed as a requirement to report only 90% of the income and HMRC has stated that action will be taken if there is evidence that it is being used as such.

If the difference between the amount reported and the amount that should have been reported is more than 10% but less than 15% of the amount to be reported, the fund can make an adjustment in the current or next period's reportable amount for the error, or provide a supplementary report within three months of the end of the period of account in which the difference occurs. If the difference exceeds 15%, the fund must provide a supplementary report to the investors.

Providing investors with an incorrect or incomplete report will be considered as a minor breach provided that the Reporting Fund provides the corrected report to investors as soon as reasonably possible.

'Minor' breaches do not have further consequences provided they are remedied as soon as possible. However, if there are four minor breaches during a period of ten years, the fourth breach will be regarded as a 'serious' breach and will result in the loss of Reporting Fund status.

'Serious' breaches: any breach which is not considered as 'minor' should be considered as a 'serious breach' and will result in the loss of the Reporting Fund status.

The possibility of correcting minor breaches without losing the fund's status as a Reporting Fund will clearly reduce fiscal risks for investors and reputational risks for funds and their managers. However, the need to provide investors with amended reports could increase the administrative burden on funds which in turn may mean investors may need to re-file their tax returns.

Investment restrictions

As previously mentioned, the current 'distributor status' rules impose a 5% restriction test for investments other offshore fund which do not have 'distributor status'. However, under the new Reporting Fund rules there will be no limits imposed on the level of investments into non-reporting funds, but instead those investments must be marked to market. Whilst this change should provide extra flexibility for fund of fund structures, it could create a risk of breaching the reporting requirements if certain investments are incorrectly classified as non-offshore funds under the new definition and as a result are not marked to market.

Fonds commun de placement (FCPs)

As previously stated, FCPs should qualify as offshore funds under the new definition. The new rules for UK investors will treat FCPs as non-transparent for capital gains purposes, but they will remain transparent for income purposes. The new rules will be effective from 1 December 2009 for UK income tax payers with the date for UK corporate tax payers yet to be determined. FCPs with investments in non-reporting funds may now wish to consider applying for reporting fund status to ensure UK investors treat their eventual disposal as a chargeable gain rather than an offshore income gain.

Conclusion

The implementation of the new offshore fund regime is clearly a welcome step in the right direction. It will facilitate operational procedures for the fund industry which will make use of the new UK reporting fund status rather the current UKDS. Due to the introduction of an up-front approval process and the fact that a fund will qualify as a reporting fund for the rest of its life, provided that the relevant provisions are met, as well as the scope for correcting minor breaches, fund investors and the fund industry will be provided with much more certainty than is currently the case under UKDS. This could make investments in offshore fund arrangements much more attractive for UK resident investors.

Furthermore, the change to a characteristics based definition of offshore fund will increase the range of products that can be distributed into the UK market and could, together with the abolition of the need for physical distributions, provide offshore fund arrangements with much more flexibility than the current regime.

However, it is worth mentioning that the new required 'income to be reported' may not be completely consistent with the current 'income to be distributed' hence there will be a need to analyse and probably revise current procedures to ensure they will meet future requirements. Furthermore, it will be necessary to put adequate procedures in place to provide investors as well as HMRC with the required fiscal information.

UCITS IV management companies: the dark (tax) side of the EU passport

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The upgrade of the UCITS III European Directive to UCITS IV status must be enacted within national law by mid 2011. The new directive deals not only with regulatory issues, products e.g. master-feeder structures, and legal aspects for example concerning fund mergers, but also covers a new dimension for management companies, breaking the link with the country of residence of the investment funds they manage.

The management company's current EU passport allows them to operate on a cross-border basis and the new regime will allow them to manage other EU-domiciled UCITS. This new possibility has raised many concerns in jurisdictions where the majority of investment funds are distributed on a pan-European basis, mainly Ireland and Luxembourg. Many political and regulatory discussions took place prior to the directive being finalised including this new passport for management companies. However, as taxation aspects were not within the scope of the directive, it can be anticipated that taxation issues could create obstacles to the effectiveness of the management passport.

The current market place

Historically in Luxembourg, management companies were exclusively used for the management of non-corporate investment funds (FCPs), and each FCP was required to be managed by its own management company. Such companies were not supposed to perform any commercial activity and enjoyed a specific tax status. Since 1988, Luxembourg-based management companies have been able to manage several FCPs and since 2002 they can also manage corporate funds including SICAVs. Management companies opting to provide these services are treated in the same way as any commercial company.

However, fund promoters are not required to establish management companies to benefit from the European passport for their funds. The UCITS III Directive introduced the concept of self-managed investment companies where functions that would otherwise be

undertaken by the management company are now an integral part of the fund structure. The establishment of self-managed investment companies restricted the scope for offering non-corporate funds which impacts the tax efficiency of the funds' investments in some jurisdictions. This option also required the duplication of resources especially if a promoter wished to propose different legal structures. Statistics show this concept was not embraced by the majority of promoters. In Luxembourg, according to data published by ALFI in March 2009, out of 356 management companies, 188 are UCITS-compliant and manage at least one Luxembourg-domiciled UCITS. The total of self-managed SICAVs, both UCITS and non-UCITS, is only 193. Hence the activity being developed by UCITS III management companies is significant and if the objective of the EU Commission was to restrict the scope of establishing such management companies as empty shells, this is clearly not the case. UCITS management companies based in Luxembourg currently employ approximately 2,300 personnel (5.6%) out of a total of 42,000 employees working in entities supervised by the CSSF (figures as per December 2008 and published by ALFI).

The current activities of UCITS III management companies

UCITS III management companies are regulated entities and thus the nature of their activities and operations is strictly defined by law. The scope of their activities and responsibilities is the same - they manage corporate or contractual funds. According to the UCITS III Directive, their principal activities relate to the management of UCITS funds, i.e. the management of the portfolios of the funds, administration of the funds and marketing of the funds' units. However, subject to prior authorisation from the CSSF, they may also exercise other activities such as investment management or advisory services for private or institutional clients. They may also offer management, safekeeping or administration services to non-UCITS funds. Currently only around 10% of Luxembourg based management companies have extended the scope of their activities to include such ancillary services.

In this context, UCITS III management companies can already operate in other EU countries through the free provision of services or through the setting up of branches. Currently most EU countries do not directly authorise management companies from other EU Member States to manage their locally-domiciled funds. This means that services rendered abroad by Luxembourg-based management companies mainly relate to distribution activities.

Management companies may delegate their services provided that sufficient controls are in place to monitor such delegation and that they do not become empty shells. If a management company sub-delegates, then the delegation contracts should include a provision to revoke the delegation at any time.

New opportunities offered by UCITS IV

In theory, once UCITS IV is adopted, management companies will be allowed to manage UCITS located in other EU member states. These new rules will clearly impact the fund industry in Luxembourg. It can be


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anticipated that some fund promoters will rationalise their fund structures and thus try to save costs by restricting the number of management companies they use. However, the real impact still needs to be determined. A similar consolidation of management companies at local level was anticipated in Luxembourg following the transposition of the UCITS III Directive in 2002; but the costs related to the use of multiple management companies within a group are often balanced out by other operational or risk management-related considerations.

The list of UCITS III management companies authorised by the CSSF clearly shows that many promoters still use several management companies to manage different families of Luxembourg domiciled funds. For example, a single Swiss promoter has registered 13 UCITS III compliant Luxembourg-based management companies and many important promoters still use more than one management company.

Tax residence of non corporate funds

Based on Article 4 of the Law of 20 December 2002 on UCIs as amended (the "2002 Law") which enacted the UCITS III Directive within Luxembourg law, an FCP is recognised as a Luxembourg FCP if the registered office of its management company is located in Luxembourg. This means that currently, if a Luxembourg FCP was managed by a foreign management company, it automatically loses its status as a Luxembourg-domiciled fund. This of course creates concerns not only on the regulatory side, but also on the tax side: for example liability to the taxe d'abonnement, VAT rules and rates on services delivered to the FCP, determination of the rules applicable for EU Savings Directive for classification/ home country rules purposes, recognition of tax transparency and the tax regime for investors are all determined by reference to the country of residence of the FCP.

With the introduction of UCITS IV, Article 4 of the 2002 Law will need to be amended. CESR's current proposal is to consider the home Member State of contractual investment funds such as FCPs as the EU Member State in which its management company has applied for authorisation and in which the depository is based. Unfortunately neither the UCITS IV Directive nor CESR requires the various tax authorities within the EU to treat that EU Member State as the jurisdiction of residence of the relevant fund. The residency concept proposed by CESR could easily be challenged by tax authorities who generally consider the place of effective management and the place of registered office of an entity as critical in determining its tax residency.

Tax residence of corporate funds

The tax residency of SICAVs incorporated as sociétés anonymes is determined by the Luxembourg tax authorities by reference to their statutory seat which will be in Luxembourg. However, in an international context and for the application of tax treaties, tax residency is generally determined based on the place of effective management. With the application of the UCITS IV Directive, day-to-day management and important decisions are typically taken at the level of the management company. The board of directors of the SICAV will probably meet a few times a year to ratify decisions already taken by the management company. In the absence of a branch of the management company in Luxembourg, such a situation may lead to the SICAV losing its Luxembourg tax residency and becoming tax resident in the country of residence of the management company.

Tax residency: potential impact in terms of direct taxes

Luxembourg investment funds benefit from a specific tax regime; they are subject to a tax based on the value of their net assets (taxe d'abonnement) and are exempt from direct taxes. SICAVs are considered tax resident by the Luxembourg tax authorities and can benefit from the protection of 26 double tax treaties, whereas FCPs are considered as tax transparent entities allowing the potential application of double tax treaties between the country of the source of the investments and the country of tax residency of the investors.

All EU member states have set up specific tax regimes for their locally domiciled investment funds with a view to avoiding potential double taxation (i.e. taxation at UCI and at investor level), so as to maintain the competitiveness of UCI investment when compared to direct investments in securities. However, each EU member state has created its own and generally complex tax regime with for example full exemption or full transparency at UCI level or application of income tax/ substitute tax at the level of the UCI with exemptions at investor level. Changing the tax residency of a Luxembourg domiciled fund will of course modify its tax regime. As in many EU member states the specific (exemption) regime is only available to locally-domiciled and -registered investment funds, a change in the tax residency of the fund may lead to the fund's profits being subject to standard corporate income tax. This risk is obvious for SICAVs but also exists for FCPs which could become subject to tax even if they do not benefit from having a legal personality. The income tax paid by the fund will not always be recoverable by investors who are resident in third countries. Whilst SICAVs may lose the benefit of Luxembourg tax treaties, investors in FCPs may not only lose reliance on tax transparency, but they may also be deemed to have disposed of their interest in the FCP (now an opaque vehicle) and may therefore become taxable on any unrealized gains (i.e. deemed liquidation).

For promoters, the cost savings to be realised by using a single management company to manage all their EU domiciled funds may partially be offset by the costs related to the liquidation of their local management companies. Tax neutral mergers between local and foreign management companies could be an easy way of having another EU based management company manage a local UCITS. Nevertheless tax neutrality would require that a branch is maintained in the country where the UCITS is registered. If such a branch was not maintained, the merger profit could be taxable and the transfer of a generally profitable local business to a single EU management company could be a costly exercise.

Consequences in terms of VAT

VAT rules have been harmonised within the EU and it would be easy to imagine that changes in the tax residency of management companies or of UCITS funds should not impact the VAT exemption they enjoy on management fees. However, the implementation of the VAT Directive and the exact scope of the tax exemption may vary between EU member states. The scope of VAT exemption on management fees is relatively broad in Luxembourg; for example should a foreign management company charge management services to a Luxembourg-domiciled SICAV then the potential exemption is determined based on Luxembourg rules and any non-exempt services will be subject to VAT at a rate of 15%. If the Luxembourg-domiciled SICAV is considered tax resident in the same country as the management company, then the VAT exemption should be determined according to the rules of the country of residence of the management company which are often less favorable. As non-exempt services will usually be charged at a rate higher than 15%, the SICAV, which is generally not entitled to recover VAT, will suffer from a higher tax charge than in the current situation, i.e. when benefiting from the services of a Luxembourg-based management company. As FCPs have no legal personality, in Luxembourg no VAT is payable on the services rendered by a Luxembourg based management company to an FCP. If the FCP is served by a foreign management company, it is not certain whether that other EU member state will follow the same approach as, for instance, the FCP may not be viewed as a tax transparent entity in the country of residence of the management company and/or because the tax residency of the FCP is challenged. Again this may lead to the FCP being subject to additional VAT compared to the present situation.

Transfer pricing issues

Over the last few years, tax authorities of some EU member states became more sensitive to transfer pricing issues and started to investigate how profits derived from the management of UCIs was allocated between entities of the same group located in different jurisdictions. This is particularly relevant for management companies which sub-contracted services such as portfolio management, advisory or distribution to other group entities, especially if some of those entities were not located in the EU and benefitted from a low effective tax rate. It is very difficult to determine the respective value added by such services on an individual level. Luxembourg-based management companies with limited substance which sub-contracted all their activities to the exclusion of the control function may find themselves in a difficult situation if the remuneration of other group entities is not justified by transfer pricing documentation (i.e. by comparison with similar management companies

and the fee level offered by third party providers). The risk of having authorities reviewing the transfer pricing policy will be even more significant when it is possible to appoint a management company in a jurisdiction other than the country of domiciliation of the UCITS. It is clear that more tax competition will exist between EU member states with a view to attracting potentially profitable business. The country of domiciliation of the UCITS (using the argument that the management company has a permanent establishment in the country of residence of the fund), the countries of the service providers (through transfer pricing audits) or the country of the management company may all try to attract and tax the biggest portion of the management fees.

Will the use of branches reduce tax risks?

The UCITS IV Directive does not envisage that a management company managing UCITS abroad will need to open a branch in each jurisdiction where it manages the UCITS. However, from a regulatory view point, it is clear that the management company will need to have some kind of presence in the country of registration or domicile of the UCITS, mainly for coordination with the local custodian, administrative agents and the regulator. The opening of such a branch may solve many of the issues discussed in this article. The existence of such a branch could allow local management companies to merge with foreign management companies to try and achieve tax neutrality. But even if the setting up of local branches may significantly reduce potential tax exposures, it may increase transfer pricing tax risks. Promoters should consider preparing documentation justifying the allocation of management fees received from UCITS to the various group entities acting as sub-contractor of the management company. In this context, the determination of an acceptable level of profits attributable to the various local branches of a management company will not be easy to achieve.

Conclusion

The UCITS IV Directive is only in its early stages of implementation but it is clear that the omission of common tax rules may create many practical difficulties, especially for promoters who would like to use a single management company for managing UCITS registered in different EU member states. The use of local branches should potentially reduce such risk. Whilst waiting for the implementation of a directive related to a common consolidated taxable basis in the EU for companies, dealing with transfer pricing audits may become the challenge of the future. Implementing specific and flexible transfer pricing rules may help Luxembourg to remain the most attractive location for management companies. Luxembourg authorities should therefore not only concentrate on the implementation of regulatory aspects of UCITS IV Directive but should also develop a flexible legal and tax environment that will encourage asset managers, despite increased competition between EU member states, to develop their UCITS IV management companies in Luxembourg. The challenge is set!

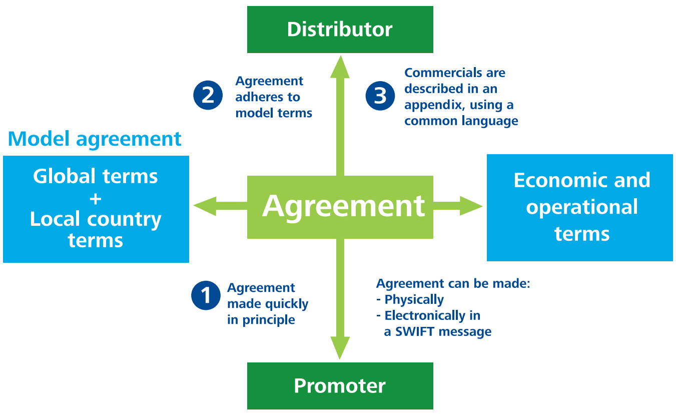
The 10-Minute Fund Sales Agreement

Noel Fessey
Global Head of Fund Services
Schroders

Noel Fessey, Schroders' Global Head of Fund Services, calls for a revolution in how we make fund sales agreements and, more importantly, how we process related commissions and statements.

It started in 2004 with the vision that mutual fund sales agreements need not be as difficult and expensive to make as they evidently were, and still are. Two years later it became a project and in the spring of 2007 work started in earnest. Now, five years from the beginning and two and a half years since we drafted our first design paper, we have completed the foundations of a new way of managing fund sales agreements and their related operations. We have created a new grammar to support most forms of fund sales agreements, from the simplest to the most sophisticated – for domestic and cross-border sales – and we intend to make it available, royalty-free, for the common good of the mutual fund industry. If it is widely adopted, we predict that in the future, companies will prepare their mutual fund sales agreements to a much higher standard in as few as 10 minutes.

What on earth, other than grammar, am I talking about? In brief, we aim to improve how our industry sells mutual funds by promoting the use of a model sales agreement and a new language to describe economic and operational conditions in a separate term sheet.



We aim to encourage our industry to embrace a new generation of commercial term sheet editors and messaging systems. From the preliminary legal stages through to the back-office processes in which positions are reconciled and commissions are paid, we aim to increase efficiency and accuracy for the benefit of everybody involved. Importantly, we aim to deliver these benefits whilst preserving the commercial freedom with which parties sell mutual funds.

If you have always done it that way, it is probably wrong

In our industry, fund sales agreements are very often customised documents. They are written by lawyers using word-processors, then printed onto paper and signed with ink by each party. When companies talk about 'standardisation' as a means to avoid the ex-pense and delay of the customised process, they in-variably mean using their own standard form of an agreement. The first step to contracting most agreements is therefore a 'battle of forms', in which the parties involved decide whose preferred form they will use as the basis for their agreement and how much modification will be necessary to make it acceptable to both sides.

This is not part of anybody's wealth creation process. Nobody could claim that this activity is part of a 'value-chain': it adds no value; not a cent. It rarely does more than ensure that the final agreement is reasonable from the perspective of both parties and that it conforms to some basic and commonplace legal principles. It is slow and expensive. It misuses scarce legal resources. It limits our ability to grow and actively manage distribution networks. It produces agreements that are often incomplete or ambiguous. It misses the opportunity to introduce straight-through processing in the commissions calculation process. It is no way to run a business. I once asked a colleague why nobody had thought to make obvious improvements. "Because the industry has always done it that way; you will never change it," he said.

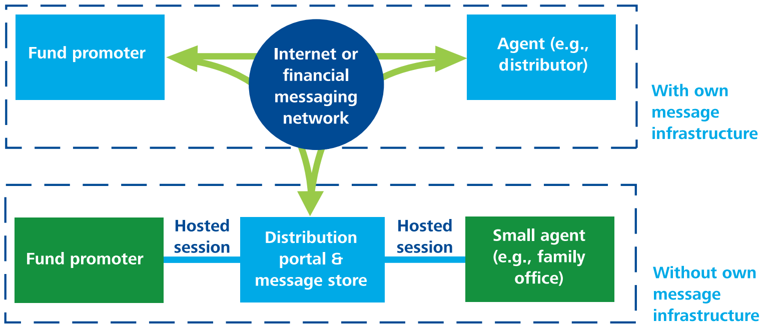
Divide each difficulty into as many parts as is feasible and necessary to resolve it

I understand why he thought that. The diversity of practice in our industry often confounds those who wish to shape it. The number of participants whose support would be required to make any change meaningful is too great. The chasm is too wide; we cannot cross it. It's too difficult. Better not to try.

But I don't agree. Fund sales agreements could and should be made more cheaply and more accurately, using a model agreement and a well-defined economic and operational term sheet. The idea of a model agreement is not innovative: the Swiss Funds Association has sponsored model fund distribution and placement agreements for years and many companies within our industry routinely use model agreements to lend securities, relying on SWIFT messages to manage the detail of each loan. We think it is time to apply the same approach to fund sales generally.

In our design, the model agreement is only a starting point for negotiation. It contains the provisions that you would expect to see in a well-considered fund sales agreement. You can use it as you find it. You can ignore the parts that are not applicable or delete them if you wish. If you have special needs, you can extend it through a side letter. You can choose what law to apply and which courts you will submit to. You can say whether your agreement permits funds to be sold by

Fund sales agreements and related reconciliations, commission payments and statements made electronically, written in standard syntax similar to SWIFT XML messages



public offer, by private placement or both, and whether the distributor may delegate sub-distribution to third parties. If that is not flexible enough, you are free to replace our model with another model (one of the Swiss models, perhaps) or your own legal terms.

And, important though it is, that is about as much as I want to say about the legal process. You see, even though we're proposing the adoption of new model agreements, the revolution that we are calling for is not in the legal domain. If we want improvement then we must stop looking at fund sales agreements as legal documents, and accept that they are really economic and operational documents, which must have legal foundation. We must change our perspective.

Accept for a moment that when you see our model agreement you will find that you're comfortable to use it as you find it. Accept for a moment that a fund sales agreement is in fact a statement of economic and operational terms. What should it contain?

It should be a statement of seven parts:

(1) the products that are the subject of the agreement;
(2) the markets in which they may be sold;
(3) the front-end loads (initial charges) that are payable on subscriptions;
(4) the rebates (trailer fees) that are payable on positions;
(5) the payment mandates through which the payments are made;
(6) the reports through which they are declared; and
(7) the contact persons who will manage the business.
If we can describe these precisely and efficiently then we can have our 10-minute sales agreement and improved back-office processing of commissions, payments and reports.

This is where the grammar comes in. We cannot efficiently share economic and operational data with our business partners – which is what we are talking about – unless we speak a common language. The aim of our technical work for more than two years has been to design such a language. It is now complete, and it is ISO 20022-compatible. It is very much like the language in which Web pages are written, and it is capable of being written and read by any term sheet editor in the same way that you can read a webpage with pretty much any browser you like.

And then we did something that unleashed the power of our imagination: we learned to talk

Our work is about more than just the legal text of fund sales agreements; it is more than an electronic form-filling exercise for economic terms. It does not take much imagination to see that a term sheet editor can be linked to a fund promoter's product database, from which product details and commission policies can be extracted to compile a sales agreement in minutes. It is not difficult to imagine that once the term sheet editor has done its job, the terms can be printed and fixed to a hard copy agreement or, as we predict, exchanged between the parties electronically, so as to make a binding contract.

But we can imagine much more. We can imagine thousands of electronic conversations between promoters and their distributors about the business that they have written together. Conversations about extending the commission network to include new distributors, products and markets; about positions, reconciliations, invoices, statements and payments; about events such as product launches, mergers, closures and fee changes, which affect commissions; about client changes to commission-earning holding accounts, particularly within global custodian networks; about greater transparency in omnibus accounts, where the 'fingerprinting' capability of our design will help commission-earning positions to stand out from the crowd; about changes to bank mandates and other operational payment data.

With this grammar, our industry has a new ability to talk about fund distribution networks. Just like in any language, you can use it to write short and long sen-tences. We prefer short. The interesting question is, what would you say?

To find out more, visit:
www.swiftcommunity.net/dmfsa
www.dmfsa.info

A brief summary of the grammar

Products and markets

Declare the products that are to be sold under the agreement.

Declare the markets in which they may be sold:

- exhaustive references are supported: ISINs for products, and country names for markets;
- general references are supported at promoter level, e.g., 'equities', 'bonds', 'Europe' and 'Asia';
- fund promoters must support general references by a public data dictionary, which allows the reference to be resolved to its members at any point in time.

Front end loads (initial charges)

Used when the central transfer agent collects front-end load on behalf of the distributor.

Optional: if not described, then the central transfer agent will process deals at NAV and the distributor may collect front-end load for itself, at rates up to the prospectus limits.

Multiple front-end load "sets" can be applied with precision:

- by **product**, e.g., 'equities', 'bonds', umbrella, sub-fund, share class, ISIN, etc.;
- by **holding address**, e.g., by business channel (retail, institutional, etc.) and by geography (France, Germany, etc.);
- by **term validity**, e.g., by start date and end date.

Each front-end load 'set' contains the following key parts:

- load-deductible **product list** and optional aggregation policy for cumulative loads;
- load-deductible **holding address list** and optional aggregation policy for cumulative loads;
- duration of period during which load is to be collected;
- instructions for sharing the load between the client, the promoter and the distributor;
- load rate table and instructions for reading it;
- instructions for payment currency, settlement terms, retrospective adjustments and de-minimis value screening.

Three formats to describe front-end load:

- **constant:** same rate for all deals;
- **discrete variable:** the rate reduces as individual deal size increases;
- **cumulative variable:** the rate reduces as individual deal size, aggregated with existing investments, increases;
- aggregation can be applied with precision by products and holding addresses.

Rebates

The commercial core of most agreements.

Multiple rebate sets can be applied with precision in the same manner as front-end loads.

Each rebate 'set' contains the following key parts:

- rebate-earning **product list** and optional aggregation policy;

- rebate-earning **holding address list** and optional aggregation policy;
- instruction to calculate rebates as a function of management fee, distribution fee, etc.;
- instruction for calculation frequency;
- duration of rebate period and day count convention;
- rebate rate table and instructions for reading it
- instructions for payment currency, eligible positions, settlement terms, retrospective adjustments and de-minimis value screening.

Rebate formula

The standard format facilitates communication.

The operands provide complete flexibility.

$$\text{Value of rebates} = \sum_{c=1}^{c=\text{FinalCycle}} \text{holdingvalue}_c \times \text{RebateBasisFactor} \times \text{Rate}_c \times \frac{\text{DayCount}}{\text{YearDays}}$$

See the full technical specification for detailed explanation.

Aggregation

The calculation of front-end loads and rebates on individual ISINs at rates that reflect a larger business relationship.

It requires two dimensions:

Product aggregation:

Taking the rate-earning ISIN as a key, aggregate products that are:

- the same ISIN, etc. or
- members of the same sub-fund, etc. or
- members of the same umbrella fund, etc. or
- members of a special list of products (e.g., 'equities', 'bonds', product A, B, C, etc.).

Holding aggregation:

Taking the rate-earning ISIN as a key, aggregate holdings that are:

- in the same holding account, etc. or
- in holding accounts that share the same transfer agency code (e.g., agent code, plan code), etc. or
- in holding accounts that are members of a special list of holding addresses.

Holdings

Two factors: where is each holding and how to measure it?

Where is it?

- depository indicator (TA, Clearstream, Euroclear, FundSettle) plus account number;
- is it shared, and if so, how often is the break-down analysed?;
- transfer agency indicator design supports proprietary hierarchies, multiple transfer agents within the same agreement.

How to measure it?

- daily;
- monthly;
- quarterly;
- half yearly;
- yearly;
- month end mean;
- quarter end mean;
- half year end mean;
- year end mean.

Commission rate tables

Reference currency:

- required when aggregating multi-currency holdings to look up the rate.

Table type:

- one or many rows (tiers) in a table, each with a threshold and a rate;
- **flat band:** aggregated holding values are used to interrogate a multi-row table to determine a single rate to apply to the entire value of the transaction;
- **sliding scale:** aggregated holding values are used to interro-gate a multi-row table to determine a series of rates to apply to tranches of the transaction (a volume weighted average rate);
- there are many variations and names for these models in the industry, but all can be supported by the DMFSA design.

Commercial viability screening

De-minimis earnings:

- applicable to rebates only;
- if the value of rebates does not cross the threshold, they are considered not to exist;
- optional: used to filter out commercially unviable *agreements.*

De-minimis payment:

- applicable to rebates and front-end loads;
- if the value of rebates does not cross the threshold, they are carried forward on account until the next payment cycle;
- optional: used to filter out commercially unviable *payments.*

General commission terms

Payment:

- fund currency or single currency;
- combinations of both are supported within the same agreement.

Settlement:

- optional: the number of business or calendar days within which payments will be made;
- free text field available to describe non-standard settlement cycles.

Retrospective adjustment:

- optional: the time limit beyond which errors will not be corrected;
- business or calendar days or free text field.

Payments

Define multiple payment mandates, arranged by business line or country as you wish.

Bank transfers:

- supports payments to any account world-wide and payments through correspondent banks.

Reinvestment into funds:

- into the funds and accounts on which the revenue was earned… or
- into the funds on which the revenue was earned, but on a single account… or
- into specific accounts and funds.

Cheque:

- mandates and payments can be linked to front-end load and rebate sets.

Contact persons

The people employed in day-to-day operations.

Can include third parties such as commission calculation agents.

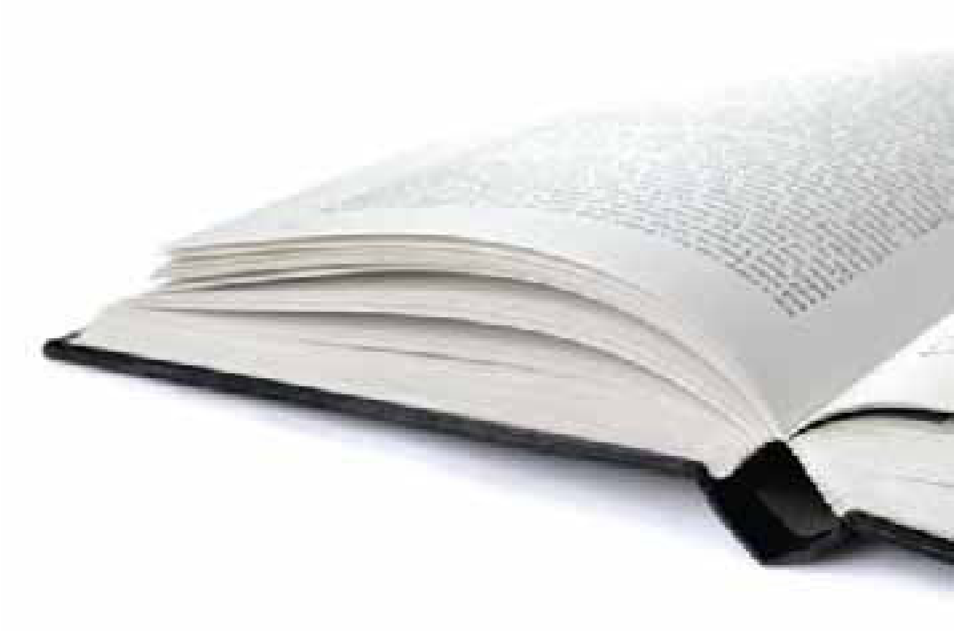
Cross-references and fingerprints

Cross-references link commission terms to payment and reporting mandates:

- every section of a fund sales agreement is assigned a locally unique tag;
- tags can be quoted in payment and reporting mandates, to indicate which commission terms they are related to.

Agreement identifiers serve as fingerprints on fund transactions:

- agreement identifiers are globally unique, and can be used to apply a "fingerprint" to fund transactions;
- fingerprints can be transmitted in public without revealing the identities of the parties to the agreement.
- fingerprints offer improvements in global custodian omnibus reconciliations, transfer management, commissioning and sales attribution.



Non retail offshore funds Where to next?

Vanessa Molloy
Partner
MPartners*

It is undeniable that the offshore landscape has changed forever. This is due to a number of reasons including the change in government in the US, the Madoff scandal, the near collapse of the banking sector, and to top it all off, the proposed Alternative Investment Fund Managers Directive.

It is understandable that professional and institutional investors are more nervous and vigilant when investing than was the case 18 months ago. This has in turn put pressure on fund managers to review their existing offshore structures and consider the commerciality of continuing as before.

One of the issues on the table for consideration by most offshore managers is the domicile of their funds. Do they sit it out offshore and see how things develop in the next year with the possibility of launching future funds onshore. Alternatively moving their existing offshore fund structures onshore either by going all the way and offering investors the maximum protection by opting for a UCITS III compliant fund structure (where the investment strategy is compatible with the UCITS requirements). Alternatively, choosing an onshore non-retail structure subject to lighter regulation than a UCITS fund.

Re-domiciliation of funds, i.e. where the fund continues to exist in a different jurisdiction to that of its original incorporation, is often a neat solution. Usually, the re-domiciliation does not trigger a capital realisation event for investors and allows the manager to keep its track record intact.

There are a number of issues that fund managers and directors need to consider when deciding if a re-domiciliation onshore is appropriate. Among these considerations are (i) does the existing jurisdiction allow for an outwards migration and does the new jurisdiction allow for an inwards migration (in both cases Ireland does not but Luxembourg and Malta do), (ii) is the fund vehicle in a corporate form (limited liability partnerships are not eligible for migration); (iii) shareholder consent issues and the increased regulatory costs of running the fund onshore, (iv) the need to appoint local services providers, and what to do when existing investors do not meet the minimum investment requirement that

*An independent Luxembourg law firm forming part of the Maitland independent network of law firms

may be higher in the new jurisdiction than the typical USD 100,000 required in the Cayman Islands and the British Virgin Islands or other onshore investor eligibility requirements.

A decision on whether to move onshore will primarily depend on whether the fund manager or the promoter thinks that the onshore profile will help to retain and attract additional capital and whether the proposed changes to the regulatory environment will make it unsustainable to remain offshore. Ultimately, many professional investors are familiar with offshore fund jurisdictions and take the jurisdiction of the fund into account together with a number of other facts (e.g. the performance of the manager etc) when deciding to make an investment.

The onshore hedge fund jurisdictions most favoured and known in the market are Luxembourg, Ireland and Malta. Of these three jurisdictions, Luxembourg and Malta allow for inwards re-domiciliation.

The aim of the table below is to set-out the salient features of the most common Luxembourg and Maltese non-retail fund structures thereby providing fund managers with a starting point in considering which of the two jurisdictions may be more suitable.

A comparative table can only go so far in comparing the jurisdictions and does not always illustrate advantages which may be difficult to quantify. Such as Luxembourg's long and established fund industry track record and reputation, its pragmatic and experienced regulator. It is therefore likely that many Maltese funds will appoint Luxembourg administrators and other Luxembourg services providers due to the expertise that Luxembourg can offer over Malta.

Comparative table – non retail fund products[1]
Malta vs Luxembourg

	Maltese Professional Investor Fund (PIF)[2] - Marketed to Qualifying Investors	Luxembourg Specialised Investor Fund (SIF)
Regulatory Authority	Malta Financial Services Authority (MFSA)[3]	Commission de Surveillance du Secteur Financier (CSSF)
Type of Collective Investment Scheme Structures	• Open-ended (SICAV); • Closed-ended (INVCO); • Mutual Fund; • Investment Partnership; • Unit Trust.	• private/public limited liability company/ partnership limited by shares/co-operative company organised as a public limited liability company (variable/fixed capital permitted); • FCP - fonds commun de placement, an unincorporated co-ownership of assets managed by a Luxembourg management company.
Minimum Investment Rule	EUR 75,000 or other currency equivalent[4]	None but see the definition of a "well informed investor"
Capital requirement	Can commence operations with minimum capital of EUR 2,000 but if self managed then own capital required of EUR 125,000	The legal minimum capital for a SIF is EUR 1,250,000 which must be reached within 12 months following approval of the fund

Eligible Investor	An investor will need to certify that he/she meets one or more of the following criteria:
	• Net Asset/Net worth in excess of EUR 750, 000; and/or;
	• Person who has reasonable experience in the acquisition and/or disposal of similar assets as that of the fund.
		Restricted to the following types of investors:
		• Institutional;
		• Professional;
		• "well-informed" – an investor who adheres in writing to the status of well-informed investor and complies with one of the following conditions:
		  • invests at least Euro 125,000; or
		  • is certified a well-informed investor according to the SIF law.

Management Share Class (fund in corporate form)	Generally, is possible	Generally not possible
Segregation of sub-funds	Possible	Possible

[1] *This table is intended to provide a sketch of the legal and regulatory requirements in each of the jurisdictions and is therefore designed as a starting-point for a more detailed and comprehensive discussion of the issues.*

[2] *It is possible for a PIF to be promoted to Experienced Investors (minimum investment: EUR 15,000) or Extraordinary Investors (minimum investment: EUR 750k). The requirements relating to these types of PIFs have not been dealt with in the above table.*

[3] *Director of the Securities Unit of the MFSA is responsible for collective investment schemes.*

[4] *The total amount invested may not fall below this threshold (or equivalent) unless due to NAV movement.*

	Maltese Professional Investor Fund (PIF)[2] - Marketed to Qualifying Investors	Luxembourg Specialised Investor Fund (SIF)
Investment/Borrowing Restrictions	None	Must comply with the principle of risk spreading. Generally no more than 30% of the value of the SIF's assets may be invested in the same type of investments issued by the same issuer or exposed in a similar manner (e.g. via FDIs). Prime Broker (outside of Lux) permitted but conditions prescribed.
Content of the Offering Document	Minimum requirement prescribed	No minimum requirement prescribed but must have sufficient information disclosed to allow investors to make an informed decision particularly in relation to the risks
Manager Requirement	Manager – optional if there is competences within the board of the Fund. If a manager is appointed, not required to be a Maltese manager but needs to meet the fit and proper test requirements if not established in a recognised country[5]	Not necessary to appoint an investment manager nor is a Luxembourg management company required. Therefore it is currently possible to appoint a BVI or Cayman management company[6]
Custodian	Custodian optional. However, the Fund needs to put in place proper safe-custody arrangements.	Yes, a credit institution which has its registered office in Luxembourg or is established in Luxembourg if its registered office is established in another EU member state.
Other Functionaries	Not required to appoint local Maltese functionaries. However functionaries appointed should be established and regulated in a recognised jurisdiction or meet the fit and proper criteria. However, if a PIF operates from outside Malta (i.e. the manager/administrator of the fund is not based in Malta), then a local judicial representative must be appointed[7]	Yes, the following needs to be based in Luxembourg: • central administrative agent; • auditor; • depositary (custodian).
Auditor	Required to appoint an auditor approved by MFSA	Required to appoint an authorised Luxembourg auditor
Reporting	Annual FS lodged within four months of the FY end with the MFSA. IFRS (International Financial Reporting Standard)	Audited annual reports (within six months of FY end) LuxGAAP if listed IFRS
Inwards redomiciliation of foreign funds	Yes, in principle it is possible	Yes, in principle it is possible
Approval process	Prior approval required. Application is filed using the schedule A to the Investment Services Rules for PIF plus accompanying documents. This will include personal questionnaires of the proposed directors and qualifying shareholders (greater than 10%) of external service providers operating from non-recognised territories.	An application for approval of the SIF needs to be submitted to the CSSF within one month of establishment. No promoter is required nor vetted by the CSSF. The CSSF will review all documents relating to the SIF but will focus on the directors of the SIF and the depositary who must be experienced and reputable.
Is a local listing on the stock exchange possible	Yes	Yes
Taxation	• Generally, PIFs are exempt from capital gains or income tax in Malta; • No tax on the NAV of the PIF; • If tax exempt, may not benefit from double tax treaties.	• SIFs are subject to an annual subscription tax (taxe d'abonnement) of 0.01% per annum on their NAV; • SIFs in a corporate form may benefit from certain of Luxembourg's double tax treaties; • No withholding taxes.
Key Advantages	• EU and onshore profile; • Not required to appoint local service providers.	• EU and onshore profile; • No promoter required and manager not subject to review; • May commence activities before formal approval is obtained.

[5] Recognised countries are Malta and members of the EU and the EEA and some other third countries.

[6] The CSSF will not assess the standing and financial situation of the investment manager and no promoter is required. However, a FCP will require a Luxembourg chapter 13 or 14 management company under the Luxembourg law of 2002.

[7] The role of the Judicial Representative is to accept directions from MFSA and to provide the MFSA with any information requested.

The challenge of cross-border distribution and the registration of UCITS funds

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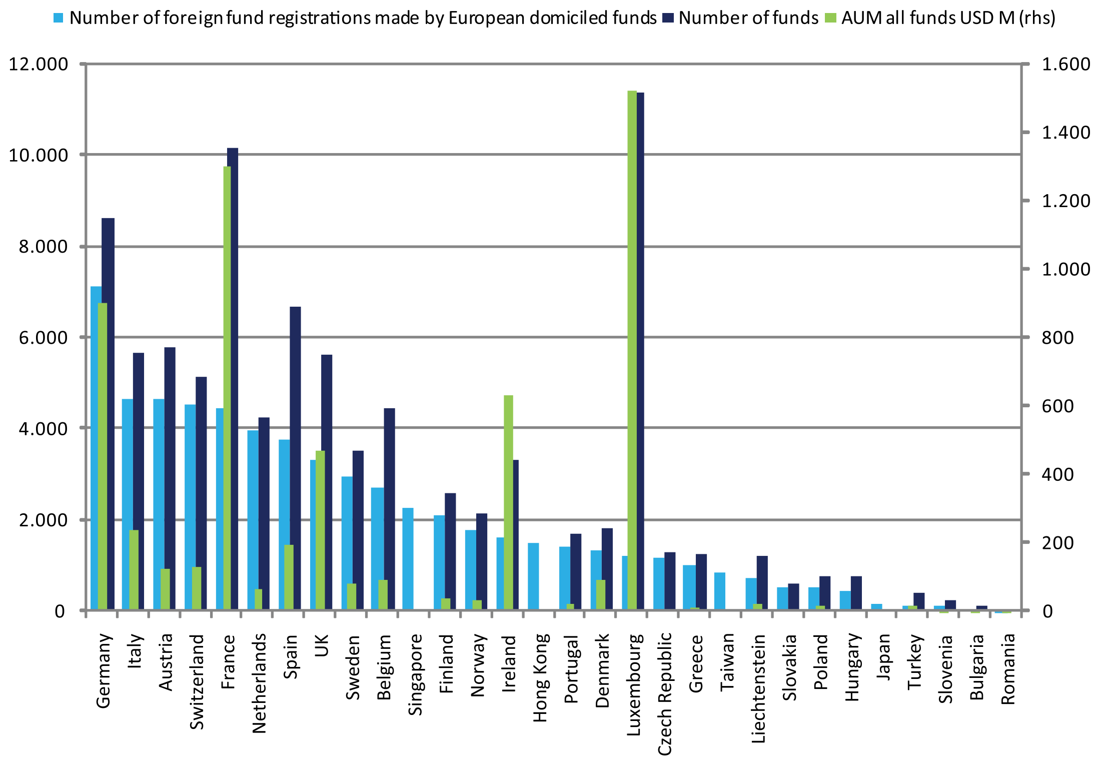
In an effort to gather assets under management, fund promoters have for many years been registering their European investment funds for sale in other countries. In the early days of UCITS investment funds, from the first domestic legislation in 1988 onward, the target markets were close to Luxembourg, such as France and Germany.



Source: Lipper and EFAMA, 2009

Nowadays, the net is being cast further each year as fund promoters seek to service clients in many countries using the same investment fund and thereby gaining economies of scale. The evolution of the UCITS market now leaves us in no doubt that Luxembourg is the domicile of choice for the cross-border distribution business model. However, the management of this business model entails significant cost and complexity.

Recently, the European Commission has acted on pleas from the fund industry to reduce the costs and delays within the industry and has amended the UCITS regime with what it calls an Efficiency Package. The aim of UCITS IV, which is due to be enacted within EU Member State legislation by 1 July 2011, is to further underpin the single market and to reduce time delays and costs.

One aspect of the UCITS IV Efficiency Package is the revised UCITS cross-border notification procedure. Under the existing UCITS regime, which allows for a two-month approval period, on occasions there are delays of up to eight weeks implying a turnaround time of 16 weeks. Deloitte estimates the costs of maintaining these cross-border registrations to be in the region of EUR 50 million on the basis of Lipper's FMI data, with 60,000 foreign fund registrations by Europe’s 26,000-odd UCITS funds stemming from fund promoters active in up to 40 countries.

The current draft of the UCITS IV proposal includes a revised mechanism for how the UCITS passport should be deployed.

The UCITS IV text states that the notification should be conducted in "no later than ten working days". UCITS IV certainly accelerates the notification process for fund promoters but there are several issues which need to be examined, prior to celebrating such an unmitigated success. The new regime is limited to the initial notification so what happens with subsequent submissions? Further, the rules do not yet foresee how the transition from the current UCITS III rules to the new UCITS IV rules will be conducted prior to the 1 July 2011 implementation deadline.

Going forward, the profusion of European investment funds may be reduced via the UCITS IV mergers mechanism while the number of cross-border registrations may further be reduced via the UCITS IV master-feeder arrangements.

UCITS IV regime

The simplification of the cross-border notification procedure is a key element of the UCITS IV Efficiency Package. With UCITS IV the home state regulator, in Luxembourg's case the Commission de Surveillance du Secteur Financier (CSSF), will grant the cross-border passport; in contrast the EU 'host' member state regulator will no longer have powers of delay or veto.

The UCITS IV proposal foresees a simple instruction in the form of a standardised notification letter, accompanied by various supporting documents, to be sent by the UCITS to its home state regulator; this proposal is, largely consistent with the MiFID, Prospectus Directive and UCITS management company notification procedure. It is however important to note that the home state regulator is not responsible for the verification of marketing arrangements with respect to the host member state regulations. Therefore, the UCITS itself must ensure the marketing arrangements are compliant prior to instructing the home state regulator of its wish to distribute in the host member state.

A significant success is the option in the UCITS IV proposal to make all UCITS documents, with the exception of the Key Investor Information document, available in the English language. This may further contribute to reducing the time to market as fewer translations will be mandatory. In practice, many fund promoters targeting retail clients will continue to translate the prospectus and annual report to better service their clients and compete with domestic funds.

In Luxembourg it is possible that more UCITS will use English as the base language for home state purposes to minimise translation requirements when distributing cross border. It is estimated that the choice of base language in Luxembourg is currently split into 40% French, 20% German and 40% English.

Notion of marketing arrangements – due diligence required ex ante to mitigate sanctions ex-post

The UCITS IV proposal, like previous UCITS Directives, foresees that the marketing arrangements in the host country are within the jurisdiction of the host member state. The UCITS IV proposal will further highlight the demarcation between the UCITS field of influence and the host member state marketing arrangements. The home state regulator will ensure the completeness of the UCITS documents as referred to in the list above. The less obvious host country marketing arrangements which consist of country specific annexes, paying agency arrangements, proof of regulatory payments and other similar obligations will not be validated by the home state regulator and will thus remain the responsibility of the UCITS. The notion of marketing arrangements is open ended but includes areas such as:

- the requirement to inform investors of the sub-funds available for sale in the host member state;
- the appointment of local paying agents and/or representatives;
- the availability of fund prices;
- the obligation to have a local distributor;
- the use of nominee structures;
- the requirement of an annex addressed to host member state investors.

It is in this area, which is outside the remit of the UCITS Directive and therefore not coordinated at EU level, that there is a risk that no significant development is made when compared to current practices.

This measure will hopefully reduce the ambiguity currently experienced when registering UCITS cross border; but, given that the host member state is limited to ex post controls, this may increase the instances of regulatory penalties.

Conclusion – some cause for celebration
In conclusion, the UCITS IV proposal delivers everything the fund industry requested, but due to the remit of the Directive, a number of potential obstacles may remain, notably in the complexity of host member state marketing arrangements. This will depend on the host member states' willingness to relax rules, such as the need for local paying agents, or maintain their local practices. To avoid regulatory sanction, UCITS will need to employ sound due diligence for all cross border activities. Furthermore, the coordination between European regulators still needs to be determined including permutations such as how the communication will flow down in the event that a UCITS and its management company are domiciled in different member states and how the transposition of the rules will be handled. Time to market will be improved but overall costs are likely to remain substantially unchanged for retail fund promoters.

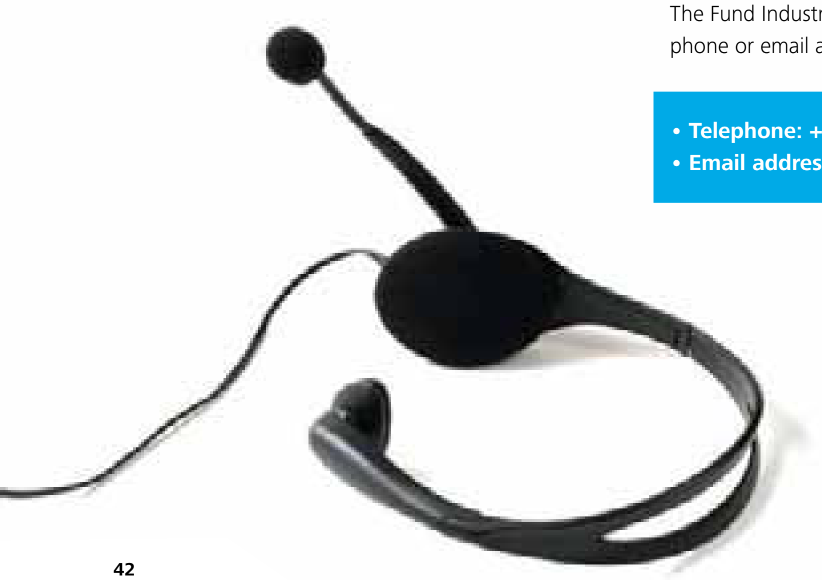
CESR's advice on the implementing measures is the next step towards reaping the benefits of the UCITS IV Efficiency Package.

Deloitte launches a Fund Industry Compliance Service

Deloitte in Luxembourg launches a new Fund Industry Compliance Service within its Deloitte Regulatory Consulting team led by partner Lou Kiesch. By delivering prompt issue specific advice and responses the service helps support the management and compliance officers of fund promoters and service providers when confronting the day-to-day compliance challenges relating to Luxembourg-domiciled funds.

To align with client needs, the service is structured around three distinct themes:

- The Investment Compliance Hotline will provide prompt issue specific advice and guidance on all issues related to the interpretation of the investment restrictions with which Luxembourg-domiciled funds must comply,
- The Marketing Compliance Hotline will provide prompt issue specific advice on the regulatory restrictions and requirements which apply to the marketing of Luxembourg-domiciled funds in the countries in which they are distributed; and,
- The Business Compliance Hotline will provide prompt issue specific advice and guidance on the day-to-day compliance risk which face fund promoters, service providers and executives located in Luxembourg, this includes AML, MiFID, and other areas of compliance risk affecting investment funds and operators.



The three services can be used to provide additional specialist support to firms existing compliance departments and can help with volume resistance in times where such resources are stretched and provide additional independent expert advice where needed.

Michael Flynn, Directeur - Regulatory Consulting, describes the service as follows:

"This service provides a proactive and interactive compliance risk solution for the fund industry. By providing timely and high quality expert opinion it will help industry professionals to address the complex issues which affect their day- to-day operations, not only in the area of investment management, but in other areas such as fund administration, distribution and custody activities. The successful execution of these activities is integral to the good governance of Luxembourg-domiciled funds.

The service complements Deloitte's Fund Registration Solutions offering and will be controlled and supported by the same Luxembourg based team."

Fund Industry Compliance Service team consists of 40 professionals each having their specialist field of competence creating a pool of resources unparalleled within a single investment fund complex. The team can respond to enquiries in several European languages.

The Fund Industry Compliance Service is available by phone or email as of 1 December 2009.

- **Telephone: +352 451 454 357 (451 45 HELP)**
- **Email address: luregulatoryhotline@deloitte.lu**

Hot off the press

Exemption of subscription tax for Microfinance funds

As a step to enhance Luxembourg's leadership and innovative positioning for new products, the Luxembourg Government has included an exemption from subscription tax for Microfinance investment funds in the draft law concerning the State Budget for the year 2010.

This initiative reflects the Government's willingness to support a sector that is rapidly growing in the Grand Duchy since 45% of worldwide assets held in Microfinance investment vehicles are domiciled in Luxembourg.

Other niche activities may benefit from similar support in the future.

The US bill "Foreign Account Tax Compliance Act": significant impact the investment management industry

The US bill "Foreign Account Tax Compliance Act" that should be adopted shortly and may significantly impact the investment management industry. The objective of the act is to tackle tax evasion through enhanced transparency and reporting.

Based on proposals included in President Obama's 2010 Budget, the Foreign Account Tax Compliance Act would force foreign financial institutions, foreign trusts, and foreign corporations to provide information about their U.S. accountholders, grantors, and owners, respectively.

In practice, investment funds investing in US assets may be forced to agree to report information to US authorities as from 2011 if they want to escape a 30% withholding tax on interest, dividends and sale proceeds.

More to come in our next edition.

To be covered in our next edition

- **Redomiciliation of offshore funds**
- **Art as a new asset class**
- **ETFs**
- **Sustainable Energy**
- **Distressed debt**
- **The Regulatory Pinball**
- **AIFM Directive evolution**
- **The EU Savings Directive and the exchange of information**
- **Distribution of non-US funds to the USA**

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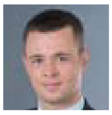

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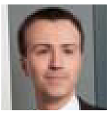

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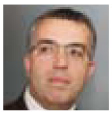

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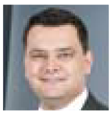

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